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Troublesome Taxation
Is Uganda's Oil Tax Regime Stalling Sector Development?

Cristal Knowledge Series

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1. Introduction

There was so much excitement at the prospect of an imminent economic bonanza in 2006 following Uganda's historic oil discovery that the government organised national thanksgiving prayers to celebrate this feat! Thirteen years later, the dream is unfulfilled because the production of this crude oil is yet to start. Many promising local enterprises that had staked their growth on crude oil development are on the verge of bankruptcy (if not already bankrupt) because of their inability to service the loans they took up to develop their capacity to serve the oil and gas industry effectively.

Since Uganda's oil discoveries, there has been no single issue that has been a subject of such controversy between the government and the International Oil Companies ("IOCs") as tax. The oil tax regime has been revised 7 times since 2008. The tax changes have been piecemeal, sometimes with the government conceding ground to the IOCs and at other times withdrawing concessions it had previously made. Despite the various revisions, a meeting of minds between the government and IOCs on all tax issues has not been achieved for all these years.

Uganda's first oil had initially been projected for 2009 but this did not materialise. Timelines for the final investment decision ("FID") by the IOCs giving their irreversible commitment to develop the necessary infrastructure to produce crude oil (estimated to cost between US$10 billion and US$ 20 billion) have slipped several times. There is significant uncertainty when FID will happen even now. Based on press reports, we understand the current FID delay is largely attributed to the unresolved issues between the government and the IOCs over taxation. The aim of this article is to outline the background to these tax problems and make some suggestions for resolving them.

It is vital to bear in mind that this is not a zero-sum game: if the IOCs do not accept that the proposed oil tax regime gives them an adequate return, they will not proceed to FID and all parties will lose out. In light of the enduring tax disagreements, it is fair to say that that some aspects of Uganda's oil tax regime need to be reconsidered to ensure that the industry takes off, which will be a 'win' for the government and the IOCs with a potentially transformative effect on Uganda's economy.

2. 2010 Income Tax Act amendments

The Income Tax Act ("ITA") was amended in 2010 introducing sweeping changes to the income tax regime for upstream petroleum activities with a retrospective commencement date of 1st July 1997 (when the current ITA came into operation). Though these changes had been intended to adequately cover all petroleum operations, their impact on the commercial viability of Uganda's discoveries was far reaching. The 2010 amendments notably frontloaded corporate income tax ('CIT') liability to the early years of commercial oil production even though the IOCs would not be profitable at that stage which adversely affected the project viability evaluation measures of return on investment ("ROI"), net present value ("NPV"), internal rate of return ("IRR") and payback period.

The key features of the 2010 amendments were:

a) Calculation of income for tax purposes

The cost deduction available for CIT purposes was linked to production sharing under the Production Sharing Agreements ('PSAs') giving rise to serious commercial consequences. Previously, these two calculations namely (for CIT deductions under the ITA and cost oil under the PSA) were separate. As we discuss further, this issue remains a thorny one in Uganda's journey to FID.

The implication of this amendment was that the IOCs would begin paying CIT at the onset of commercial crude oil production though they would not be profitable at this stage because of the tax relief due on their significant development costs. Prior to this amendment, the IOCs would aggregate revenues from sales of their cost and profit oil with deductions for opex and capex in accordance with the ITA rules to determine their CIT liability. This is different from how recoverable costs for purposes of the PSAs are determined. It is usual to cap the costs that IOCs recover each year under PSAs to enable governments receive early oil revenues even before these projects become technically profitable. Royalties in the oil fiscal regime also serve this objective.

With this amendment, costs incurred by IOCs for their operations would not be deductible to the extent they exceeded the cost oil entitlement under the PSA for the relevant year. As cost oil recovery is capped under Uganda's PSAs, this had the effect of limiting CIT relief for current year opex, tax depreciation and brought forward losses. This accelerated the

timing of payment of CIT for the IOCs to the onset of commercial crude oil production even though they would not ordinarily be profitable for CIT purposes under the normal ITA accounting rules. This can significantly increase government tax revenues but has a major impact on project viability. It is possible that some oil fields in Uganda could be rendered uneconomic under this tax regime.

b) Transfers of PSA interests

Given the controversy over the tax treatment of Heritage Oil's sale of PSA interests as amplified below, it is not surprising that the tax treatment of PSA transfers was considered in the 2010 amendments. The original rules, introduced in 2008, adopted a "step-in shoes" approach to oil interest disposals. Under these rules, the transferor/seller of a PSA interest was not taxed on any gain, but the transferee/buyer did not have a step up in basis for future tax depreciation or calculating taxable gains. This meant that the buyer acquired the seller's tax basis in assets and continued to tax depreciate them. This approach has been taken by other jurisdictions, notably Norway.

When it became apparent that Heritage Oil was likely to sell their PSA stake, the ITA was amended in 2009 eliminating the tax exemption on gains from the sale of PSA interests. This was to ensure that government would tax the profits that oil companies would make from the sale or transfer of PSA interests. While it is fair to tax gains from the sale of PSA interests, this amendment did not consider the differing circumstances and reasons for the transfer of PSA interests. Subsequent proposals to make the tax position on PSA interest transfers more closely matched to the commercial reality have not been given much consideration by the government. While IOCs sometimes dispose PSA interests to cash in and make profits (which was clearly the motive of Heritage), they are usually intended to raise funds for exploration and development operations as well mitigating sector risks by diversifying a portfolio of projects. Taxing PSA interest disposals uniformly without regard to the objective of the sale or transfer is a serious flaw in the present tax regime.

The 2010 amendments did not affect the step-in-shoes approach for buyers that had been introduced in 2008. Upon transfer of PSA interests, the seller's excess deductions from prior period's expenditure would pass over to the buyer. Undepreciated cost pools too would pass to the buyer who would continue to depreciate these on the same basis as if there had been no disposal. In the case of assets which are not depreciable for tax, the buyer would inherit the seller's cost base for calculation of any gains or losses on a future disposal. There were further rules provided guiding on the determination of capital gains and losses upon the transfer of PSA interests.

c) Ring fencing

The amendments maintained the ring-fencing arrangement whereby the calculation of income tax was on a standalone basis for each PSA held by a company. This is normal international practice and means that the IOCs may not reduce income tax from a producing PSA with tax deductions from a PSA which is still in the exploration phase or from downstream activities. Ring fencing must be approached with caution: while it can speed up CIT payments, it may also discourage further exploration and development activities in marginal fields thereby inhibiting industry growth and an expanded future tax revenue base.

3. Exit of Heritage Oil

As noted above, in 2010, Heritage Oil, one of the major players in Uganda's oil and gas sector at the time, sold its 50% PSA interest in 2 blocks to Tullow Oil for US$1.45 billion after which it closed operations in Uganda. Following completion of this transaction, the Uganda Revenue Authority ("URA") assessed US$434 million or 30% of the consideration as the tax due. Though Heritage Oil objected to this position, it lost its appeal against this tax assessment both in Uganda's Tax Appeals Tribunal and the London Court of International Arbitration ("LCIA").

In the aftermath of this tax assessment by the URA, revenue bodies in Tanzania, Kenya and Mozambique also started to focus on the tax consequences of the transfer of PSA interests. In 2012, Kenya introduced a punitive withholding tax regime to tax the supposed windfalls that IOCs were making on transfers of PSA interests. It turned out that the governments had misunderstood the motives of these transfers that were prevalent in the region at the time and the result was a significant fall in exploration activity as a result of the punitive tax now attaching to farm-out transactions. Governments perceived PSA transfers as avenues of IOCs to make windfall profits which in fact was not true. Transfers of PSA interests mitigate sector risks as well as raising funds to fund exploration and development activities. Following engagement by the IOCs that explained the rationale for PSA transfers, Kenya revised its regime for taxing PSA interest transfers.

By 2010, East Africa was widely seen as the next oil and gas frontier. Oil majors and independents flocked to Kenya, Tanzania and Mozambique to be part of the exciting hydrocarbon discoveries that were being made at the time. Unfortunately, the dispute between Uganda and Heritage Oil delayed the pace of development of country's oil sector which up to then was the most advanced and promising in East Africa. Instead the dispute became the focus of international attention raising Uganda's risk profile. Most of the new investment in oil and gas in East Africa between 2010 and 2013 went to Tanzania and Mozambique attracting many majors and independents that included ENI, Shell, ExxonMobil, Statoil, Petrobras, Anadarko, BG and Total.

4. VAT amendments for 2011

The Value Added Tax ("VAT") Act too was revised in 2011 ending the investment trader facility that previously enabled investors in capital projects such as oil and gas to register for VAT and claim a refund of the VAT they incurred at the investment stage. As a result of the 2011 VAT amendments, oil companies would incur (but could not recover) 18% VAT on their supplies including imported services. The IOCs criticised these changes as adversely affecting the commercial viability of developing Uganda's oil discoveries. By this amendment, Uganda deviated from international VAT best practice. Uganda and Rwanda stood out in the region as the only countries where VAT incurred on imported services would be incurred as a cost. While it had been suggested that this amendment sought to discourage the importation of services to give an advantage to local suppliers, some services genuinely could not be sourced locally. As the country prepared for oil field development, there was need for expensive specialised services that could not be procured locally. The inability to claim the VAT incurred on the importation of these services increased project costs adversely impacting the viability of capital-intensive ventures.

The 2011 amendment created the strong impression that Uganda's tax policy, either consciously or inadvertently, was focussed on increasing tax revenue collections aggressively in the short term regardless of the long term impact on the investment climate for capital projects.

5. Tullow oil farm down to CNOOC and Total

In 2012, Tullow Oil completed the sale of two thirds of its 3 PSA interests to French oil major Total and the China National Offshore Oil Corporation (CNOOC) for US$2.9 billion with each party obtaining 33.33% interest and operating one of the PSAs. Following completion, URA demanded for US$437 million as the tax due on this sale. Tullow oil disputed this tax assessment arguing that these PSAs provided for a tax exemption on transfers of interests.

While upholding URA's tax assessment, Uganda's tax appeals tribunal threw out Tullow's defence of the claimed tax exemption noting that the previous energy minister did not have authority to grant it. Tullow lodged a case at the LCIA where we believe it had good chance to defeat the URA. Tullow Oil and government however agreed to a settlement before the matter could be heard in the Tribunal with Tullow paying US$250 million as opposed to the US$437 million that the URA had initially assessed.

6. 2015 amendments

The tensions between the government and the IOCs over tax issues lingered on affecting the pace of development of the sector. Following 5 years of unrelenting advocacy by industry stakeholders, the oil tax laws were amended in 2015 to address a majority of the concerns with respect to the 2010 and 2011 tax amendments. These changes were welcomed by the IOCs, International Monetary Fund and industry experts as a step in the right direction

The breakthrough was achieved in October 2014 when President Museveni announced at a Uganda Chamber of Mines and Petroleum event that Uganda's extractive sector tax regime would be revised in 2015. The President spoke against taxing capital earmarked for investment. His position was that that only income deriving from the capital invested should be taxed. Whether the 2015 tax amendments entirely captured this position is another matter.

The key 2015 tax amendments included:

a) The elimination of the cost cap for IOC deductibility of costs for CIT purposes. This meant that oil companies would only pay CIT when profitable;

b) 18% VAT on supplies and services imported by the IOCs was relieved through the deemed VAT paid regime. This is similar to the zero rate VAT system where IOCs would not incur any cash outflow on VAT;

c) Oil exploration costs would be depreciated for tax when incurred;

d) Withholding tax on non-resident services too was reduced from the usual 15% rate to 10%.

e) Oil companies could register for VAT prior to commencement of commercial business operations enabling them to recover input VAT incurred in this period.

These amendments were welcomed as a step in the right direction. Though it has been argued in quantified terms by the URA that tax revenue would be lost as a result of these changes revision, we do not agree. The 2015 amendments would go a long way to enable Uganda's oil project reach commercial threshold short of which it would abort. If the project would not move ahead, URA would not collect the initial taxes it projected as the additional fiscal burden would have resulted in the project's cancellation.

There were some omissions in the 2015 amendment which are a cause of some of the tax disputes today. The step in shoes provision was deleted creating lack of clarity on the tax treatment by the buyer of a PSA interest going forward of the seller's undepreciated cost pools and unitised tax losses. The amendments too did not sufficiently consider all the differing reasons for PSA transfers so as to closely match the tax regime with commercial realities.

7. 2017 and 2018 amendments

In 2017, the cost cap for deductibility of costs for CIT purposes was re-introduced. This would see the IOCs paying CIT at the onset of oil production whether they were profitable or not as described above. While government tax revenues would in theory be accelerated, this was punitive to the oil companies and there are better suited fiscal instruments to maximise early oil government revenues: royalties and a cost recovery cap already achieve this. CIT is ordinarily imposed on profits. Companies in other sectors are allowed a full deduction of their business costs in determining their income tax liability. Denying the oil companies full deduction of their annual business expenses departed materially from the normal principles of income taxation and international benchmarks.

With the 2017 amendment, IOCs would pay income taxes at the onset of oil production. They were also likely to be in a perpetual CIT paying position because of the caps introduced on the deduction of their annual business expenses. In view of the significant capital expenditure incurred early in the life of petroleum projects, oil companies may never be able to utilise all the tax losses that would arise prior to generating cash flows during the exploration and development stages. Project payback would also be delayed as companies would be required to make CIT payments even though they are not technically profitable. Debt repayments to project lenders in the early years of oil production could be delayed because of the cash flow constraints likely imposed by this change. Lenders could revisit their commitment to provide funding for this project or price their capital more expensively. This we understand based on media reports is a key stumbling block to Uganda's oil FID.

On a more positive note, following the signing of the intergovernmental agreement ("IGA") between Uganda and Tanzania in 2017, the ITA was amended in 2018 giving the IGA the status of an international agreement for income tax purposes. This agreement lays out the legal and fiscal framework mutually agreed by the IOCs and the governments of Uganda and Tanzania to regulate the operations of the East African Crude Oil Pipeline beginning at Hoima in Uganda and terminating at Tanga port in Tanzania.

8. Proposals for policy reform

To create a more competitive environment for investment and accelerated growth of Uganda's oil and gas sector, the following tax measures should be considered. If all these issues are addressed, we believe Uganda would have taken a fundamental step to secure investment in oil and gas development and the accompanying benefits in terms of increased government revenues and economic growth.

a) Exemption from tax for some PSA interest transfers

It is important that Uganda's oil tax regime exempts profits earned on the sale of PSA interest that are reinvested in

Uganda's oil sector. Though Uganda presently provides for a capital gains reinvestment ('rollover over') relief, its scope is narrow and does not extend to PSA interest transfers to third parties. Taxing profits raised from PSA transfers re-invested into the country's petroleum sector amounts to taxing that investment which is inconsistent with government's aspiration of attracting foreign direct investment. The main driver of the tax policy on PSA transfers in Uganda and some developing countries is the perception that windfall profits are made for every farm out transaction which is in fact not true. PSA transfers as explained above are aimed at mitigating sector risk as well as raising finances to fund oil and gas activities.

There is also a narrow window for exemption from taxation for intra-group transfers under the ITA which should be expanded to cover all group reorganizations involving a direct or indirect transfer of PSA interests. Group reorganizations undertaken by upstream petroleum companies may be treated as taxable assignment transactions under current law, even though they do not give rise to commercial profits .Financing covenants for development expenditure may require the transfer of the petroleum license interests to a special purpose entity as a measure of securing the lenders' funding. Taxing such transactions aimed at optimizing group operations is inconsistent with the government objective of attracting FDI to the upstream petroleum sector.

Uganda's ITA should also be revised to exempt from taxation consideration on a PSA transfer in the form of work obligations. This arises when the transferee earns a right in the transferor's PSA interest by incurring some of the costs the transferor is under duty to spend under the PSA work commitments. Taxing notional gains raised from the assumption of the work obligations of the transferor under a PSA by the transferee reduces the investment available for core petroleum operations.

b) Capping tax deductibility to cost oil

We recommend that the country reverts to the 2015 ITA amendment position that eliminated the cost cap for deductibility of costs for CIT purposes. This meant that oil companies would only pay CIT when profitable. This is the logical position. The royalty and cost oil recovery cap provisions in the PSAs are sufficient to ensure that the government receives oil revenues even before oil projects become profitable.

c) Transferability of past costs

The 2010 step-in-shoes approach sufficiently addressed the issue of transferability of past costs at sale of PSA interests and this position should be reinstated. Upon transfer of PSA interests, the seller's excess deductions from prior period's expenditure would pass over to the buyer. Undepreciated cost pools too would pass to the buyer who would continue to depreciate these on the same basis as if there had been no disposal.

9. Conclusion

The government and IOCs have different objectives which frequently clash but for the industry to move forward, they must find common ground. It is also important to understand that oil and gas projects only proceed to development if they meet commercial threshold and make financial sense. It is futile maintaining a hardline tax stance oblivious of this reality! This is the reason the importance of sensible fiscal and taxation regimes in this regard cannot be overstated. It is therefore always important for the IOCs and government to have candid and open deliberations on the impact of tax on project economics. Uganda's crude oil final investment decision will be a game changer for the economic prospects of the country. Both the IOCs and government need to move with speed to iron out outstanding issues so that the people of Uganda can start to reap benefits that will accrue from oil monetisation. Geopolitics frequently shifts and the future of the oil industry is under scrutiny with many thinking its significance may diminish in a few coming years.

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