

The Taxation of Upstream Oil and Gas Operations in Uganda **Income Tax at the onset of crude oil production**



1. Introduction

In a major fiscal boost for the Government of Uganda (“GoU”) but also a departure from how the other sectors of the economy are taxed, the International Oil Companies (“IOCs”) will be liable to income tax in their first year of petroleum production regardless of the accrued tax losses they will be carrying forward at the time arising from their past exploration costs and capital expenditure in the ongoing development phase building the requisite infrastructure for crude oil production.

The issue of the IOCs paying income tax at the onset of crude oil production was a sticky one in their negotiations with the GoU preceding the Final Investment Decision (“FID”). The IOCs had argued that frontloaded income tax payments and other fiscal matters were blocking Uganda’s oil project from achieving the target return on investment. Uganda’s oil FID was indeed reached in February 2022 after the IOCs and the government had struck settlement on the contested matters that enabled the project to achieve commercial viability.

To date, since 1997 when the ITA was enacted, Uganda’s upstream petroleum income tax regime has been amended seven (7) times. This article chronicles this journey to the current position of the law where the GoU is on course to collect income tax from the IOCs in their first year of commercial crude oil production.

2. Enactment of the ITA in 1997

Uganda’s Income Tax legislation (“ITA”) was enacted in 1997. This is the same year that the GoU revived oil search activities when it entered into (2) Production Sharing Agreements (“PSAs”) with Jersey domiciled Heritage Oil and Australian incorporated Hardman Resources.

It is therefore not surprising that the ITA in 1997 did not provide for any specific provisions under which the upstream oil and gas sector in Uganda would be taxed because little was known about its potential and prospectivity. It is only the mining sector that had some dedicated provisions therein notably the variable rate of income tax.

3. 2006 Income Tax Amendment

Uganda’s petroleum exploration activities gathered

momentum in 2001 when Energy Africa farmed into some of the oil blocks licensed to Heritage Oil and Hardman Resources. The promising exploration prospects and the rising crude oil prices at the time enticed Irish founded Tullow Oil in 2004 to acquire Energy Africa giving it a 50% stake in the blocks that Energy Africa co-held with Heritage Oil.

The first upstream oil and gas sector related income tax amendment was in 2006 at a time when the IOCs had struck significant crude oil finds that were drifting towards thresholds for a commercial discovery. It is at that point that the country began paying attention to how the oil and gas sector would be taxed.

Section 22 of the ITA that broadly deals with taxpayer deductions was amended in 2006 providing that those expenditures and losses incurred by IOCs during the exploration, development and production of petroleum in a contract area would be allowed as a deduction only against the income of that area that is included in gross income.

A unique feature of petroleum taxation is the operation of individual projects via ringfencing arrangements that this amendment introduced. Ringfencing simply means that an IOC operating one project while developing another cannot for tax purposes consolidate revenues and expenses from the different projects. Ringfencing seeks to protect the tax base, which could otherwise be eroded through unremitting deductions.

4. 2008 Income Tax Amendment

Hardman Resources found crude oil in June 2006 at the Mputa well. Other finds by Tullow Oil and Heritage Oil at the Kingfisher Well followed and Uganda had passed the threshold for commercial discoveries by 2008. In 2007, Tullow Oil acquired Hardman Resources and the future of Uganda’s oil and gas sector was shaping up.

In 2008, the ITA was yet again amended introducing Part IXA exclusively dealing with the taxation of upstream oil and gas operations. This amendment affirmed that if there was any inconsistency in the provisions for the taxation of the oil and gas sector under that Part and other Parts of the ITA, Part IXA and the PSAs would prevail.

It was deducible from this amendment that gross income for the IOCs was the aggregate of cost oil and

profit oil. Cost oil is the crude oil that the IOCs receive reimbursing them for the costs they incurred on petroleum operations as a contractor of the Government while profit oil is the crude oil shared between the IOCs and the Government after the deduction of royalties and cost oil. Most of the operating expenses and the tax depreciation of capital expenditure including prior accrued tax losses would be deductible in arriving at the taxable profits for the IOCs.

Ringfencing was maintained but a key clarification introduced by the amendment was the confirmation that gains that arose on the transfer of PSA interests would not be taxable.

The ITA as was amended in 2008 allowed the IOCs to fully utilize their accrued sunk exploration and development costs via tax depreciation as allowable deductions prior to paying income tax in contrast with the position today where the IOCs will begin paying income tax at the onset of crude oil production irrespective of the unutilized tax losses they will be carrying forward at the time.

5. 2009 Income Tax amendment

There were yet again major amendments to Part IXA of the ITA in 2009. In fact, some would have retrospective application from 1997 when the ITA was enacted.

At the time of the 2009 ITA amendments, it was in public domain that Heritage Oil was considering exiting Uganda's market and the Government was keen to tax the capital gains if any that would arise on the divestiture of Heritage Oil's petroleum interests in Uganda. This transaction would have concluded tax free if the law was not amended in 2009 to revise the 2008 Income tax position where both losses and gains arising on the transfer of petroleum license interests would not be considered for tax purposes.

This amendment imposing Capital Gains Tax ("CGT") on farm down transactions triggered off protracted tax disputes between the IOCs and the GoU initially with Heritage Oil and subsequently with Tullow Oil. The tax treatment of petroleum interest transfers was again at the heart of the tax disputes between the IOCs and the Government in 2019.

The 2009 amendments also tidied up several provisions in Part IXA of the ITA to ensure clarity in the

taxation of upstream oil and gas operations in Uganda.

6. 2010 Income Tax Amendment

The operational environment for the oil and gas industry could not get any worse at the time. It was a period of raging resource nationalism with several resource countries tightening their fiscal environment so as to extract more tax revenues from the IOCs.

Against this backdrop, Uganda's ITA was again amended in 2010. The amendments provided for clearer rules of computing capital gains on transferring. Government was determined to tax farm down transactions. Whether this fiscal policy was appropriate is another matter. What is however certain is that government had misconstrued the purpose of farm down transactions in the oil and gas industry which still is a contentious matter. While some PSA interest transfers are motivated by the desire to cash in, not all are. Farm down transactions in some instances are a means of raising funds for petroleum operations as well as mitigating the risk in the sector that the IOCs bear.

A consequential change of the 2010 amendments was the restriction of costs that the IOCs would deduct meaning that they would pay income tax at the onset of crude oil production. This was achieved by restricting tax deductible costs to the cap of the cost oil that the IOCs were entitled to every year. This tax measure was widely criticized by the IOCs as one that would significantly affect the viability of Uganda's oil and gas project.

7. 2015 Income Tax Amendment

Following sustained concerted lobbying by the IOCs, the government revised Uganda's oil and gas fiscal regime by adopting new Value Added Tax and Income Tax rules in 2015. These measures were lauded as a step in the right direction towards achieving Uganda's FID as key blockers inhibiting the attainment of the project investment hurdles had been removed.

This amendment to the ITA reinstated the pre-2010 position where the IOCs would be able to fully utilize their sunk exploration and production costs before they would commence paying income taxes. It would take the oil companies some years to recoup their sunk costs before they would pay income taxes.

8. 2017 Income Tax Amendment

It was only short-lived relief for the oil and gas industry as the ITA was again amended in 2017 reverting back to the 2010 position where the IOCs would pay income at the onset of oil production regardless of whether they were fully profitable or not. We understand there were disagreements between the Ministry of Energy and Mineral Development and the Ministry of Finance and Economic Development on whether this amendment was really appropriate.

The re-imposition of this restriction irked the IOCs re-echoing their earlier stance that this amendment was adversely affecting the economic viability of Uganda's oil project. While other sectors of economy were allowed a full deduction of their business costs in determining their income tax liability, there was a restriction for the IOCs which departed materially from the normal principles of income taxation and international benchmarks.

9. 2021 Income Tax amendment

Though the 2021 ITA amendment reiterated the 2017 ITA position it clarified that the deductible costs for tax purposes for Contract Areas being developed presently by the IOCs would be capped to the annual IOC cost oil entitlement in accordance with the respective applicable PSAs.

Whereas this amendment did not do away with the possibility of the IOCs paying income tax at the onset of oil production, it is understood that there was

reduced income tax burden on the IOCs in the early project years. This is because both the GoU and IOCs agreed to relax the underlying cost recovery caps in the respective PSAs to arrive at a win-win position that would enable the project to achieve the requisite investment hurdles marks to reach FID through accelerated project payback period and recoupment of sunk project costs.

To make amends for reduced income taxes in the early years of Uganda's oil project as a result of the 2021 amendment, the ITA further introduced a windfall tax enabling the government to earn more tax revenues during periods of high crude oil prices. The 2021 ITA amendment introduced a windfall tax chargeable where the international oil price was 75 dollars per barrel or more on any day of a year of income. Windfall taxes in the extractive sector represent special taxes designed to capture part of the extra profits created when international prices of commodities soar

10. Conclusion

The IOCs and the Government who are the principal stakeholders in the upstream oil and gas sector have conflicting objectives that incidentally must converge for the sector to move ahead. While the government wants a deal that maximizes petroleum revenues and taxes, there is a need for balance so that the investment aspirations of the IOC shareholders are also met. It is a delicate balance that can take time to achieve and the 7 amendments to Uganda's oil income tax regime before eventually the long-awaited FID was reached in February 2022 are testament to this.

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Contacts for this Publication



Denis Yakoyasi Kakembo

dkakembo@crystaladvocates.com
+256 751 834 168

Denis is the Managing Partner at Cristal Advocates where he also leads the energy and tax practice. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates, he had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

He holds a Master of Laws degree in Petroleum Taxation and Finance from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■



Bill Page

bpape@crystaladvocates.com

Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

Bill is a graduate of Oxford University and completed his inspectors' training with the UK Inland Revenue in 1989. ■



John Teira

jteira@crystaladvocates.com
+256 704 493 997

John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

He holds a Bachelor of Laws degree from Makerere University and a Post Graduate Diploma in Legal Practice from the Law Development Centre and various other qualifications. ■



Dickens Asiimwe Katta

dasiimwe@crystaladvocates.com
+256 772 370 021

Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■



Francis Tumwesige Ateenyi

ftumwesige@crystaladvocates.com
+256 702 540 936

Francis leads the litigation and dispute resolution practice at the firm. He is an Advocate of the High Court of Uganda with expertise in oil and gas, infrastructure and dispute resolution. He has been part of teams advising on projects in Uganda, Tanzania, Mozambique and South Africa. He specializes in regulatory compliance, national content, health and safety and dispute resolution.

He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

He holds a Master of Laws degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom and various other qualifications. ■



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Contact us

Cristal Advocates
32 Lumumba Avenue
4th Floor, Padre Pio House
Lumumba Avenue

P.O. Box 1769 Kampala, Uganda
Tel: +256 (414) 671 274
Email; admin@cristaladvocates.com
www.cristaladvocates.com