Cristal Advocates

Uganda's Tax Regime on Oil and Gas Interest Transfers
A Legacy of Disputes

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1. Introduction

When Uganda struck commercial discoveries of crude oil in 2006, it was apparent that the absence of an appropriate fiscal regime for taxing oil and gas license (PSA) interest transfers could become a source of contention, a prediction that came to pass.

Advancing the sector to the next level required the companies behind these discoveries to either fully divest or dilute their license stakes, to facilitate the entry of larger international oil companies (IOCs) with the requisite financial and technical expertise for the development phase. As the IOCs began farming into existing PSAs, governments hastily passed numerous tax amendments in their bid to capture the perceived windfall gains from these transfers triggering monumental fiscal disputes across the region.

Though Uganda's Income Tax Act (ITA) provisions relating to the taxation of PSA interest transfers have been amended severally since 2008, gaps in the regime persist. Without revising the law to consider an elaborate framework that fully accommodates the sector's nuances, disputes, as seen with the long-drawn-out Heritage Oil litigation among others, are likely to remain a recurring challenge, undermining the sector's fiscal predictability, as this commentary expounds.

2. The 2008/9 ITA amendments

Uganda's maiden rules on taxing PSA interest transfers were introduced in the ITA in 2008. Enacted alongside a package of other fiscal measures for upstream oil and gas operations, they established a structured framework for the taxation of upstream petroleum agreement transfers.

From the outset, the ITA adopted a "step-in-shoes" approach for PSA interest disposals. This meant that the transferee (buyer/farmee) did not receive a stepped-up basis for tax depreciation or calculating taxable gains. Instead, the buyer would inherit the transferor's (seller's/farmor's) original tax basis and continue depreciating the assets accordingly. Further, the rules also provided for the non-recognition of gains and losses when determining the chargeable income of an oil company transferring its PSA interests.

When it became evident that Heritage Oil would soon divest its PSA interest stake, the ITA was amended in 2009 to ensure that any gains arising on such transfers would be taxed.

3. The 2010 ITA amendments

The ITA provisions relating to the taxation of PSA interest transfers, among others, were again amended in 2010. Notably, these amendments applied retrospectively, effective from 1st July 1997, the date of enactment of the current ITA. Whilst they reinstated the step-in shoes approach of the 2008 ITA amendments, they also set out to ensure that gains arising on the transfer of PSA interests would not escape taxation.

Curiously, despite their retrospective application to 1997, the government's primary focus at the time appeared to be the 2010 Heritage PSA transfer transaction, rather than earlier transactions involving Energy Africa and Hardman Resources.

The tax disputes involving Tullow Oil and Heritage Oil against the Government of Uganda stemmed directly from the ITA amendments between 2008 to 2010.

4. The 2015 ITA amendments

The period between 2009 and 2012 saw several tax amendments from income tax to value added tax, which were viewed as potential barriers to Uganda's progress towards the final investment decision (FID) for its crude oil discoveries. These amendments, while aimed at enhancing revenue collection, raised concerns about their impact on the commercial viability of the country's oil sector.

After extensive deliberations between industry stakeholders and the Government of Uganda, coupled with input from an IMF mission, the ITA and Value Added Tax Act provisions governing the taxation of oil and gas activities were amended in 2015. While these amendments addressed several industry concerns, they fell short of fully resolving the critical issues surrounding the taxation of PSA interest transfers. Despite valuable insights gleaned from previous tax disputes, the revised ITA provisions still left key gaps, which actually led to the collapse in 2019 of Tullow Oil's intended dilution of its PSA stake to Total and CNOOC.

The 2015 amendments also affirmed that consideration for the transfer of PSA interests, in the form of carries or work obligations, would be subject to taxation. As we discuss further, this fiscal position is arguably unjustified. Unlike earlier amendments, which adopted the "step-in shoes" approach to clearly define how the transferee would handle the farmor's undepreciated costs, the 2015 amendments were silent.

Furthermore, under the 2015 amendments, exploration costs incurred by an oil company would be immediately written off for tax purposes, effectively crystallizing tax losses for the company in the year the costs were incurred. However, a potential complication would arise when the company would divest its PSA interests to another entity. While the transferee would become entitled to the transferor's cost oil from the transferor's previously incurred exploration costs, these costs would have already been written off for tax purposes by the original PSA holder, placing the transferor in a tax loss position. As a result, the new acquirer would be unable to deduct these exploration costs against its booked cost oil in the future.

5. Scope for policy for reform

It is worthwhile to note that the ITA amendments from 2008 to 2015 did not fully align the tax treatment of PSA interest transfers with the underlying commercial realities. While oil companies may occasionally dispose off PSA interests to realize profits, many such transactions are primarily intended to raise funds for exploration and development activities, as well as to mitigate sector risks by diversifying project portfolios. These amendments did not adequately consider the overall objectives of farm out transactions thereby contributing to the ongoing fiscal challenges on the issue.

Farm-outs/assignments or transfers of PSA interests are at the core of oil and gas industry. While initially viewed by the government as principally an opportunity for the IOCs to cash out "windfall profits", farm-outs are actually a sign of a dynamic sector charting a path of growth and progress.

It is rare for early exploration activities in frontier basins to attract larger independents or major oil companies. However, as the prospects of finding commercial reserves improve due to the early work of junior companies, larger independents and majors are attracted to acquire stakes in projects through farm-outs or assignments. Countries that impose onerous requirements on rights transfers may inadvertently stifle sector growth and deter investment. Such requirements often include burdensome approval conditions and punitive fiscal measures that tax investments rather than the profits generated from business operations.

The consideration for transfers of PSA interests can take the form of cash, carry, or a combination of both. Cash is typically used to reimburse the past costs incurred by the party divesting its upstream petroleum interest, which may either reflect actual past costs or, more rarely since the 2014/15 oil price crash, a payment in excess.

Under a carry arrangement, the acquiring party assumes certain future exploration and development cost obligations of the transferor. Taxing such carries or work obligations under Uganda's income tax regime presents a fundamental issue, as it effectively taxes funds earmarked for reinvestment into the project. This concern was raised in the aborted 2019 Tullow Oil PSA interest transfer transaction.

The failure to adopt a differentiated approach to the taxation of PSA interest disposals, applying a blanket treatment without regard to the transaction's specific commercial objectives or strategic intentions, represents a flaw in the existing tax regime.

6. Conclusion

While the aborted 2019 Tullow PSA interest transfer transaction was revived in 2020, subsequently allowing Uganda to secure its long-awaited oil and gas FID, it did not address the current flaws in the taxation of PSA interest transfers pursuant to the 2015 ITA amendments. The resolution appeared more as a negotiated settlement, based on several considerations rather than as a fundamental correction of the underlying tax issues.

Given the unresolved concerns, it is highly probable that another major tax dispute will arise on the transfer of PSA interests in the future. For Uganda to solidify its position as a globally competitive oil producer, a paradigm shift in the taxation regime on the transfer of PSA interests is imperative. A robust, sector-specific fiscal and legal framework has become a critical necessity, not only to foster a stable, predictable investment environment but also to ensure sustainable growth in the oil and gas sector.

Contacts for this Publication

Denis Yekoyasi Kakembo

Denis is the Managing Partner of the Firm. He is qualified both as a Lawyer and Chartered Accountant with UK training and vast experience serving local, regional and international companies in Sub Saharan Africa. He is recognized as a notable corporate and commercial law practitioner in Uganda.

Before joining Cristal Advocates, Denis spent nearly 10 years at Deloitte, an international professional services firm, where he started his career and rose to senior roles. While with Deloitte, he worked and lived in Uganda, Kenya, Tanzania and the United Kingdom.

Education

a) Master of Laws in Petroleum Taxation and Finance with distinction - University of Dundee, UK
b) Certified Public Accountant (Uganda) - ICPAU
c) Certified Chartered Accountant ("ACCA") – ACCA
d) Post Graduate Diploma in Legal Practice - Law Development Center, Uganda
e) Bachelor of Laws degree - Makerere University, Uganda

John Teira

John is a Partner with the firm but presently on sabbatical leave. Before joining Cristal, he worked as a Private Secretary to the President of Uganda. Prior to this role, he had worked with Shonubi Musoke & Company Advocates and Post Bank Uganda Limited.

John is presently a Member of Parliament representing Bugabula County North in Kamuli District in Uganda National Assembly.

Education

a) Post Graduate Diploma in Legal Practice - Law Development Centre, Uganda
b) Bachelor of Laws (Honours) - Makerere University, Uganda
c) Diploma in Law (First Class) - Law Development Centre, Uganda
d) Basic Philosophy of Public Service Administrative Communication - Uganda Management Institute, Uganda

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Dickens Asiimwe Katta

Dickens is a Partner at Firm where he also leads the oil and gas practice. Before joining Cristal Advocates, Dicken had served as Company Secretary of the Uganda Refinery Holding Company Limited (URHC) and the Uganda National Oil Company (UNOC) where he played key role in its formation.

Prior to joining the UNOC, Dickens had spent five years as Legal Counsel at the Petroleum Directorate of the Ministry of Energy and Mineral Development, where he evaluated several oil and gas transactions, negotiated contracts, and participated in the preparation of Uganda's oil laws and regulations.

Education

a) Master of Laws in Petroleum Law and Policy with merit - University of Dundee, UK
b) Post Graduate Diploma in Legal Practice - Law Development Center, Uganda
e) Bachelor of Laws degree - Makerere University, Uganda

Bill Page

Bill is a Senior Advisor at the Firm and is a leading global energy and tax practitioner with extensive international experience.

From 1986 to 1998, Bill 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 during a period of major infrastructure development for crude oil production.

From 2004 to 2008, Bill worked in Russia, leading Deloitte's oil and gas industry group and establishing the firm's Sakhalin office. In 2009, he moved to East Africa, where he led Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia, and Mozambique. Initially based in Kampala, Uganda, he later relocated to Dar es Salaam, Tanzania.

In 2014, Bill returned to the UK to support Deloitte UK teams on projects investing in Africa and remained a key member of Deloitte UK's energy and resource practice until his retirement in September 2018.

Education

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

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Contact us

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

P.O. Box 1769 Kampala, Uganda
+256 (414) 971274
admin@cristaladvocates.com
www.cristal advocates.com