WHEN THE HUNTERS LEARN TO SHOOT WITHOUT MISSING, THE BIRDS LEARN TO FLY WITHOUT PERCHING

(Protecting source taxation in Uganda's upstream oil sector from artificial profit shifting)

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ABSTRACT

This paper examines the phenomenon of artificial profit shifting as a component of illicit financial flows. Uganda's upstream oil sector involves a rent sharing regime with the non-resident international oil companies. The involvement of International Oil Companies (IOCs) creates taxing rights for host governments. Unfortunately, these taxation rights can be susceptible to the phenomenon of artificial profit shifting - an aggressive strategy of tax avoidance which contravenes applicable anti-abuse tax laws and therefore falls within the prescriptive envelope of illegality. This paper discusses the unique opportunity for the application of anti-abuse tax laws, the need for judicial cooperation in doing so, and the need for negotiation of proper rent-sharing fiscal regimes, as a solution to curb artificial profit shifting whose negative impact on the tax-to-GDP ratio continues to undermine Uganda's efforts in achieving sustainable economic development.

KEY WORDS: *Illicit Financial Flows, Artificial Profit Shifting, Anti-Abuse Rules, Judicial Cooperation, Resource Colonialism*

INTRODUCTION

Lawlessness has permeated global commercial and financial affairs far more extensively than is commonly perceived[1]. This essay takes for its province; Uganda, and for its purpose; to drum out such lawlessness, particularly in the form of artificial profit shifting, a tax-related component of Illicit Financial Flows (herein after IFFs) in the country's nascent upstream oil sector.

What are IFFs?

The captains of the world economy have conceded that progress in international trade and finance has to be measured against the yardsticks of poverty alleviation and sustainable development[2]. This is reflected in the unanimous adoption of the sustainable development goals (SDGs) by all 193 members of the United Nations[3], as a moral compass for 'globalization,' an often spoken but seldom defined term used by many to describe the growing inter-connectedness of the world[4].

Sustainable development is achieved when a country is able to meet the requirements of the present generation without compromising the ability of future generations to satisfy their needs[5]. Under target 16.4 of the SDGs, states are called to by 2030, significantly reduce IFFs[6]. Further, the Addis Agenda[7], which provides a global framework for financing the SDGs, makes explicit

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1 *Raymond W. Baker*, Capitalism's Achilles Heel, Dirty Money and How to Renew the Free-market System, John Wiley & Sons, Inc, p.15

2 *D Rodrick*, 'Globalization for whom? Time to change the Rules – and focus on poor workers' (2002) 104(6) Harvard magazine 29-31

3 See United Nations Sustainable Development Summit 2015, 25-27 September, Press Release, Historic New Sustainable Development Agenda Unanimously Adopted by 193 UN Members available at https://sustainabledevelopment.un.org/content/documents/8371Sustainable%20Development%20Summit_final.pdf

4 *Simon Lester, Bryan Mercurio, Arwel Davies*, World Trade Law, Text, Materials and Commentaries 2nd ed., Oxford and Portland Oregon 2012.

5 *Barbier, E.B*, 2007, Natural Resources and economic development, Cambridge University press.

6 *United Nations*, Transforming Our world: The 2030 Agenda for Sustainable Development, A/RES/70/1, available at https://sustainabledevelopment.un.org/content/documents/21252030%20Agenda%20for%20Sustainable%20Development%20web.pdf

7 *United Nations* (2015a), 'The Addis Ababa Action Agenda of the Third International Conference on Financing for Development', 7 July 2015

reference to the need to redouble global efforts towards reducing IFFs in order to eliminate them by 2030[8].

The term illicit financial flows came into being in the 1990s; however, it only began to resonate with leaders, international organizations and other entities in the last ten years[9]. IFFs can be defined broadly as movements of money and value from country to another that are illicitly earned, illicitly transferred, and/or illicitly utilized[10]. Such movement is considered illicit when it is marred with illegality[11].

What is Artificial Profit Shifting?

Artificial profit shifting is a tax related component of IFFs. Under the current international taxation system, multinational corporations (MNCs) can often reduce their global tax liabilities through profit shifting activities[12]. Tax-motivated profit shifting changes the effective tax rates paid by MNCs[13]. However, profit shifting is not without limits[14]. Legal profit shifting is restricted by a range of laws and regulations[15]. When it comes to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place, no or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it[16].

Background to Artificial Profit Shifting

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[8] *Lucystar Miyandazi*, The Complexities of Tackling illicit Financial Flows in Practice, The example of Tanzania, Discussion paper No. 255, ecpdm, June 2019, p.1

[9] *Yeon Soo Choi and Rachel McGauran*, Illicit Financial Flows via Trade Mis-invoicing, Study Report 2018, World Customs Organization, p.7

[10] *Global financial integrity,* A Scoping study of illicit Financial Flows Impacting Uganda, September 2018, p.3

[11] *Id*

[12] *Alexander Klemm and Li Liu*, The Impact of Profit Shifting on Economic Activity and Tax Competition, IMF Working Paper, WP/19/287, p.4

[13] *Id* p.5

[14] *Id*

[15] *Id*

[16] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, available at http://dx.doi.org/10.1787/9789264202719-en

The background to artificial profit shifting is a delicate balance between legitimate individual rights of tax payers and the abuse of those rights by tax payers themselves. To understand this statement, it is important to define what ‘tax’ is, how tax is levied, what the ‘legitimate individual rights of tax payers’ refers to, and what is meant by the ‘abuse’ of those rights by tax payers themselves.

What is tax?

Tax is defined as a compulsory exaction of money by a public authority for public purposes enforceable by law and is not payment for the services rendered[17]. About 80 percent of overall government revenues come from taxes[18].

How is tax levied?

By principle, tax is strictly a creature of statute[19]. This means that no tax is imposed except under the authority of a law by a legislative body and the tax system is designed on the foundation that there is no presumption as to tax[20]. The principle that tax is a creature of statute is a requirement of legal certainty that enables the function of the rule of law whose purpose is to guard against arbitrary abuse of power by tax authorities[21]. Basically, the equity principle means that a tax claim is justified if the state’s claim on that income is based on a set of legal principles and not something that is abstract[22].

What is meant by ‘legitimate individual rights of tax payers?’

The basis for the legitimate individual right of the tax payer (whether it be a natural person i.e. an individual, or an artificial person i.e. a company) is the equity principle of certainty that entitles a tax payer to pay only what the law prescribes.

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[17] Chief justice Lathan in *Mathew’s v The Chicory Marketing Board* (1938) 60 CLR 236 at p.276

[18] *J. Vernon Henderson and William Poole*, Principles of Microeconomics, Volume 1, D.C Heath, 1991, p.598

[19] *Geoffrey Morse, David Williams and Sandra Eden*, Davies: Principle of Tax Law, Eighth edition, sweet and Maxwell, 2016.

[20] Justice Rowlaat in *Cape Brandy Syndicate v IRC,* [1921]1 KB 64

[21] See, *Emmanuel Kasimbazi*, Tax Payers’ Rights and Obligations: Analysis of Implementation and Enforcement Mechanisms in Uganda, Danish Institute for International Studies (DIIS) Working Paper No. 2004/12, p.9 writing on inappropriateness of tax authorities requiring more taxes than prescribed by law or enforcing tax obligations using arbitrary means.

[22] *Porus F. Kaka*, “Source Taxation: Do We Really Know What We Mean?”, Twenty-First David R. Tillinghurst Lecture 2016

However, equity is also justified on the basis of the benefits approach and the ability to pay approach[23]. According to the benefits approach, each tax payer should contribute to tax revenues in line with the benefits she receives from public services[24]. The ability to pay approach takes the view that the government needs to raise a certain sum of money and each individual should contribute in line with her ability to pay[25].

Therefore, once a tax liability is prescribed under statute, a tax payer may not pay less than what is required by the statute except when an exemption prescribes so. And such laws which permit tax exemptions are construed in a so called *strictissimi juris* manner against the entity claiming the exemption[26]. In other words, the law does not look with favor upon tax exemptions and he who seeks to be thus privileged must justify it by words too plain to be mistaken and so categorical to be misinterpreted[27].

The distortion of equity principles in taxation for purposes of impermissible tax avoidance

Tax planning involves arranging one's financial affairs by intelligently anticipating the effects of tax laws on the arrangements that have been adopted[28]. In general, tax planning aims to reduce the outflow of cash resources made available to the government by way of taxes so that the same may be effectively utilized for the benefit of the individual or the business, as the case may be[29].

Tax planning which is otherwise valid in law cannot be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the state[30]. This rule applies, if not universally, at least within all Western constitutional democracies[31]. Nevertheless, tax planning inevitably reaches a point

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[23] *Dorothy Kwagala-Igaga*, When More is Less: An Analysis of the Reforms in the System of Direct taxation of profits From Business Activity in Uganda, A dissertation submitted to the University of Warwick in Accordance with the Requirements of the Degree of Doctor of Philosophy of the School of Law, p.18

[24] *Id*

[25] *Musgrave, RA and Musgrave,* PB, Public Finance in Theory and Practice (New York, McGraw-Hill Book Company, 1989, p.219

[26] *URA V Siraje Hassan Kajura*, Civil Appeal No. 09 of 2015 [2017] UGSC 63 (20 December 107)

[27] *Id*

[28] *Institute of Chartered Accountants of India*, Direct Tax Laws, Volume 1, 14.2

[29] *Id*

[30] *Union of India v Azadi Bachao Andolan*, (2003) 263 ITR 707 (SC)

beyond which it cannot be tolerated within a legal system if it is intended that the system be just[32]. Accordingly, the use of corporate entity in tax planning is legally valid provided its use is within the contours of law[33].

The misuse of rights is a legal concept. In civil law jurisdictions, the juridical basis of the limits to the logical implications of corporate legal personality is generally the concept of abuse of rights[34]. It is this concept that the ICJ referred to in re Barcelona Traction, Light and Power Co. Ltd [1970] ICJ 3, when it derived from municipal law a limited principle permitting the piercing of the corporate veil in cases of misuse, fraud, malfeasance or evasion of legal obligation[35]. These examples illustrate the breadth, at least as a matter of legal theory, of the concept of abuse of rights, which extends not just to the illegal and improper invocation of a right but to its use for some purpose collateral to that for which it exists[36].

Tax law has also seen the development of the doctrine of 'abuse of tax laws'[37], to distinguish permissible from impermissible tax avoidance. Therefore, tax avoidance is not illegal per se (meaning that there are circumstances in which it can be illegal).

Rather conspicuously, multinational companies have proven themselves capable of employing impermissible aggressive tax avoidance strategies characterized by artificial profit shifting. In recent years, no company has provided a more dramatic example than Heritage Oil and Gas in its operations in Uganda's upstream oil sector.

UGANDA'S UPSTREAM OIL SECTOR

From 2006 onward, a series of oil discoveries put Uganda on the global energy map[38]. Owing to the discovery of 6.5 billion barrels of oil[39], of which 1.4 to 1.7 billion are economically

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[31] *Klaus Vogel*, Double Tax Treaties and Their Interpretation, International tax and Business lawyer Volume 4:1, p.79

[32] *Id*

[33] *Mathews P. George and Pankhuri Agarwal*, Use of the Corporate Vehicle for Tax Planning: The Vodafone Case and Direct Taxes Code, in NUJS Law Review 201 (2010) at p. 203

[34] *Prest V Petrodel Resources Limited* [2013] UKSC 34 (Supreme Court), Lord Sumption at Para 17

[35] *Id*

[36] *Id*

[37] *Carlo Garbarino*, Legal interpretation of Tax Law: Italy, in Legal Interpretation of Tax Law edited by *Robert F. van Brederode and Richard Krever*, Series on International Taxation Volume 46, Senior ed. *Professor Kees van Raad*, International Tax Center, Leiden University

recoverable[40], the World Bank described Uganda as the hottest inland exploration frontier to watch in the oil and gas sector[41]. These were the largest onshore oil finds in sub-Saharan Africa in over two decades[42].

Description of the rent sharing regime in Uganda's upstream oil sector

The upstream sector involves the search and recovery of crude oil, other hydrocarbons and minerals, as well as their commercial recovery and production[43]. This includes three phases, i.e. exploration, drilling and production[44]. Exploration and production of oil and gas are complex activities which involve sophisticated techniques and resources[45]. The exploration process for instance involves geological, geophysical, and geochemical analysis using sophisticated software and technologies, such as advanced 3D seismic sampling, analysis, test drilling or excavation services, etc[46]. The upstream sector involves partnership with IOCs which carry out operations because the oil sector is capital intensive and requires a lot of expertise[47].

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[38] *Luke Patey*, Oil in Uganda: Hard bargaining and complex politics in East Africa, The Oxford Institute for Energy Studies (OIES) Paper: WPM 60, October 2015, p.4

[39] Official figure cited from at "Upstream UNOC Uganda National Oil Company Limited" https://www.unoc.co.ug/upstream/

[40] *Id*; See also *Philip Daniel, Lee Burns, Diego Mesa Puyo and Emily M. Sunley*, Uganda Technical Assistance Report- Fiscal Regimes for Extractive Industries: Next Phase, IMF Country Report No. 17/367, International Monetary Fund, December 2017, P.7

[41] *ACODE*, Petroleum Development, People and biodiversity conservation in Uganda: Legislating for sustainable exploitation of Uganda's petroleum resources at www.acode-u.org; See also *Marion Angom and Fiona Magona*, State of Oil and Gas in Uganda (2017) available at http://www.mmaks.co.ug/sites/mmaks.co.ug/files/article-attachments/2017/07/state -oil-and-gas-east-africa.pdf

[42] *Luke Patey*, supra note 38

[43] Committee of Experts on International Cooperation in Tax Matters, Eighteenth session, New York, 23-26 April 2019, Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, E/C.18/2019/CRP.11, p.5

[44] See, *Havard Devold*, Oil and Gas Production Handbook: An Introduction to Oil and Gas Production, Transport, Refining and Petrochemical Industry, Edition 3.0 Oslo, August 2013

[45] *Kimuli Anthony*, Is Uganda's Petroleum fiscal system efficient? ,Faculty of Management Aberdeen Business School, The Robert Gordon University, A Dissertation submitted in partial fulfillment of the requirements for the postgraduate Msc Degree in Oil and Gas Accounting, 2013, p.1, available at http://www.wgei.org/wp-content/uploads/2018/01/Kimuli-A-Dissertation.pdf

With the involvement of IOCs, a fiscal arrangement is needed. A fiscal regime is a set of instruments or tools that determine how the revenues from oil and mining projects are shared between the state and companies[48]. The major economic rationale is to provide a rent to the state as compensation for the depletion of its finite resources while giving the investor enough incentives to develop them[49].

To ensure that the state as resource-owner receives an appropriate share of the economic rent generated from extraction of oil and gas, the fiscal regime must be appropriately designed[50].

Uganda's Production Sharing Contractual Rent Sharing Fiscal Regime

Uganda operates a contractual petroleum fiscal arrangement known as the Production Sharing Agreement (PSA)[51]. Under this contractual arrangement, the government remains the owner of oil and gas resources and awards the IOC with a license to exploit the oil and gas[52]. The contractor is compensated in kind through cost oil which is the portion of the total value of available crude oil for recovery of costs, as well through profit oil which is the portion of available crude oil after costs have been recovered[53].

In other words, the IOC bears the exploration risks; provides the necessary investment which is essential for exploitation of the hydro carbons in return for a share of petroleum produced[54]. This

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46 Committee of Experts on International Cooperation in Tax Matters, Eighteenth session, New York, 23-26 April 2019, Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, E/C.18/2019/CRP.11, p.8

47 *Johnson D*, 2003, International Exploration Economics, risk, and Contract Analysis, Penn Well Books

48 *Natural Resource Governance Institute*, Fiscal Regime Design, What Revenues the Government Will be Entitled to Collect, March 2015; See also *Gudmestad Ove*, *Zolotukhin Anatoly and Jarlsby Erik*, Development of Petroleum Resources with emphasis on offshore Field, June 2010, WIT Press

49 *Energy Charter Secretariat*, Taxation Along the Oil and Gas Supply Chain, International Pricing Mechanisms for Oil and Gas, 2008, p.8

50 *Emil M. Sunley, Thomas Baunsgaard and Dominique Simard*, Revenue from the Oil and Gas Sector: Issues and Country Experience, p.1

51 *Wilson Bahati kazi and Barbra Beyeza*, Getting a Good Deal? An Analysis of Uganda's Oil Fiscal Regime, CRPD Working Paper No. 64, December 2018

52 *Tordo S.*,2007, Fiscal Systems for hydrocarbons: design issues, World bank publications

53 Art 12 Model Production Sharing Agreement 2012 (herein after MPSA 2012)

54 *Onyeukwu, H*, 2010 Fiscal Regimes In a Volatile Oil Price Era: What Options Exist for Balancing the Interests of the Resource Country and Investor Company? International oil and gas conference and exhibition in China, Society of petroleum engineers

means that after deducting cost oil to cater for costs incurred by IOC, the remaining production is profit oil[55]. Profit oil is split between the state and the operator according to the provision in the PSA[56]. The apportionment of profit oil is on a sliding-scale allocation set in favor of the government and based on cumulative production[57].

Tax consolidation under the PSA rent sharing regime

The profit oil of the IOC is subject to a corporate income tax at a rate of 30%[58]. And aside from corporate income tax charged on profit oil of the IOC, other forms of taxes the government collects include capital gains tax in case of transfer of assets by IOC and stamp duty on documents processed by IOC[59]. Uganda also operates a hybrid PSA where the IOC pays what is typically considered as a tax on production, i.e. royalties[60]. Further, the IOC pays non-tax revenues i.e. a signature bonus paid upon obtaining a license to explore and a production bonus upon obtaining a license for production[61].

Uganda's production sharing regime is also combined with a form of equity participation known as carried equity participation by the NOC on a carried interest basis[62].

Therefore, under this production sharing agreement model, the total share of government revenue take is the sum of; revenue from government share of profit oil, corporate income tax from IOC share of profit oil, royalty payments by IOC, bonuses payments and a percentage of the contractors' share of the profit oil under the state equity participation provisions.

Under this rent sharing fiscal regime is where source taxation and artificial profit shifting become relevant.

SOURCE TAXATION IN UGANDA'S UPSTREAM OIL SECTOR

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[55] *Kristen Bindemann*, Production Sharing Agreements: An Economic Analysis, Oxford Institute for Energy Studies, October 1999, p.14

[56] *Id*

[57] Art 12 Model MPSA 2012

[58] Subject to Article 13 of MPSA 2012; see also Income Tax Act of Uganda Cap. 340

[59] See income tax Act

[60] Art 9 MPSA 2012

[61] *Id* Art 8

[62] *Id* Art 10

Although Uganda also engages a local content policy in the oil sector designed to try and enhance the benefits for local people beyond revenue to jobs, creation of businesses and so on[63], tax consolidation remains the key issue in the oil sector. As already discussed in the previous section, a significant source of revenue for the host country is from the taxation of the profit oil share of the IOC as well as taxation of other activities of the IOC within the host country. This is often referred to as source taxation.

What is source taxation?

Foreign companies with significant activities in a country are typically only taxed on the income from sources within that country[64]. This is the concept of source taxation which must be distinguished from resident taxation. According to resident principle, if a company or person is classified as resident, tax authorities of their residence have full taxing power over worldwide income[65]. In other words, a resident country claims the right to tax income that a company earns regardless of where in the world that income is generated.

On the other hand, a source country's jurisdiction to tax foreign persons is limited to income earned within the source country's borders[66]. Under the current international norms, however the taxpayer's residence country is required to accommodate the source country's taxing right by employing a foreign tax credit or by exempting foreign source income[67]. Thus, source taxation is at once geographically constrained, but also jurisdictionally superior to residence taxation[68].

Source –based taxation is consistent with a benefits perspective on justifying tax jurisdiction[69]. Source jurisdictions provide significant benefits to corporations that carry on business activities within them[70]. Such benefits include the provision of infrastructure or education, as well as more

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[63] See Ministry of Energy and Mineral Development, National Content Policy for the Petroleum Subsector in Uganda, February 2017

[64] See Article 7 of OECD, Articles of the Model Convention with Respect to Taxes on Income and on Capital 2017

[65] See Article 4 of OECD Model Tax convention

[66] *Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni*, The David R. Tillinghast Lecture "What's source Got to do With It?" Source Rules and U.S. International Taxation, Tax Law Review [Vol. 56: 2002], p.83

[67] *Id*

[68] *Id*

[69] *Reuven S. Avi-Yonah*, Tax Competition, Tax Arbitrage, and the International tax Regime, Law and Economics Working papers Archive 2003-2009, University of Michigan Law School 2007, P.22

specific government policies such as keeping the exchange rate stable or interest rates low[71]. These benefits justify source-based taxation in the sense that the host country's government bears some of the costs of providing the benefits that are necessary for earning the income[72].

Tax planning to avoid source taxation

In recognizing that a company may be taxed multiple times, the resident country that claims to tax on a worldwide basis gives a credit or exemption for taxes paid to other governments where that income is made in order to eliminate such double taxation[73]. Where there is a double tax treaty, then the treaty will take over the method of grant[74]. Otherwise, the type of credit or exemption a company gets to prevent double taxation depends on the domestic tax law in its country of residence[75].

Owing to the differences in tax rates from one country to another, which result as a matter of principle - because states are sovereign and hence have the right to impose each their own tax rates, thereby often competing with one another to have more attractive tax rates for investors, but also from a practical point, - because each state has varying economic needs and therefore each country's tax system is designed with different objectives (i.e., it is true that one objective is to raise revenue, but it is also the case that the government uses the tax system to encourage investment in certain types of assets or in certain specific industries[76]), multinational companies are able to use formal arbitrage to significantly reduce their tax liability.

For multinational corporations, whereas the ability to operate in several jurisdictions presents exposure to the taxing rights of more than one country, it also presents even more opportunities for tax planning. This development has opened up a new avenue of tax avoidance where firms artificially move taxable profits to tax havens[77].

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[70] *Id*

[71] *Id*

[72] *Id*

[73] See Chapter V Articles 23 A and 23 B of OECD Model Tax Convention

[74] See OECD Model Tax Convention Commentary on the provisions of Article 23 A Para 38

[75] *Id*

[76] *Sebastian James*, Incentives and Investments: Evidence and Policy Implications, December 2009, Investment Climate Advisory Services of the World Bank Group, p.1

[77] *Ludvig Wier and Hayley Reynolds* , Big and 'unprofitable', How 10 per cent of multinational firms do 98 per cent of profit shifting, United Nations University World Institute for Development Economics Research (WIDER) Working Paper 2018/111, p.1

When tax liability appears to be unavoidable, for a company looking at tax planning opportunities, an alternative could be to lower the tax liability by reducing either the tax base or the tax rate which are the elements that determine the tax due. The tax planning tool kit to achieve this involves; i) avoiding taxable presence in relation to the activities performed by intermediate subsidiaries in source country, ii) reducing tax base in high tax jurisdiction source country by means of deductible payments, iii) striving for non-current taxation of the low tax profits at a level of parent company in parent residence country, and finally iv) using Hybrid mismatch arrangements to provide particular benefits in reducing the tax level at intermediate subsidiaries.

The use of this tax planning tool kit is for the purpose of facilitating profit shifting of taxable income from the countries where it is generated to other countries where it can be shielded from tax liability.

HERITAGE OIL AND GAS LIMITED ARTIFICIAL PROFIT SHIFTING IN UGANDA, CASE STUDY

In 1997, a PSA was concluded by government of Uganda with Heritage Oil and gas Ltd in respect to exploration area 3 consisting of the Semiliki basin[78]. The interests of Heritage Oil were eventually purchased by Tullow Oil which in turn sold part of its interests to the China National Offshore Oil Company (CNOOC) and Total, following confirmation of the presence of commercially viable amounts of oil in 2006[79].

The sale by Heritage to Tullow resulted in a challenge to the income tax assessment of US$ 404,925,000 against Heritage by the Uganda Revenue Authority[80]. In order to avoid this tax, Heritage Oil and Gas Company resorted to the extensive use of artificial profit shifting mechanisms to illegally avoid capital gains tax. The company's artificial profit shifting vehicle, was characterized by the following features;

i) **The use of sham transactions without substance.**
The use of sham transactions means that a company will involve the use of 'mail-box companies', also often referred to as 'paper companies'. These companies do not exist in reality but only on paper. In this case, Heritage was incorporated in The Bahamas and later registered in Mauritius in 2010 with no oil business or commercial activity in Mauritius[81]. Further revelations from the Panama Papers contained emails written by an accountant acting on behalf of Heritage precisely stating that Heritage

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[78] *Dan Ngabirano*, Whose prosperity? A critical analysis of the politics involved in Uganda's Petroleum Sector Regulation, taxation and Revenue management Legislative Processes, September 2019

[79] *Id*

[80] *Heritage Oil and Gas Limited v Uganda Revenue Authority,* TAT Application No. 26 of 2010

[81] *Id* p.5

Oil and Gas Limited was looking to re-domicile to Mauritius to avoid the capital gains tax due on the sale of the asset within eleven days[82]. This meant that Heritage Oil and Gas would report its profits in Mauritius where it had no actual physical presence.

ii) Treaty abuse of the Uganda-Mauritius double tax agreement.

Treaty abuse means that a company can take advantage of a tax treaty between two countries in order to facilitate what is commonly referred to as double non-taxation i.e. when the company is taxed in neither the country where it generated/sourced the income from nor where it is resident. It was discovered that Mr. Paul Richard Atherton, the director of Heritage had given false evidence to the Tax Appeals Tribunal of Uganda (and his evidence was at that stage accepted) that the change in registration of the defendant from the Bahamas to Mauritius was "not purposely done to take advantage of the benefit Mauritius could offer in light of the transaction with Tullow", when in fact the move to Mauritius (not disclosed to the Uganda Revenue Authority at the relevant time) was indeed a part of the defendants tax planning, because Mauritius was one of the few countries which had a double tax treaty with Uganda[83].

iii) The artificial avoidance of permanent establishment.

The artificial avoidance of permanent establishment means that company will use malafide methods to avoid substantial activity in a country where it is generating income. This is because source taxation rights on activities in source countries when those activities are not based on interest in immovable property, requires there to be permanent establishment. Heritage Oil and Gas Limited attempted to artificially avoid tax on income it had sourced in Uganda by outsourcing its drilling activities in Uganda to a third party[84], and having no assets in Uganda[85], so as to avoid permanent establishment. With this set of circumstances in place, Heritage then attempted to avoid the tax assessment by claiming that its activities were not from immovable property and therefore without permanent establishment, it was not taxable in Uganda. The operations were actually done by an affiliated company called Heritage

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82 "Panama Papers: How Jersey-based oil firm avoided taxes in Uganda – BBC News" https://www.bbc.co.uk/news/amp/worl-africa-35985463

83 *Tullow Uganda ltd v Heritage Oil and gas ltd* at Para 51, In the High Court of Justice, Queens Bench Division Commercial Court

84 *Heritage Oil and Gas Limited v Uganda Revenue Authority, supra* note 80, p.4

85 *Id*

Oil and Gas (Uganda) Limited[86]. The company was also careful to make sure that the sale of assets was concluded in Holland, negotiated in the Channels Islands, primarily in jersey with some discussion in London[87]. Heritage claimed that the sale of assets took place outside Uganda and so the income could not be attributed to activities in Uganda[88].

The case was concluded by a holding that Heritage Oil and Gas was liable to pay the tax in Uganda. The tribunal prevented the treaty abuse of the Uganda Mauritius Double Tax Agreement, as well as the artificial avoidance of permanent establishment and the use of sham transactions by holding that The Double Tax Agreement allowed for the taxation of business profits, shipping and air transport, associated enterprises, dividends, interest, royalties inter alia, and further that Uganda's Income tax law did not limit itself to taxing income by non-residents from immovable property, but also to taxing income sourced in Uganda through permanent establishment by the agent of a multinational acting in the ordinary course of their business as the case was for Heritage Oil and Gas (U) limited[89].

Heritage continued to deny liability and adamantly refused to pay the tax. This was compounded by the fact that it was feared that Heritage had exited the country. What ensued was political and administrative mechanisms to recover the tax. The government of Uganda used its enforcement mechanisms by issuing agency notices on Tullow which had purchased the interest of Heritage and appointing it as Heritage's agent in respect of its tax liability[90]. On top of the agency notices were lengthy negotiations that included the head of state of Uganda. Tullow ultimately made payment to the Government of Uganda pursuant to those notices[91]. It then commenced proceedings against Heritage in order to obtain a contractual indemnity pursuant to a provision in the Sale and Purchase Agreement that gave Tullow the right to an indemnity in respect of capital gains tax imposed on Heritage but charged to Tullow by the Government[92].

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[86] *Id* p.8-9

[87] *Id* p.5

[88] *Id* p.13

[89] *Id* p. 54

[90] See facts laid out in *Tullow Uganda ltd v Heritage Oil and gas ltd*, In the High Court of Justice, Queens Bench Division Commercial Court

[91] *Id*

[92] *Id*

This was a rare victory against artificial profit shifting. This victory is made more significant taking into account the impact of artificial profit shifting on the economy.

IMPACT OF THE CHRONIC RESCIDIVISM OF IFFs VIA ARTIFICIAL PROFIT SHIFTING ON TAX-TO-GDP RATIO AND THE RESULTING HARM

Generally, the impact of IFFs on least developed countries such as Uganda is a lack of sustainable development characterized by continued reliance on official development assistance also known as aid and/or debt. Developing countries require sustainable sources of finance for development[93]. Most countries will need to increase domestic tax revenues to gradually replace aid and debt as sources of finance for public goods and services[94].

Tax-to-GDP ratio

The tax-to-GDP ratio is simply a reflection of how much of a country's output goes to government in form of tax receipts[95]. It would follow therefore that a country that is willing and able to mobilize a higher ratio of its output in tax revenues should have more resources to finance its current and development programs[96].

Indeed, the high reliance on debt and aid is due to a low tax-to-GDP ratio. Since 2000, the highest tax-to-GDP ratio in Uganda was 13.5% in 2017, with the lowest being 10.4% in 2010[97]. In 2018, Uganda's tax-to-GDP ratio was lower than the ratio in neighboring Kenya (18 per cent) and Rwanda (16 per cent); and was also below the broader COMESA and Sub-Saharan Africa averages[98]. During his national address after the reading of the 2020/21 Budget, President

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[93] *Francis Weyzig*, International Finance and Tax avoidance via Dutch special Purpose Entities, Paper for Presentation at Research Seminar, Radbound university Nijmegen, 21 October 2013, p.2

[94] *UNCTAD*, The Least Developed Countries Report 2010: Towards a New International development Architecture for LDCs, Geneva United Nations

[95] *Uganda Revenue Authority*, Tax To GDP Ratio: A Comparative Study of Uganda with selected East African Countries and South Africa, 2013, p.5

[96] *Id*

[97] Revenue Statistics in Africa 2019 – Uganda, available at https://www.oecd.org/countries/uganda/revenue-statistics-africa-uganda.pdf

[98] *World Bank*, Uganda Economic Update, 11th Edition, Financing Growth and Development: Options for Raising More Domestic Revenues, May 2018

Yoweri Museveni decried the low ratio of tax-to-GDP in Uganda, which stands at 14.3%[99]. Since 1997, this ratio has stagnated only growing from 11% in 23 years[100].

In 2016, Uganda collected natural resource revenues totaling 15 percent of its GDP, while the world average was 1.9 percent[101]. With the discovery of oil, the influence of natural resources on the domestic economy is bound to be even more pronounced in the future[102]. Oil is expected to contribute an average Net Present value of 2 billion for at least 26 years[103], more than the US$1.7 billion that Uganda gets as development assistance from donors every financial year[104]. The tax contribution to that net value is not concordantly stated, but it will be undoubtedly significant in raising the tax-to-GDP ratio.

The aim of this paper is not to unfairly use an extreme anecdote as a template for what may be perceived as an 'incorporeal' practice by some, but rather to help use it as a template to describe a real problem of artificial profit shifting, which is not limited to only the natural resource extractive sector but the entire economy. If the impact of the problem of artificial profit shifting in other sectors of the economy were to be appraised, the true scale of its negative impact on the tax-to-GDP ratio and consequently undermining sustainable development in the least developed countries such as Uganda by forcing the reliance of unsustainable sources of funding i.e. official development assistance would be evident.

Reliance of Official Development Assistance

Official development assistance (ODA) is defined as government aid designed to promote the economic development and welfare of developing countries[105].

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[99] *Andrew Mwenda*, The trouble with URA, column in the Independent magazine, June 15, 2020, available at "The trouble with URA" https://www.independent.co.ug/the-trouble-with-ura/

[100] *Id*

[101] *Global financial integrity*, A Scoping study of illicit Financial Flows Impacting Uganda, September 2018, p.8

[102] *Id*

[103] *Corti Paul Lakuma*, Oil Wealth in Uganda: Analysis of Macroeconomic Policy Framework, Centre for Research on Peace and Development (CRPD) Working Paper No. 62, December 2018, p.2

[104] *Dickens Kamugisha*, Legal Ownership of Oil: Socio-Economic Implications for Uganda, in *Oil watch Africa Network*, Oil Production in Africa: Livelihoods and Environment at Stake, Should the oil rather remain in the ground? May 2010, p.3

[105] "OECD iLibrary Official development assistance (ODA)" https://www.oecd-ilibrary.org/development/official-development-assistance-oda/indicator-group/english_5136f9ba-en

In 2015, The High Level Panel Report noted that having received $1.07 trillion of official development assistance between 1970 and 2008 according to the OECD, Africa was estimated to have lost in excess of $1 trillion in IFFs, which is equivalent to all of the official development assistance received by the continent during the same time frame[106]. And most recently, The Africa Growth Initiative at Brookings in its up to date 2020 Policy Brief has also noted that between 1980 and 2018, sub-Saharan Africa received nearly $2 trillion in foreign direct investment and official development assistance, but emitted over $1 trillion in IFFs[107]. In 2015, The Africa Centre for Energy Policy noted that IFFs in Ghana account for more than half of its official development assistance[108].

PROTECTING SOURCE TAXATION AGAINST ARTIFICIAL PROFIT SHIFTING

Uganda's policy toward taxing non-residents is an aggressive approach of the Income Tax Act of Uganda towards the collection of tax from non-residents[109]. Take 'capital gains tax' for instance, designing and enforcing a legal regime for taxing non-residents on capital gains realized from domestic sources is a topic of vital importance for developing countries[110].This is true of most types of income, be it rent, interest, royalty, dividend, or business profit[111]. Taxing capital gain, therefore, is invariably needed to ensure that income from assets in one's country is properly subject to tax[112]. In this sense, capital gain taxation is intrinsically about protecting the tax base from erosion[113].

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[106] *Report of the High Level Panel on Illicit Financial Flows from Africa*, 'Track it, Stop it, Get it', Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development, p.13

[107] *Landry Signe, Mariama Sow, and Payce Madden*, Illicit Financial Flows in Africa; Drivers, destinations, and policy options, Africa Growth Imitative at Brookings, Policy Brief, March 2020, p.2

[108] *The Africa Centre for Energy Policy*, Illicit Financial Flows and The Extractive Industry in Ghana, A Report Prepared for February 2015, p.20

[109] Professor David J. Bakibinga appearing as expert witness in Tullow Uganda ltd v Heritage Oil and gas ltd (supra) at Para 77, In the High Court of Justice, Queens Bench Division Commercial Court

[110] *Wei Cui*, Taxation of Capital Gains, Papers on selected Topics I Protecting the Tax Base of Developing Countries, p.3

[111] *Id*

[112] *Id*

[113] *Id*

The solution to artificial profit shifting is a robust legal framework, backed by judicial cooperation. This results in the applicability and enforcement of anti-abuse laws.

i) Applying relevant anti-abuse legislation

Domestic anti-abuse rules and judicial doctrines may be used to address transactions entered into for the purpose of obtaining treaty benefits in inappropriate circumstances[114]. These rules have moved from the realm of law referred to as *lex ferenda* i.e. the law 'as it ought to be', to the realm of law referred to as *lex lata* i.e. the law 'as it is'. Anti-avoidance rules are divided into two main categories: "general" and "specific"[115].

a) ***Specific Anti-Avoidance Rules***

Tax law designed to deal with particular transactions of concern are termed as either specific anti-avoidance rules (SAARs) or, less commonly, targeted anti-avoidance rules (TAARs)[116]. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law[117].

Common specific anti-avoidance rules include, Transfer pricing rules, thin capitalization rules or rules limiting interest deductibility, limitation of benefit rules/clauses, controlled foreign company (CFC) rules, etc.

It is worthy to note that the specific anti-avoidance provisions do not, nor in the nature of things could they be expected to lay down a series of precise rules for dealing with every kind of problem that may arise in tax avoidance[118]. Modern commerce organizes itself in an infinite variety of ways, and it would be impossible within the fairly narrow limits of any section in the Income Tax Act to specify an exhaustive set of rules for dealing with every kind of problem that may arise[119].

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[114] United Nations, Model Double taxation Convention between Developed and Developing Countries (herein after U.N Model Tax Convention), 2017 Update, commentary to Art. 1 para 16

[115] *Ernst & Young*, GAAR Rising, Mapping Tax Enforcement's Evolution, February 2013, P.2

[116] *Id*

[117] U.N Model Tax Convention Commentary to Article 1 Para 31

[118] *John Mugalula*, Anti-Tax avoidance Provisions Under The Income Tax Act Cap 340: A Perspective Analysis, p.2 available at http://ssrn.com/abstract=1633890

[119] *Id*

The SAARs admit only a limited reconstruction and are specific to one form of transaction, or are triggered only for one tax regime[120].

b) ***General Anti-Avoidance Rule***

The General Anti avoidance rule is part of the income tax code in Uganda[121]. The general anti avoidance rule (GAAR) is intended to prevent abusive arrangements that are not adequately dealt with through specific ant-abuse rules or judicial doctrines[122].

The GAAR is a key mechanism designed to limit the use of artificial schemes which circumvent the tax statute's purpose despite such schemes being in compliance with the text of the statute[123]. Several countries across the world have already implemented the GAAR to combat abusive tax avoidance. These include India[124], Italy[125], Australia[126], Canada[127], China[128], Germany[129], South Africa[130], United Kingdom[131], Belgium[132], France[133], New Zealand[134], United States[135], Netherlands[136], etc.

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120 *Graeme S. Cooper*, International Experience with General Anti-Avoidance Rules, 54 SMU L. Rev. 83 (2001), p.97, https://scholar.smu.edu/smulr/vol54/iss1/7

121 Codified under section 91 of Income Tax Act of Uganda

122 U.N Model Tax Convention Commentary to article 1 Para 41

123 *James Nuwagaba*, From Judicial exposition to Legislative Intervention: The GAAR's Odyssey of Uncertainty, p.1

124 Chapter XA introduced to the Income Tax Act 1961, s. 95 to 102, Income Tax Act 2012, see also Rules and Clarifications

125 Italy introduced in 1997 a GAAR (Article 37-bis)

126 Australian GAAR is contained in Part IVA of the Income Tax (ITAA 36)

127 Canada's GAAR is contained Section 245 of the Income Tax Act 1988

128 China's GAAR was introduced in article 47 of the PRC Enterprise Income tax Law in 2008, On 2 December 2014 China also issue regulations on the application of the GAAR (Administrative Regulations for the General Anti-avoidance Rule (Trial Implementation))

129 Germany's GAAR is contained in Section 42 of the General Tax Code

130 South Africa's GAAR is contained in section 103(1) of the Income Tax Act

131 U.K's GAAR is contained in Ss. 206 to 215 of the Finance Act 2013 of UK

132 Belgium's GAAR is contained in Art. 344 of the Belgium Income Tax Code 1992

The applicability of the GAAR is necessary not just to ensure compliance but also for deterrence. It enjoins the tax payer to act in good faith/bonafide and not malafide while fulfilling their tax obligations

ii) The need for judicial cooperation through anti-avoidance judicial doctrine

The role of the judiciary is a very critical role. The need for anti-avoidance doctrines and precedents is critical but should not be at the expense of impartiality or independence. The judiciary must ensure that the distortion of equity principle by both sides is not achieved, i.e. the tax authorities' arbitrary collection of taxes and the tax payers misuse of rights.

Some countries have developed through their courts, various anti-avoidance doctrines, such as the 'substance over form' doctrine or the concept of 'abuse of law'[137]. These are essentially doctrines relating to interpretation of tax legislation[138]. While the interpretation of tax treaties is governed by the general rules that have been codified in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties[139].

In Uganda, the Tax Appeals Tribunal has recently applied the GAAR to in a case that involved withholding tax on interest payments between affiliated parties[140].

iii) Supplementing Domestic Anti-Avoidance Rules

It is important to supplement domestic ant-avoidance rules considering their relationship with tax treaty provisions. Where a taxpayer has artificially transferred a source of income to a resident of another country, anti-avoidance legislation might allow the country from which the transfer has been made to continue to tax the

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[133] France's GAAR is contained under Art. L 64 of the French Tax Procedure Code

[134] See Income Tax 1994 of New Zealand, s BG 1 and GB 1

[135] See I.R.C S.7701 (o) (2012)

[136] See Dutch abuse of law doctrine (fraus legis)

[137] *Phillip Baker,* Improper Use of Tax Treaties, tax Avoidance and Tax Evasion, Paper No. 9-A, May 2013, Papers on Selected Topics in Administration of Tax Treaties for Developing Countries, United Nations department of Economic and Social Affairs, United nations Secretariat, p.8

[138] *Id*

[139] U.N Model Tax Convention, Commentary to Article 1 Para 45

[140] *ATC (U) Ltd V URA*, TAT Application No. 17 of 2019, pp. 9-10 (Decision delivered on 26th may, 2020)

income arising[141]. However, a tax treaty may say that the income is taxable in only one country, and this could be raised as a defense to the anti-avoidance legislation[142]. The applicability of Uganda's domestic GAAR may have limitations if there is not GAAR in the double tax treaty. The MLI is a good option because it saves the burden of lengthy renegotiation of double tax treaties.

The BEPS action 6 which deals with the prevention of treaty abuse as a minimum standard is to be implemented through the multilateral instrument[143]. The multilateral instrument operates to incorporate/append its provisions automatically into the bilateral tax treaties of its states parties[144].

iv) Negotiation of equitable rent sharing regimes

Indeed, there is fundamental conflict between oil and gas companies and the government over the division of risk and reward from a petroleum project[145]. Both want to maximize rewards and shift as much risk as possible to the other party[146].

Nevertheless, the right choice of fiscal regime can improve the trade-off between each party's interests[147].

Fiscal regimes must include Investor-state arbitration as a substitute for domestic tribunals. Investor-state arbitration is mainly used to settle disputes arising from bilateral or multilateral investment treaties concluded between states or from contract clauses between state and investor e.g. PSA contract. These investment treaties grant international legal protection to foreign investors from certain types of adverse action by the governments of the host states in which they invest[148].

States need to get rid of the caricature of investor-state arbitration being pro-investor. Arbitration, the dispute settlement technique and framework of dialogue, is consensual, and attempts to encourage negotiated outcomes (i.e., amicable settlement

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141 *Phillip Baker*, supra note 112, p.4

142 *Id*

143 See Action 15 of BEPS Action Plan

144 See Article 6 of Multilateral Convention to implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

145 *Emil M. Sunley, Thomas Baunsgaard and Dominique Simard*, Revenue from the Oil and Gas Sector: Issues and Country Experience, p.1

146 *Id*

147 *Id*

148 *Jonathan Bonnitcha*, Assessing the Impacts of Investment Treaties : Overview of the evidence, International Institute for Sustainable Development (IISD) Report, 2017, p.1

between the parties)[149]. In the case of Uganda, it is argued that in pursuit of this objective (dominance over the sector and maximum revenue extraction), the ruling coalition was motivated by the opportunity to use petroleum revenues to extend their stay in power through patronage and military procurements[150].

Negotiating rent-sharing fiscal regimes that take into account the long-term sustainable needs of the country as opposed to the short-term needs of the ruling class which may be unduly inequitable to other stakeholders involved plays a vital role in enhancing compliance by multinational tax payers involved.

CONCLUSION

For the first 70 years of the 20th century, private IOCs dominated the global oil industry outside North America and communist countries[151]. These foreign investors operated under the concession system[152]. Concessions are criticized as too favorable to foreign oil companies[153]. This precipitated the use of the phrase "resource colonialism"[154].

Resource colonialism is not common today because of the resource nationalistic identities that states have taken up as a result of post-colonial resource nationalization. The principle of permanent sovereignty over natural resources is well recognized today[155].

In the Oil and gas industry today, reserve ownership and production are dominated by governments and government-owned or sponsored national companies[156]. Government-owned

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[149] *Sergio Puig*, No Right Without a Remedy: Foundations of Investor –State Arbitration, Penn Law: Legal Scholarship Repository, 2014, p. 841-842; See also generally Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (ICSID), Rules of Procedure for Arbitration Proceedings, r. 21

[150] *Dan Ngabirano*, supra note 78

[151] *Paul Stevens,* International Oil Companies: The Death of the Old Business Model, Research Paper, Chatham House The Royal Institute of International Affairs, May 2016

[152] *Energy Charter Secretariat,* supra note 49, p.16

[153] *Id*, p.17

[154] See concept of 'Resource Colonialism' discussed in *Linda Marie Robyn*, "Resource colonialism and Native Resistance: The Mining wars in Wisconsin," (1998), Dissertations 1577, available at https://scholarworks.wmich.edu/dissertations/1577

[155] See *UN General Assembly*, Permanent Sovereignty over Natural Resources, 17 December 1973, A/RES/3171

national oil companies (NOCs) control 78 per cent of global oil reserves and 58 per cent of global oil production[157]. These percentages are slightly below the 2011 percentages of 90 per cent and 75 per cent respectively[158].

In addition to NOCs, international oil companies (IOCs) also supply oil to the market, such that 84 per cent of the world's oil is produced by about 100companies (NOCs and IOCs)[159]. However, IFFs by IOCs in the oil sector remain a concern. The sums involved are significant and the issue is highly political - $400 million (the amount of Capital gains tax involved in the Heritage Oil dispute) is more than the Ugandan government's annual health budget[160].

Therefore, it is important to the current economic development agenda that taxation should provide a stable flow of revenue to finance development priorities, both physical (e.g. infrastructure) and socio economic (e.g. social protection measures), among others[161]. Some commentators such as the Platform London have gone as far as asserting that, such tax avoidance (which offends the threshold of legality) in countries such as Uganda and Nigeria perpetuates and reinforces 'resource colonialism.[162]

The proper applicability of anti-avoidance rules protects the legitimate right of the individual tax payer while preventing the abuse of that right by the tax payer themselves. When the hunters learn to shoot without missing, the birds inevitably learn to fly without perching. Therefore, a regime of anti-abuse tax laws that conflates tax law with morality by focusing not just on the law but also on the behavior of multinationals, without placing such multinationals at odds with the expectations of their shareholders by invoking the notion of 'voluntary taxes,' is necessary. And this, for the government, is in keeping in line with the two concepts of 'the right to tax' and 'right tax'[163],

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156 *United Nations*, New York 2017, United Nations Handbook on selected issues for Taxation of the Extractive Industries by Developing Counties, p. 12

157 *Id*

158 See figures in *Silvana Tordo, Brandon S. Tracy and Noora Arfa*, National Oil Companies and Value Creation, World Bank Working Paper No. 218, 2011, p. xi

159 *United Nations*, supra note 146

160 *Keith Myers*, Selling Oil assets in Uganda and Ghana – A Taxing Problem, Revenue Watch Institute, 16th August 2010, p.2

161 *Taku Fundira*, The G-20 Tax Agenda and Africa's Taxation Needs, South African Institute of International Affairs (SAIIA), Occasional Paper 216, Economic Diplomacy Programme, April 2015, p.6

162 *Platform Briefing*, Making a Killing: Oil Companies Tax Avoidance and Subsidies, Charity no. 1044485, February 2013, p.17

[163] See Porus F. Kaka discussion on the concept of 'right to tax' and 'right tax' in *Porus F. Kaka*, "Source Taxation: Do We Really Know What We Mean?", Twenty-First David R. Tillinghurst Lecture 2016