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Infosheet No. 16, 2011

UNDERSTANDING THE TAX DISPUTE: HERITAGE, TULLOW, AND THE GOVERNMENT OF UGANDA

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Currently, a series of tax disputes are swirling around Uganda's burgeoning oil sector, the results of which will have immense implications for any future government revenue, and, potentially, even the country's investment climate. Anyone interested in the governance of Uganda's petroleum sector and its ability to finance meaningful investment in the country would do well to pay close attention to these disputes and their eventual legal outcome.

Background

On July 26, 2010, one of the major players in Uganda's petroleum sector, Heritage Oil, sold its exploration licenses in the Albertine Rift to Tullow Oil. (Heritage and Tullow together owned a 50 percent stake in two lucrative exploration blocks: 1 and 3A.) With the sale, Tullow became the sole company licensed to operate in those areas. (In addition to its stake in Blocks 1 and 3A, Tullow also has the sole exploration rights to Block

2.) Tullow purchased Heritage's stake for US $1.45 billion, after which Heritage ceased to operate within Uganda.

In the aftermath of the deal, however, the Uganda Revenue Authority (URA), which was acting on behalf of the Government of Uganda, requested $434 million—or 30 percent of the sale—in capital gains taxes. Heritage disputed the tax, saying that its lawyers believed that the sale was not taxable, given that the Production Sharing Agreements (PSAs) which the company signed with the government failed to mention such a payment. Heritage further argued that the sale of its assets to Tullow Oil was not taxable in Uganda because the sale itself took place outside Uganda (in the Channel Islands off the coast of France) and because the company itself is not incorporated in Uganda (being domiciled in Mauritius). The Government of Uganda, meanwhile, has argued that the assets sold were located in Uganda, and that their sale was done with the consent of the Ugandan government, making the transaction taxable under Ugandan law.

Legal Proceedings in London:

1. Government of Uganda versus Heritage Oil involves the payment of a capital gains tax ($434 million) on the sale of its oil exploration rights to Tullow Oil for $1.45 billion.

2. Tullow Oil versus Heritage Oil regards a "tax" of $313 million that Tullow says it paid to the Government of Uganda on behalf of Heritage, in lieu of Heritage's (unpaid) capital gains tax. Heritage is counter suing Tullow for $283 million, which is the amount of money that Tullow withheld from Heritage pending the resolution of Heritage's tax dispute with the Ugandan government.

By the Numbers

The Payments	The Money
Total amount of sale (for Heritage's stake in Blocks 1 and 3A)	$1.45 billion (or Ush 3.77 trillion)
Capital gains tax that GoU wants Heritage to pay	$434 million (or Ush 1.13 trillion) (30% of total sale)
Money not given to Heritage from the sale of Blocks 1 and 3A	$283 million (or Ush 736 billion)
"Refundable deposit" paid by Heritage to GoU	$121 million (or Ush 315 billion)
Total amount that GoU has, and that Heritage wants	$405 million (or Ush 1.05 trillion) *
"Tax" payment made by Tullow to GoU	$313 million (or Ush 814 billion) **
What Tullow will receive from the "farm-down"	$2.9 billion (or Ush 7.54 trillion) ***

** $405 million = $283 million + $121 million[1]*
*** $313 million = $283 million + an extra $30 million*
**** $2.9 billion = $1.46 billion each from CNOOC and Total*

The Government of Uganda versus Heritage Oil

Given these disputes, the Government of Uganda is currently locked in a row with Heritage Oil over the legitimacy of the capital gains tax. In May 2011, arbitration commenced in London to resolve the dispute. (The PSA that Uganda signed with Heritage designated the United Kingdom as the jurisdiction for the resolution of disputes, a designation that has recently come under fire within Uganda by individuals who wonder why the government failed to tap Ugandan courts to arbitrate issues related to the country's

1 The figures here are rounded, which accounts for any minor discrepancies.

oil sector.) Through the proceedings in London, Heritage is seeking "the release of approximately $405 million currently on deposit with the Uganda Revenue Authority (URA) or in escrow with Standard Chartered Bank following HOGL's [Heritage Oil & Gas Ltd] sale of its interests in Uganda."[2] The Ugandan government, meanwhile, is seeking to keep the $405 million in question, plus an additional $30 million, which together would comprise the $434 million claimed as a capital gains tax.

In the midst of these arbitration proceedings in London, the Uganda Tax Tribunal took up the case, and on November 23, 2011, ruled against Heritage Oil and in favor of the Ugandan Revenue Authority. For the URA, the ruling is significant not only because it could influence the proceedings in London, but also because it would provide a precedent for future oil transactions and tax obligations. Indeed, in early 2011, Tullow approached the Government of Uganda with plans to "farm-down" a total of two-thirds of its interest in Blocks 1, 2, and 3A to two larger oil companies: China's CNOOC and France's Total. The move will trigger approximately $2.9 billion in revenue to Tullow, which could, theoretically, reap $870 million in capital gains taxes for Uganda.

Tullow Oil versus Heritage Oil

As a result of Heritage's refusal to pay the tax, Tullow Oil's relations with the Uganda government went into a downward spiral. Afraid that this dispute would affect

The capital gains tax revenue from the sale of Heritage's licenses (Ush 1.13 trillion) could pay the yearly salaries of over 209,000 primary school teachers at a monthly rate of Ush 450,000 per teacher.

its future business in the country, Tullow proposed a way to resolve this matter. Heritage would pay approximately $121 million as a "refundable deposit" to the Government of Uganda, while Tullow would withhold approximately $283 million of its payment to Heritage, and instead place the money (along with an extra $30 million from Tullow's own pocket) in an escrow account pending the resolution of Heritage's dispute with the government.

This money, which amounts to a total of $313 million ($283 million plus $30 million), is the subject of additional legal proceedings pending in London, for which Tullow is suing Heritage. Tullow's argument is that the $313 million it paid the Government of Uganda amounts to a "tax" that it paid on Heritage's behalf. [3]Heritage has countered by arguing that the $313 was a political payment for which Heritage should not be liable, and is counter-suing Tullow for the $283 million that Tullow withheld from its payment for Blocks 1 and 3A.

What's at stake?

Given the fact that the primary parties involved in these tax disputes are the Government of Uganda and Heritage Oil, one might wonder why Tullow decided to get involved at all. Furthermore, why did Tullow choose to invest so much money—money that it risked loosing, depending on the outcomes of various legal cases in London?

In order to answer these questions, it's important to understand that foremost, Tullow went out on a limb in order to meet the Ugandan government's tax requirements because it wanted to retain its assets in Uganda, which at the time, were threatened on two fronts. The first front was the potential for a hostile takeover attempt by the Italian oil company, ENI,

2 Heritage Oil Plc Press Release (16 May 2011). Accessed at http://www.heritageoilplc.com/resource/afr17ee1of10m-40lq46n97d3.pdf

3 In a press release from May 16, 2011, Heritage argued that Tullow's decision to pay URA the $313.4 million was made without Heritage's knowledge and consent, contrary to the provisions of the Sale and Purchase Agreement (SPA) and the supplementary agreement between the two companies. Heritage argued that the supplementary agreement makes it explicitly clear that Heritage alone would manage the tax dispute with the Government of Uganda. Heritage, therefore, considers that the payment made by Tullow to URA was contrary to the terms of this agreement, and thus for "Tullow's own commercial reasons." Ibid.

which wanted to purchase Heritage's stake in Blocks 1 and 3A. Tullow managed to thwart this attempt by exercising its right of pre-emption (which essentially allowed Tullow "first dibs" in purchasing Heritage's share of the exploration blocks.) The second threat came by way of the Ugandan government's decision to withhold its approval for an expedient farm-down of Tullow's subsequent total assets (Blocks 1, 2, and 3A) to CNOOC and Total. Arguably, this is no longer an effective threat, given the reported progress on the farm-down negotiations. But the delays on the publicly announced timelines have indicated cause for concern, at least as far as Tullow is concerned.

With regard to the legal proceedings in London, a number of outcomes are possible—outcomes that have significant ramifications for Uganda's oil sector. If Heritage Oil wins arbitration, then the Government of Uganda will be required to pay back the $121 million "refundable deposit" that Heritage placed in escrow. If Heritage looses, however, it will be required to pay an additional $313 million to the Ugandan government, which means that Uganda will have to return Tullow's advance payment of that amount. These legal battles are immensely importance to Tullow, first because a legal precedent will be set regarding capital gains taxes, and second because the rulings in London will likely affect the Government of Uganda's attitude toward the farm-down. The government, for instance, may hang onto its right to approve the farm-down long enough to guarantee its interest in a tax from that transaction, or alternatively, the government may require that the tax be paid in advance of the approval. Tullow, which would like the farm-down completed as soon as possible, may be agreeable to these terms. In any case, it should go without saying that the Government of Uganda, which is convinced of its right to tax (a political hot potato, considering the current climate of suspicion over various allegations clouding the sector), will be publicly aggressive in enforcing these rights as the final decision-maker on all new deals.

Tullow's farm-down to CNOOC and Total could, theoretically, give Uganda over $870 million (or Ush 2.26 trillion) in capital gains tax revenue. This is the equivalent of one-third of Uganda's total budget for the fiscal year 2010/11.

What this means for the future of Uganda's oil sector

The tax issue and the complications concerning the farm-down will, in all likelihood, only further delay any future licensing rounds for oil exploration in the country. In terms of political risk, Uganda—despite its attractiveness as a resource-endowed country—may remain dicey for investors because of the transactions surrounding these tax disputes. Arguably, both Tullow and the Government of Uganda made legally questionable deals in order to continue their partnership. That said, the insertion of formal rules into the sector (through the introduction of new laws and institutions) will be a welcome departure from the tenor of the current climate—even if the quality of these new rules is not yet known.

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