A CRITICAL EXAMINATION OF THE ITA IN OPTIMIZATION OF INCOME TAX REVENUES IN UGANDA'S OIL AND GAS INDUSTRY

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JANUARY 2021

DECLARATION

I Bernard Olok, hereby declare that this dissertation is my work and it has not been submitted before to any other institution of higher learning for fulfillment of any academic award.

Signed…………………………………

Date…………………………………….

APPROVAL

This is to certify that, this dissertation entitled "**A CRITICAL EXAMINATION OF THE ITA IN OPTIMIZATION OF INCOME TAX REVENUES IN UGANDA'S OIL AND GAS INDUSTRY**" has been done under my supervision and now it is ready for submission.

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ABSTRACT

The discovery of oil and gas in commercial quantities in Uganda is a source of great joy for the peoples of Uganda. The Government as well as the people are expectant that the oil and gas revenues will speed up socio-economic developments and drive out poverty from Uganda.

The key expectation is that the oil and gas revenues will contribute the much-needed funding to improve Uganda's physical infrastructures and improve the people's livelihood. Whereas this expectation may be true, great care should be taken to ensure that the revenues from the oil and gas industry in Uganda is safeguarded and secured through effective management of costs of petroleum exploitation.

The cost of petroleum exploitation is a significant factor in ensuring that the oil and gas resources fetch a better economic rent compared to the tourism industry as well as other agricultural activities that are currently being carried out in the Albertine Graben. The effective management of petroleum exploitation cost by the Host Government should ensure a balance between maximization of returns on investments by the International Oil Company and maximization of the Host Government revenues. This balance is a delicate but achievable by the Host Government through the design and application of effective fiscal instruments and fiscal regimes.

The effective management of costs in the oil and gas industry in Uganda will ensure optimization of the income tax from the oil and gas revenues by increasing the size of the profit oil as well as the share of the Host Government take. If the costs are managed poorly the revenues will be wiped away by the cost recovery provision under the Production Sharing Agreements as well as the ITA.

The ITA is therefore the litmus test to reveal whether the much desired oil and gas revenues will be optimized or not. The second most important determinant for optimization of the oil and gas revenues in Uganda is the institutional and legal frame work regulating petroleum activities. Where the institutions and the laws are weak, revenues from the oil and gas industry will not be optimized and the possibility of attracting an oil curse will become a high likelihood.

DEDICATION

This work is dedicated to my father Jacob Wilson Olwa and my mother Lucy Margret Achola for their encouragement not to always tire in acquiring new knowledge and to continuously learn and unlearn in this world, may the Almighty God reward you with longest life.

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General Introduction

The discovery of oil and gas in Uganda provides a new ray of hope for the peoples of Uganda through increased government revenues from oil and gas. These revenues may be realized inform of bonuses, royalties, government share of profit oil and income taxes. The study will be undertaken to find out whether income tax revenue will be optimized by critically examining whether the ITA will be efficient in optimizing revenues from the oil and gas industry in Uganda.

1.0 Background of the Problem

Uganda discovered considerable quantities of oil and gas and recently the country has shown readiness to commence commercial production.[1] It is anticipated that the commencement of the commercial production will bring in the much desired revenue that will be used to speed up the rate of economic growth and development for Uganda.[2]

Whereas the above optimism seems to keep every Ugandan expectant following the Government promise to use oil and gas revenue for infrastructure development of Uganda, those revenues have subjected Africa's largest oil and gas producing countries to excessive dependence on the petroleum sector. Research has revealed that the oil revenues have instead led to portraying oil resources as a curse as exemplified in Nigeria.[3]

World over revenue from oil and gas industry has been sourced using the predetermined fiscal instruments, examples which include Production Sharing Agreement, Service Contracts and Concession agreements. Each of the above instruments provide for income taxation alongside royalties, bonus payments and production sharing schemes. Much of the income taxation in the above fiscal instruments is left to the particular country's income tax regime as evidenced in the Uganda's ITA.[4]

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[1] Bahati W., Beyaza B; Getting a Good Deal? An Analysis of Uganda's Fiscal Regime: CRDP Working Paper Number 64 of 2018 page 1

[2] Oil and Gas Revenue Management Policy; Ministry of Finance Planning and Economic Development; February 2012

[3] Oil and Gas Revenue Management Policy; Ministry of Finance Planning and Economic Development; February 2012

[4] Article 13 of the Model Production Sharing Agreement of Uganda 2016

Therefore the ITA Chapter 340[5]as the study will show is one useful instrument in the optimization of Uganda's revenue as a country as long as taxable costs are wisely managed by key stakeholders.[6] The ITA has better impact on the countries development when compared to royalty income and bonuses paid by International Oil Companies to the Host Government.[7] If income taxation is ignored in any particular country the citizens risk disempowerment and the nation becomes a petro state.[8] This makes the Host Country very vulnerable to changes in oil and gas prices and it destroys the local economy and can lead to the oil curse.[9]

Research shows that most of the Sub-Saharan African big oil producers like Angola and Nigeria are almost failing to transform the benefits of the oil revenues to enhance their countries economic growth and development.[10]

In Ghana, the recent discoveries and commencement of oil and gas production raised much hope for the government to use it to spur economic growth and development for all its citizenry. Unfortunately, the much anticipated revenue and socio economic growth following the commencement of commercial production is not being felt in Ghana.[11]

One of the problems identified for both countries above is that both the Ghanaian Government and the Nigerian Government signed bad Production Sharing Agreements which surrendered in ignorance the countries income tax to the international oil companies.[12] This is so because of the complexity of the oil and gas industry. African Governments do not have competent human resource to undertake cost verification and monitoring of International Oil Companies in respect of capital expenditures, carry forward of losses, transfer pricing challenges, ring fencing and range

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[5] Throughout the thesis is abbreviated as the ITA

[6] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010. The authors point out the need to guard against open ended tax exemption, allowances, withholding taxes and cost recovery measures that further compromise the progressivity of a fiscal regime.

[7] Nakhle C.;Petroleum Taxation: Sharing the oil wealth: A Study of Petroleum Taxation yesterday, today and tomorrow page 27 (Routledge Studies in International Business and World Economy)

[8] Niklas R., The Geopolitics of Russian Energy; Gas, Oil and the energy security of tomorrow; ISSN 1650-1942; October 2018 page 35

[9] Niklas R., The Geopolitics of Russian Energy; Gas, Oil and the energy security of tomorrow; ISSN 1650-1942; October 2018 page 35

[10] Odusola A.; Tax Policy Reforms in Nigeria: Research Paper No. 2006/03; United Nations University: ISSN 92-9190-767 page 25

[11] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 30

[12] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 22

and limits of expenses that may be considered tax deductible expenses provided for in the Income Tax legislations of the respective countries.[13]

In the case of Uganda the ITA was amended in 2008 in order to streamline income taxation in the oil and gas industry.[14] The amendment specifically provides for taxation of incomes from the oil and gas industry while integrating oil and gas taxation within the broader scheme of income taxation in Uganda.[15]

The above law notwithstanding, the challenge still remain how to optimize income tax from the oil and gas industry in order to increase the size of the economic rent from the oil and gas industry.[16]

At the forefront in Uganda today income tax optimization can be achieved through careful approval and audit of the recoverable costs in petroleum operations. The approval of recoverable costs for International Oil Companies will require a having competent and efficient tax administration if the object of income tax optimization is to be achieved in the oil and gas industry.

1.1 Statement of the Problem

Uganda has signed Production Sharing Agreements with the International Oil Companies and oil and gas production is yet to commence.[17] These Production Sharing Agreements state that income taxation is to be determined by the tax laws applicable in Uganda.[18]

In securing the oil and gas industry revenues in Uganda, the prominent issue that arises is how to balance the competing interest of the International Oil Companies which is centered on maximization of return on their investments and government's priority of maximizing revenue from oil and gas industry. The government's problem is exacerbated by lack of adequate technical

[13] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 22
[14] PART IX A of the ITA cap 340 Laws of Uganda
[15] For example corporation tax rate of 30% is applicable to the International Oil Company as well as local companies. Similarly carry forward of losses equally apply alongside other provisions on allowable deductions
[16] Article 13 of the 2016 Model Production Sharing Agreement of Uganda provides that the International Oil Company is liable for all taxes in Uganda.
[17] Uganda has signed 7 Production Sharing Agreements with International Oil Company's
[18] See Article 13 of the Model Production Sharing Agreement

capacity[19] to verify and monitor the recoverable costs and capital investments costs provided under the ITA.[20]

The other difficulty is how to balance conflicting institutional mandate of government (Petroleum Authority of Uganda, Uganda Revenue Authority and the Auditor General's Office) of scrutinizing and approval of International Oil Companies costs. Who will approve or disapprove final costs for determination of profit oil has a fundamental role on oil and gas industry revenues in Uganda.

1.2 Purpose of the Study

The purpose of this study is to find out how the ITA can be used in optimizing revenues from Uganda's oil and gas industry by critically examining the ITA's provisions on cost recovery.

1.3 Significance of the Study

The study will be useful in understanding how the ITA can be used in optimizing revenues from Uganda's oil and gas industry. The lessons from the study will then be useful in informing tax policy and institutional reform by the Government of Uganda before Uganda's commencement of commercial oil and gas production. The study also will further the understanding of managerial aspects of the costs associated with the exploration, development and production in Uganda and how the country can optimize income tax from this sector.

1.4 Justification of the Study

The study will enable Uganda to understand aspects of managing petroleum costs and devise ways of using management knowledge to maximize revenues from the oil and gas industry.

1.5 The General objective of the study

The general objective of the study is to determine the adequacy of Uganda's ITA cost recovery provision in optimizing revenue from the oil and gas industry in Uganda.

1.6 Specific objectives of the study

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[19] See the local content policy and the Local Content Act

[20] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 21-22 paragraph 3.4

1) To determine how deductions for petroleum exploration expenditures are applied as per the provisions of the ITA and explore the impact on income tax revenue optimization in the oil and gas industry in Uganda.
2) To examine how expenditures for petroleum development are provided for under the ITA and how this impact on oil and gas income tax revenue optimization in Uganda.
3) To understand how operating expenditure impacts the optimization of revenues from income tax in the oil and gas industry in Uganda.
4) To determine how the approval and monitoring of petroleum exploration, production and operating costs impact on income tax revenue optimization in the oil and gas industry in Uganda
5) To establish how the current corporation income tax rate of 30% may be impacting on income tax revenue optimization in Uganda.

1.7 Research Questions

1. How does petroleum exploration expenditures provided under the ITA affecting the optimization of revenue from Uganda's oil and gas industry?
2. How does petroleum development expenditures provided under the ITA affect the optimization of revenues from Uganda's oil and gas industry?
3. How do petroleum operating expenditures affect the optimization of revenues from income tax in Uganda's oil and gas industry?
4. How does the monitoring of oil and gas exploration, production and operating costs impact income tax optimization in oil and gas industry in Uganda?
5. How does the corporation tax rate of 30% impact on income tax revenue optimization in the oil and gas industry in Uganda?

1.8.1 Scope of the Study

1. Temporal scope: The study will cover the period 2006 to 2016 following the discovery of Uganda's commercially viable oil and gas resources.
2. Geographical scope: The study will consider the entire Ugandan oil and gas industry.
3. Subject matter scope: The study will examine the ITA and how it can be used in optimizing income tax from the oil and gas revenues in Uganda.

1.9. The Theoretical Framework

The work will review the optimal taxation and economic rent theory with a view of giving a good theoretical appreciation of income taxation in Uganda's oil and gas industry. The research will attempt to identify areas where income tax in the oil and gas industry will be optimized in order to hasten economic growth and development of Uganda.

The two theories reviewed below will set the foundation for the conceptual framework and will be a major compass for literature review. It will also aid the understanding of the research problem as well as avail a guide for the research.

The work will consider the optimal tax theory and the economic rent theory as a basis to explain how income tax from oil and gas in Uganda can be optimized through minimization of exploration, development and operating costs.

1.9.1 Optimum Tax theory in brief

The optimal tax theory examines the optimization of income taxes from a commodity and how optimum tax can be obtained. It argues that optimum taxation can be achieved when there are profits. Mirrlees argues that income tax optimization can be achieved through an application of marginal tax rates.[21] The fundamental principle of optimal tax theory states that if an economic policy is optimal, any change in it should leave the total welfare unchanged while generating additional revenue to the government. The optimal tax theory posits that a tax system should be chosen with a view of maximizing the social welfare function but subject to a set of constraints.

Optimal tax theory is hinged on the ability to pay but without discouraging the effort of earning income.[22] In this case, care must be taken in designing tax policy which discourages the International Oil Company from maximizing its effort in the oil and gas industry through use by the Host Government of an effective cost recovery mechanism.

[21] J.A Mirrlees; Optimal Tax Theory: A Synthesis; No. 176 of May 1976,Massachussets Institute of Technology page 8
[22] Gregory Mankiw N. G, Weinzierl, Yagan D; The Optimal Taxation in theory and practice; NBER Working Paper Series 15071; National Bureau of Economic Research (June 2009) page 3

The optimal tax theory examines how a tax policy can be designed in ways that provide sufficient incentives for a high ability taxpayer and keep them producing at high levels.

1.9.2 The economic rent theory

The economic rent theory examines the opportunity cost of a factor of production over and above its next best use. For example Uganda has to choose between tourism in the Albertine region and the oil and gas exploitation. Nakhle has argued that economic rent theory is the bedrock of oil and gas taxation globally. [23]

Bina argues that the cost of oil and gas production is set higher than the benefit a country receives from its own oil and gas resources.[24]

The question that remains to be considered is how the owners of natural resource can maximize their economic rent. It is argued in this work that this can be achieved through devising an appropriate income tax regime which ensures that surplus incomes are redistributed through optimum taxation policy.

As Nakhle argues, oil and gas industry needs a special approach if its revenue is to be maximized.[25] She also argues that the best approach to petroleum taxation is having a combination of royalty income and profitability based taxes. According to Nakhle economic rent is equivalent to higher taxable capacity.

Nakhle asserts that the most desirable tax base in the oil and gas industry is the economic rent but she notes that profit based taxes less likely to be easily determined by way of policy.[26]

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[23] Nakhle C.;Petroleum Taxation: Sharing the oil wealth: A Study of Petroleum Taxation yesterday, today and tomorrow page 19 (Routledge Studies in International Business and World Economy)

[24] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 193

[25] Nakhle C., Mining and Petroleum Taxation: Principles and Practice; Revenue Mobilization and Development, IMF December 2011(Conference Paper) page 7

[26] Nakhle C.;Petroleum Taxation: Sharing the oil wealth: A Study of Petroleum Taxation yesterday, today and tomorrow page 19 (Routledge Studies in International Business and World Economy)

2.0 LITERATURE REVIEW

2.1 Introduction

The literature reviewed in this chapter builds from the key concepts in the theoretical framework considered in Chapter one. It will be undertaken analytically and objectively with a view of ascertaining what has been studied about income taxation in the oil and gas industry and how the study can guide Uganda's income tax fiscal policy.

The key challenge that the study intends to explore is how the optimization of income tax revenue can be realized in the oil and gas industry in Uganda. The study will try to seek a balance between attracting investment in the oil and gas industry and optimization of revenue through income tax fiscal instruments which are the basis of the research's objectives.

It is noted that the general oil and gas fiscal instruments such as bonus payments, royalties and government take enshrined in the Model Petroleum Sharing Agreements already has fixed percentages which makes their computation fairly easy. The challenge that remains is the task of determining the cost of exploitation/production of the oil and gas resources. The cost of production is useful in determining what profits are available to be shared by the Host Government and the International Oil Company.[27]

The International Oil company is reimbursed its contract expenses through cost oil.[28] Determination of cost oil is critical to the computation of royalties, government take and the profit oil that remains to be taxed for income tax purposes. In computing of cost oil the key fiscal income tax instruments such as allowable exploration and expenditure deductions, operating expenses and other tax deductible expenses which are provided within the ITA are applied to determine chargeable oil.

[27] Article 11.4 of the Model Production Sharing Agreement of Uganda 2016
[28] Article 11.3 of the Model Production Sharing Agreement of Uganda 2016

The determination of chargeable oil and later profit oil upon which the tax rate is applied requires that the approval of costs by the Petroleum Authority of Uganda (PAU) and an Audit by the Government. It is not clear which government department will carry out the audit but Article 28 of the Model Production Sharing Agreement states that the audit is to be carried out by the Government or an independent auditor of international repute appointed by the Government.[29] Notably, there is need for a competent oil and gas management structure within the Host Government departments with sufficient capacity to verify and approve costs in the oil and gas sector,[30] competent to assess, audit, collect and recover income tax revenue from the oil and gas sales.[31]

Therefore a critical assessment of exploration costs, development costs and operational costs as well as the technical capacity to monitor costs by government personnel is discussed to assess what the ideal standard should be in order to maximize income tax revenues in the oil and gas industry.

Nakhle reveals that determining taxable income from oil and gas production is controversial.[32] This is because economic rent is considered as a bonus and secondly the general presumption that tax based on economic rent is optimal because is likely to meet the tax criteria. As Nakhle also contends, economic rent is viewed as an important and legitimate source of government revenue since its appropriation (in theory) can take place without destroying economic incentives. She concludes that the taxation of income in the oil and gas industry is synonymous with 'plucking the goose' without losing the golden eggs.

Therefore plucking the goose without losing the golden eggs in this research on the one hand, means achieving a balance between the International Oil Company's objectives of maximizing return on investment by maximizing cost recovery through effective operationalization of the tax instruments provided under the Production Sharing Agreement. On the other hand the Host

[2929] Section 1 Annex C of the Model Production Sharing Agreement of Uganda 2016
[30] This mandate is vested in the Petroleum Authority of Uganda under Article 11 of the Model Production Sharing Agreement of Uganda 2016
[31] This role is vested in Uganda Revenue Authority under Part IXA of the ITA
[32]Nakhle C.;Petroleum Taxation: Sharing the oil wealth: A Study of Petroleum Taxation yesterday, today and tomorrow page 19 (Routledge Studies in International Business and World Economy) page 19

Government objective of maximizing revenue from the oil and gas industry through minimizing costs using an efficient and transparent cost approval and monitoring mechanism.

The analytic framework below must at the end reveal that income tax optimization in the oil and gas industry based on the current ITA is lopsided in favor of the International Oil Company. This is because specific provisions for taxing the petroleum industry under Part IXA of the ITA lifts provisions of the Production Sharing Agreements and wholesomely makes all contract expenditures under the Production Sharing Agreements tax deductible expenditures.

Below is the objective centered analysis by analysis of the relevant literature;

2.2 The Analytical Framework

Objective 1

2.2.1 Exploration Expenditure and its impact on the optimization of income tax in the oil and gas industry

Introduction

Exploration expenditure forms part and parcel of the scheme for special taxation of petroleum under part IXA of the ITA.[33]Exploration expenditures means expenditures which are incurred by a licensee in undertaking exploration authorized under a petroleum exploration right.[34]

The Act therefore does not provide an exhaustive list of what exploration expenditures are comprised of. It should however be understood that exploration expenditures are approved by the Petroleum Authority of Uganda pursuant to the Production Sharing Agreement in operation in a particular Contract Area.

Exploration expenditure that is allowed under the ITA should be understood to be those exploration expenses relating to petroleum operations where there is a commercial discovery of oil and gas. In addition the Licensee should have signed a Production Sharing Agreement with the Government in respect of that Contract Area.

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[33] See section 89 G of the ITA cap 340.

[34] Section 89 A ITA cap 340

The literature reviewed herein does not expressly discuss petroleum exploration expenditure but generally provides for allowable deductions under the ITA. Although some cases from the South African courts and English courts have generally discussed what expenditures of deriving chargeable income are comprised of. However a few selected cases in general mining industry is used to further illustrate the treatment of allowable deductions by courts. Attempts have been made to use Nigerian Courts in interpreting some tax allowable deductions in the oil and gas industry.

The detail discussions are presented below;

Bakibinga states that in order to determine chargeable income for a particular year of income certain deductions are allowed by the ITA.[35] The learned Professor further notes that deductions are allowed for expenditures and losses that are incurred by the person in production of income included in the gross income. Those expenditures and losses must be incurred in that particular year of income.[36]

The learned Professor further emphasizes that under section 22(1) of the ITA, the deductible expenditure or loss must be incurred in the production of income that are included in gross income.[37] For example directors pay and similar expenses are allowable deductions under the ITA.[38]

The learned Professor notes that the second important element under section 22(1) of the ITA is any loss arising on disposal of a business asset whether the asset is of revenue or of a capital nature.[39]

[35] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 76
[36] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 76

[37] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 76

[38] Commissioner of Income Tax vs. P.Co. and ors 1 EATC 131 (Tanganyika) Court of Appeal
[39] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 76

In the context of oil and gas industry, the loss or gain derived from disposal of business asset was considered in the case of **Tullow Uganda Limited and another vs. URA**[40] where Tax Appeals Tribunal held that income derived from disposal of a business asset is business income.

The ITA provides for deductibility of bad debts written off in the taxpayers' accounts during the year of income. The basis for deductibility of bad debts is founded upon criteria that the debt is unrecoverable and all efforts to collect the debt must have failed.[41] In addition the taxpayer reasonably believes that the debt will not be recovered.[42]Lastly the amount must be included in a person's income for the year of income.

It must be stated clearly that the debt may be in respect of money lent by the financial institution in the ordinary course of its business.[43] There is a high likelihood that this provision is relevant to the oil and gas industry in Uganda.

In conclusion, it is observable from the analyzed literature that exploration expenditure is deductible where there is discovery of oil in commercial quantities and a production Sharing Agreement is signed and an oil production license is issued. The oil exploration expenditures must be the exploration expenditures approved by Petroleum Authority of Uganda (PAU) for a specific Contract Area. It is further observed in the literature that all exploration costs approved by Petroleum Authority of Uganda may be considered as allowable contract expenditures and this may negatively impact on the optimization of income tax revenue in the oil and gas industry in Uganda. This view is shared by Amaoko-Tuffour and Owusu Ayim that cost overstatement and profit stripping may occur as a result of inadequate capacity by Host Government to control and contain costs provided in the fiscal regime.[44]

Objective 2

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[40] TAT application number 4 of 2011

[41] Commissioner of Income Tax vs. T.Ltd [1971] E.A 569 a bad debt was disallowed because there was no effort made to recover money from the guarantors.

[42] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 78

[43] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 79

[44] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 21-22 paragraph 3.4

2.3 Development expenditure and its impact on optimization of income tax in the Oil and Gas Industry

Introduction

Petroleum development expenditure means expenditure incurred by a licensee in undertaking operations authorized under a petroleum production license.[45]

In this research, it is argued that most of the petroleum development expenditures are related to expenses for the acquisition and establishment of capital assets. These are costs that ensure that an oil field in a particular contract area is developed and ready to start producing oil and gas. These expenditures ensure that oil and gas is available at the well head. It will be noted that development phase is the most expensive as well as the most capital intensive phase of the oil and gas operations.

It must also be noted that the use of the words "authorized operations" must be understood to mean development operations approved by Petroleum Authority of Uganda when approving the International Oil Company's work programs and budget for the development phase of the oil and gas industry.[46]

Below is a detailed discussion of development expenditure and its impact on the income tax optimization

Bakibinga states that as a general rule capital expenditure is not deductible for purposes of ascertaining chargeable income but only revenue expenditure is allowed as a deduction in ascertaining chargeable income.[47]This position was considered in the case of **CIR vs. George Forest Timber Co. Limited.**[48]The Supreme Court of South Africa held that money spent in acquisition of an income producing concern or source of future profits as opposed to money spent in working it is a capital expenditure and therefore not deductible.

Innes CJ noted the characteristic quality of capital as:

[45] Section 89A ITA Cap 340
[46] Article 5 Model Production Sharing Agreement 2016
[47] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 80

[48] 1924 AD 516, 1 SATC 20

"... that it is wealth employed in creating fresh wealth and invested to produce an income...."

The courts in South Africa in the above case considered ancillary works to a capital asset such as sewage disposal system in a gold mining company. The court noted that in determining whether the expenditure attached to the transaction is one of a revenue or a capital nature, the nature of the transaction must be must be examined and the purpose of the expenditure must be considered as an important factor.

Court further noted that expenditure which is incurred for the purpose of establishing, improving or adding to the equipment of income generating structure is capital expenditure and it is not allowed as a deduction; whereas the expenditure which is incurred as part of the cost of performing the income producing operation is revenue expenditure and therefore deductible.

Watermeyer CJ in **New State Areas Ltd vs. CIR**.[49] states that expenditure of a capital nature may occur when the taxpayer acquires property, plant, tools respectively as a means of production which he uses in income producing operations. These items may as well be used to expand and improve the existing earning capacity of the business. It is noted that when the expenditure is used to increase revenue generation capacity, then it is revenue expenditure and is considered as allowable deduction.

In light of the above authorities it can be deduced that petroleum development expenditure ordinarily should not be allowed as a deduction in the absence of express wordings of a Statute to that effect because it is a capital expenditure.

The challenge this presents is that the cost recovery mechanism for the oil and gas industry incorporates all costs incurred in bringing out oil and gas from underground. Therefore the cost recovery mechanism in the oil and gas industry offends the rules of income taxation and impacts negatively on the optimization of income tax in the oil and gas industry.

As already noted, the purpose of a particular expenditure is what makes it revenue or a capital expenditure. Care must therefore be taken in scrutinizing costs to ascertain whether the expenditure is one of a capital nature or of revenue expenditure. It is not clear in the oil and gas industry whether the approved costs will be monitored at the development phase by Petroleum

[49] 14 SATC page 115

Authority of Uganda or Uganda Revenue Authority or both. It is suggested that a multi departmental team comprising the Petroleum Authority of Uganda, Uganda Revenue Authority and office of the Auditor General should be appointed to approve and monitor petroleum development costs.

It is also not clear whether all the approved costs will become allowable development expenditure costs. If the question of approved costs and actual costs incurred in petroleum development is not monitored accurately, there will be a high risk of cost overstatement thus hindering the income tax revenue optimization through reduced profits[50]. This is a similar view held by Amaoko-Tuffour and Awusu-Ayim in their research.[51]

Cost of additional waterworks to support mining operations

In the case of **Palabora Mining Co Limited vs. SIR**[52] court held that the expenditure incurred in construction of additional waterworks to supplement the existing water works which was under construction by another separate company was expenditure incurred solely for the purpose of accelerating the earning of profits by the taxpayer. It was therefore deductible since it constituted an expenditure of a revenue nature.

Bakibinga notes that the general rule as to non deductibility of capital expenditure has exceptions. The statutory exceptions provide for deductibility of capital allowances such as minor repairs and capital equipment, [53] depreciable assets, [54] initial allowance for items of eligible property,[55]industrial building allowance,[56] start up costs[57] and costs of intangible assets.[58]

It is worth noting that the consideration of whether an asset qualifies as a capital asset (plant and machinery) will very much depend on the nature of the taxpayer's business. The English courts

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[50] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 21-22 paragraph 3.4

[51] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 21-22 paragraph 3.4

[52] 35 SATC page159
[53] Section 26 ITA
[54] Section 27 ITA
[55] Section 27 A
[56] Section 29 ITA
[57] Section 30 ITA
[58] Section 31 ITA

have tried to distinguish objects used for purpose of a business and the objects which simply form a setting in which the business is carried on as not being plants.[59]

Ormerod L.J in John Good and Sons Ltd's case[60] states that some items may be excluded from the definition of plant because it is more a part of the setting than part of the apparatus for carrying on trade. This view was premised on the nature of the trade carried on by the taxpayer.

The courts approach of distinguishing an object used for purpose of a business and the objects which simply form a setting in which a business is carried out has attracted a lot of litigation. The courts have however dealt with the distinction on a case by case basis and for the plants which qualify it will be held by the courts to be so. Unfortunately this may complicate revenue administration at the time of accounting and audit.

None the less the problems of distinguishing plant and machinery and its business purpose will not arise in the context of oil and gas industry. This is because all expenses of acquisition of and establishment of capital assets used in petroleum development will be considered contract expenses and allowed as a deduction to the International Oil Company.

Similarly, Lord Denning M.R pointed out in **Bridge House (Reigate Hill) Ltd vs. Hinder**[61] that whether an object will be categorized as plant or not is a matter of impression depending on the setting in which the business is carried on.

How the above views will be handled by the courts in the context of oil and gas industry development seems to be that development expenditure which incorporates cost of acquisition or construction of capital assets like well drilling and casing machinery will be allowed as petroleum development expenditure. [62] The most likely treatment might be that all items of a capital nature used in the petroleum exploration and development operations might qualify as deductions as per the criteria under the ITA as amended.

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[59] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 87

[60] [1963]1 All ER 141
[61] (1971) 47 T.C 182
[62] Section 89(2) & (3) of the ITA Cap 340.

There is a remote likelihood that the above common law principles may be applicable in Uganda although their applicability will depend on the circumstance of each case. It is noted that the provisions of the Act which allow for deductibility of all petroleum development expenditure on acquisition of capital assets used in petroleum exploitation will negatively impact on the optimization of income tax in the oil and gas industry in Uganda.

This will very much be in line with the argument presented by Bina that the International Oil Companies set a very high price of its capital, labour and entrepreneurship for the global oil and gas industry so that the economic rent obtainable by the state is greatly reduced by such costs.[63]

This seems to confirm the view that in the oil and gas industry because of the high risks involved the profitability of the oil and gas industry is guaranteed through extravagant cost recovery instrument in the Production Sharing Agreements and the provisions of the ITA which approves of such costs.

Repairs

In the case of **Bed-Odeco vs. Powlson**[64]court disregarded interests and fees on acquisition of loans to finance oil rig construction and observed that such expenditure was not incurred on the provision of an oil rig. Court noted that the expenditure was for the provision of finance and not the provision of a plant. In the Ugandan case the Production Sharing Agreement limits interest on loans acquired for petroleum development to 50% of the total development expenditure and the interest should not be higher than London Inter Bank Offer Rate (LIBOR) a globally accepted key benchmark interest rate that indicates borrowing cost between the banks.

Expenses incidental to acquisition of capital assets

Lord Russel in **Bed-Odeco vs. Powlson**[65] set a permissible limit on capital expenditure and said that qualifying capital expenditure is not limited to the price paid to the supplier but includes transport from the supplier premises to the place of the user if it forms part of the price for the

[63] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 193

[64] [1978] 2 All ER 1111
[65] [1978] 2 All ER 1111

plant. It includes other expenditures in addition to the price paid to the supplier which would qualify on similar grounds. Suffice to note that this was catered for in the Production Sharing Agreement and it is recoverable under the Agreement as being contract costs.

Lord Wilberforce in **Bed-Odeco vs. Powlson**[66] noted that the expenditure on capital equipment includes transport, installation and does not extend to expenditures more remote in purpose.

Capital Allowances Deductions from the perspective of the Nigerian petroleum industry

Idubor and Asada note that capital allowance deduction is granted to the International Oil Company under the Petroleum Profit Tax Act (PPTA).[67] They explain that the chargeable profit equals to assessable profit less capital allowances.[68] For deductible capital allowances to apply, the amount of tax chargeable on the company should not be less than 15% of the tax which would be chargeable on the company for the period if no deduction were to be made under section 20 of the Petroleum Profit Tax Act.

The above authors note that the amount allowed as capital deduction is an aggregate amount computed under the 2nd Schedule of the PPTA. Or a sum equal to 85% of the assessable profits of the accounting period less 17% of the total amount of deduction allowed as petroleum investment allowance, whichever is less.[69]

Idubor and Asada further note that the capital allowance are granted for qualifying capital expenditure at the rate of 20% (1-4 years), 19% for the 5th year and1% of asset value is retained in the books of accounts until the asset is disposed.[70]

The above authors further note that investment tax credit is available as a tax off-set where crude oil producing company executes Production Sharing Contract with the Nigeria National Petroleum Company.[71] It is a qualifying expenditure necessary for petroleum operations, placed into use

[66] [1978] 2 All ER 1111
[67] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195
[68] Section 20 PPTA
[69] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195

[70] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195
[71] Section 22 PPTA, 2nd Schedule

during the accounting period. It is for assets first used in such operation. It has 2 separate rates 5% for on-shore and 10% for off-shore operations that includes100 meter of water depth.[72]

A qualifying capital expenditure (QCE) incurred by an International Oil Company creates a balancing charge where a company recoups all its claimed QCE on an asset. It is noted that the general tax incentive in the Petroleum Profit Tax Act might be lost in ambiguity in these Acts. Okoro and Obutte have argued that this gives rise to the challenge of interpretation that necessitates specialist tax consultants and law firms. This has attracted protracted costly litigation for the oil and gas revenue in Nigeria.[73]

It is to be noted that the provisions for capital allowance deductions applicable in Nigeria are in many respects similar to those found in the Uganda ITA. The Nigerian capital allowance deductions could be described as extravagant and simply eroding the tax base.

It might be pointed out that the capital allowance deductions provided under the ITA may also allow for 100% recovery of the cost of acquisition, installation or construction of the asset, plant or machinery falling under the capital allowance deductions. Similarly its impact is to reduce the amount of profit oil available. Therefore the capital allowance deductions under the current ITA are unlikely to enable optimization of income tax in their present form.

It was noted earlier in this work that expenditures on the acquisition of capital assets as a general rule are not deductible save for certain specified exceptions. It is observed that the general rule seems to be applicable in the oil and gas industry as the norm without any of the aforesaid exceptions. In such cases it reduces the size of economic rent and consequently reducing the available income tax to the Host Government.

[72] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 196

[73] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol. 7 Issue 2 February 2018 page 11

The special consideration of experience from Nigeria in respect of petroleum development expenditure

It is observed by this study that Nigeria's income tax fiscal regime provides very generous deductions for petroleum development expenditure which increases the International Oil Company's petroleum exploitation and development expenditure. These features are quite often bound to encourage excessive tax incentives by providing for extravagant tax deductions.

Okoro and Obutte state that a tax incentive is a creation of the tax law and it is aimed at encouraging particular activities in the economy.[74] It refers to various standards, rates and regulatory modes created by law to encourage and motivate investment in the sector. Okoro and Obutte argue that they are flexible instruments in laws, policies and contracts that lessen tax burden for categories of persons and businesses. It takes the form of tax reliefs, tax holidays, allowances and deductions for the benefit of a targeted group of taxpayers.[75]

Investment tax credit as a deduction from chargeable petroleum tax

It is claimed based on the provisions of the Petroleum Profit Tax Act (PPTA).[76] International Oil Companies which executed Production Sharing Contracts with Nigeria National Petroleum Company in 1993 are entitled to claim investment tax credit throughout the duration of the production sharing contract. It is provided as an offset against tax in accordance with the Production Sharing Contract. The investment tax credit is 50% of the rate of chargeable profit for the duration of the Production Sharing Contract. In computing the tax payable, the investment tax credit shall be applicable in full to the petroleum operations in the contract area so that the chargeable tax is the amount of chargeable tax less the investment tax credit. The tax credit covers the entire oil and gas industry from exploration to production.[77]

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[74] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol 7 Issue 2 February 2018 page 10
[75] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol 7 Issue 2 February 2018 page 10
[76] Section 22 PPTA Cap 13(2004)
[77] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 194

The critique of the above incentive is that it erodes the tax base.[78] Therefore income tax cannot be optimized under such tax policy instrument. Fortunately Uganda's ITA as well as the Production Sharing Agreements does not have such deductible tax credit.

Idubor and Asada have argued that tax deductible incentives and deductible allowances accruable to the International Oil Company's is in recognition by Nigerian National Petroleum Company and the Ministry of Petroleum Resources that the International Oil Companies face enormous financial burden like high cost of investments, the tax regime and the volatile nature of the Niger Delta region.[79] Thus the allowances and incentives that are used as mechanisms for encouraging investment in the oil and gas industry by Nigeria National Petroleum Company is wider in scope and application. These take the form of petroleum investment tax (credit) allowance and allowable expenditure deductions.[80]

2.3.4 Exemption of income against double taxation

Okoro and Obutte have argued that taxed incentive against double taxation deals profits under the Petroleum Profit Tax Act and exempts income or dividends paid out of the taxed profits under the Petroleum Profit Tax Act.[81] This criterion is meant to prevent double taxation. It considers withholding tax under Personal Income Tax and Corporation Income Tax.[82]

The amounts considered under section 60 of the Petroleum Profit Tax Act must have also been considered in the computing chargeable profits upon which tax is charged, assessed and paid.

As was pointed out by Mirrlees in the optimum tax theory, the obstacle to income tax optimization includes tax treaties and double taxation agreements.[83] This means that double taxation treaties

[78] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 21-22 paragraph 3.4

[79] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195

[80] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195

[81] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol. 7 Issue 2 February 2018 page12

[82] Section 60 and section 9 of the PPTA read together.

[83] J.A Mirrlees, Theory of Optimal Taxation (Nuffield College Oxford) page 1246

impact on oil and gas industry revenues by reducing the incomes available for taxation by the Host Government.

Uganda through its Production Sharing Agreement expressly prohibits deduction of any income tax payable in Uganda or the government of a foreign country. The only grey area under the ITA is section 21 (af) which exempts income of an operator outside an industrial park in case of a foreigner whose investment capital is United States Dollars 15 million. The income is exempt for 5 years from the date of commencement of investment. This provision is silent on its operation in the oil and gas industry hence leaving a loophole for tax loss as well as litigation.

2.3.5 Pioneer Status

This is another tax incentive meant to give a company preferred position in getting established.[84] It is applicable where investment is first of its kind or the existing industry is not producing in sufficient quantities to meet the current expected market requirement. It applies to an industry with a high prospect of development.[85]

The pioneer status incentive is limited to the Companies Income Tax and does not apply to Petroleum Profit Tax Act. Pioneer status is granted for an initial period of 3 years and renewable twice for one year each and runs for a maximum of 5 years.

Odusola notes that the Nigerian tax system oil and gas tax system is characterized by complex and distortionary inequitable taxation provisions. He argues that tax waivers, tax holidays and allowances are falling short of positive effect in Nigeria and have failed to boost economic activity.[86]

In conclusion, tax incentives are impacting the scope of tax deductions in Nigeria's oil and gas industry particularly because in most cases these are seen as fiscal instruments which can be used to encourage foreign direct investments in the oil and gas industry. Ultimately it is worth ensuring

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[84] The Industrial Development (Income Tax Relief) Act Cap 17 Laws of the Federation of Nigeria.

[85] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol. 7 Issue 2 February 2018 page 12

[86] Odusola A.; Tax Policy Reforms Nigeria: Research Paper No. 2006/03; United Nations University : ISSN 92-9190-767 page 25

that the tax policies are carefully designed and implemented if they are to aid the optimal attainment of revenue in the oil and gas industry.

It should be further noted that a poorly designed tax incentive has an effect of reducing the profit oil and the Host Government's take hence leading to the resource nationalism. A poorly designed tax incentive also can simply lay a trap for capital outflow and poor harvest of natural resources. Therefore petroleum tax incentives must be designed to achieve the objective of revenue optimization by Host Government while encouraging investment in the heavily capital intensive and very expensive oil and gas industry.

Objective 3

Operating expenditure and its impact on the oil and gas industry

Introduction

Operating expenditure is the expenditure not falling under exploration expenditure and does not fall under development expenditure**.** It is defined as all necessary, appropriate and economical expenditures incurred in petroleum activities after start of commercial production.[87]

In the language of the ITA this can simply be understood as the expenses of deriving income under the general scheme of the Act.[88]In the context of this research it is the other expenses which do not fall under exploration or development expenditure either directly or through apportionment by the Production Sharing Agreements. It forms an integral part of cost oil[89] and is very critical in determining profit oil or profit gas. The discussion of operating expenses is considered below;

As mentioned above, cost oil refers to the portion of oil produced and retained by the Licensee as reimbursement for costs of exploration, development and production.[90] There is a cost recovery

[87]Uganda Model Production Sharing Agreement Section 2.3
[88] This expenditure is usually provided for under section 22 of the ITA Cap 340
[89] Defined by section 4(e) of the Income Tax Amendment Act as contractor's entitlement to a share of production as cost recovery under a Production Sharing Agreement
[90] Oil and Gas Revenue Management Policy; Ministry of Finance Planning and Economic Development; February 2012 page 12

limit set by the Production Sharing Agreement of 60% per year of total production after deduction of royalties. The 40% costs are carried forward to the subsequent year until full recovery is made.[91]

Not all costs incurred by the Licensee are recoverable. Only costs approved by the government are recoverable.[92] It is worth noting that the approved costs are not necessarily allowable costs for tax purposes. It is the mandate of Petroleum Authority of Uganda to approve costs, budgets and work plans and carry out compliance monitoring.[93] Uganda Revenue Authority conducts tax audits using the provisions of the ITA.[94] Uganda Revenue Authority's audit is limited to financial audits.[95] The Auditor General may be required by Petroleum Authority of Uganda to conduct oil and gas compliance and statutory audits under section 22 of the National Audit Act Number 7 of 2008.[96]

Operating expenditure deductions for oil and gas industry defined

Okoro Obutte argues that operating expenditure is the most common form of tax incentive available in the oil and gas industry.[97] He states that in the case of Nigeria, the expenditure must be wholly, exclusively and necessarily incurred in the production of income in the specific fiscal year and must be incurred within or outside Nigeria for the purposes of petroleum operations.[98]

The Ugandan Production Sharing Agreement adopts the use of the wording necessary, appropriate and economical while allocating costs and expenditures in petroleum operations.[99] The Uganda Model Production Sharing Agreement 2016 restricts expenditures to a specific contract area and

[91] Oil and Gas Revenue Management Policy; Ministry of Finance Planning and Economic Development; February 2012
[92] Oil and Gas Revenue Management Policy; Ministry of Finance Planning and Economic Development; February 2012
[93] Article 11 of the Model Production Sharing Agreement of Uganda 2016
[94] Section 3 of the URA Act
[95] Section 3 of the URA Act
[96] Section 10 (3) of the Petroleum(Exploration, Development and Production) Act No. 3 of 2013 requires Petroleum Authority of Uganda consult and cooperate to the greatest extent possible with Government ministries and departments and agencies having duties, aims or functions related to those of the Petroleum Authority of Uganda
[97] Okoro J., Obutte P; Tax Incentive as a tool for Marginal Field Development in Nigeria: International Journal of Innovative Research and Development Vol 7 issue 2, Feb 2018

[98] Okoro J., Obutte P; Tax Incentive as a tool for Marginal Field Development in Nigeria: International Journal of Innovative Research and Development Vol 7 issue 2, Feb 2018
[99] Section 2 Annex C of the Kanywataba Production Sharing Agreement between Tullow Uganda Limited and the Government of Uganda. The same wordings are used in the 2016 Model Production Sharing Agreement.

does not allow other expenses incurred outside Uganda unless expressly stated in Production Sharing Agreement.[100]

The above restriction can support income tax maximization by extending the restriction to non deductible expenditure expenses incurred outside Uganda. This provision is further supported by the ring fencing provision in the contract area where costs are limited to a particular contract area and cannot be consolidated with costs from other contract areas.[101]

Idubor and Asada have argued that the oil and gas industry is unique because it is heavily capital intensive in development and exploitation.[102] They further argue that it involves a sophisticated and complex organization but having huge financial rewards for the International Oil Company. In Nigeria, it is characterized by high environmental pollution costs and lack of trained indigenous personnel.[103]

2.2.2 The impact of allowable expenditure on the oil and gas industry revenues

The allowable expenditures are contained under the provision of cost oil enshrined in the production sharing contracts.[104] The operating mechanism is that the International Oil Company operates at its sole risk and expense under the control of the host government. The International Oil Company is entitled to recover its costs out of the production from a contract area through cost oil.[105] The balance of the production referred to as profit oil is shared on a predetermined percentage split between the Host Government and the International Oil Company.[106] The International Oil Company's income is liable to taxation.[107]

[100] Income Tax Amendment Act 2010 Section 4(c) Defines contract area to mean an area subject of a petroleum agreement.
[101] The Income Tax Amendment Act 2010 section 4 (c) defines a contract area as an area subject of a petroleum agreement.
[102] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 188
[103] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 188
[104] Section 4 Income Tax Amendment Act 2010 defines allowable contract expenditure as deductions that may be allowed for purposes of ascertaining chargeable income from petroleum operations.
[105] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 14
[106] Article 12 of the Model Production Sharing Agreement 2016
[107] Article 13of the Model Production Sharing Agreement 2016

After cost recovery, the equipment and installations become property of the Host Government at the outset or progressively through amortization schedules.[108]

Atsegbua argued that the Production Sharing Contract signed between Nigeria National Petroleum Company and AON in 1979 for a period of 20 years provided that AON was entitled to recover its costs from the production of oil and gas in commercial quantities.[109] It allowed AON to recover interest expenses on money borrowed for operation but its reimbursable costs was limited to 40% of the recoverable costs per annum of the available crude oil. Any unrecovered costs from previous years were carried forward until fully recovered by AON.[110]

As noted by Atsegbua above, the deduction of interest expenses from borrowed funds for operations was recoverable by the International Oil Company fully in Nigeria. The wordings "petroleum operations" is wide enough to cover petroleum exploration and development costs.

In Uganda's case, borrowing is limited to the development phase and funds borrowed must not exceed 50% of the total approved costs of development of a contract area.[111] The rate must not be above London Interbank Offer Rate.[112] This is restrictive and allows for minimization of contract expenditures. The problem with the Nigeria's Production Sharing Agreement did not provide limits to what can be borrowed and the rate at which the interest should be charged. This has the effect of inflating interest expenses and reducing the size of profit oil.

Atsegbua explains that after allocation of cost oil, the remaining 60% is divided on 50% basis between Host Government and AON. The net realizable price of 30% allocated to AON pays

[108] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 14

[109] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 14

[110] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 14

[111] Annex B, Section 3(l) of the Model Production Sharing Agreement 2016

[112] Annex B, Section 3(l) of the Model Production Sharing Agreement 2016

petroleum profit tax on its share.[113] The remaining balance is termed profit oil and shared in the ratio 65:35 between the Host Government and the International Oil Company.[114]

The 40% cost oil enables the International Oil Company to obtain quick reimbursements of exploration, development and other operating costs they have incurred. The Host Government may reduce the 40% recovery limit when the price of oil is high.[115]What is noted is that Nigeria National Petroleum Company pays tax on its share of the profit oil normally through International Oil Company as a matter of administrative convenience.

Samanhyia and Samanhyia argue that the Nigeria National Petroleum Company- AON production sharing contracts were found to be lopsided in favor of International Oil Company. It should be noted that the real problem in optimization of the oil and gas revenues lies in the details of terms of the fiscal instrument used.[116]

It is noted by Samanhyia and Samanhyia that the Nigerian National Petroleum Company was using service contracts by 1993.[117] The main difference between the service contract and the production sharing contract lies in the mechanism for recovery of costs and remuneration of contractors.

Atsegbua has argued that under risk service contracts, the national oil company is the owner of the petroleum resources and the International Oil Company's role is limited to making available its financial and technological resources.[118] The International Oil Company takes all the risks and avails all the necessary investment through provision of capital for exploration and exploitation. International Oil Company only is reimbursed its expenses upon discovery of the oil in commercial

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[113] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 15

[114] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 15

[115] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 15

[116] Samanhyia F., Samanhyia S.; Fiscal Regime of Ghana's Oil and Gas Industry: A Pre- Commercial Production Review: European Journal of Business and Accountancy Volume 4, No.9 of 2016 (ISSN 2056-6018) 65

[117] Samanhyia F., Samanhyia S.; Fiscal Regime of Ghana's Oil and Gas Industry: A Pre- Commercial Production Review: European Journal of Business and Accountancy Volume 4, No.9 of 2016 (ISSN 2056-6018) 65

[118] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 20

quantities. The Host Government represented by Nigeria National Petroleum Company takes over the operations usually upon completion of development phase and commencement of commercial production.[119]

The International Oil Company will be reimbursed its costs of exploration and exploitation in cash according to a predetermined formula over a number of years. The risk service contracts were meant to remedy the defects in the Production Sharing Contracts relating to cost recovery oil, taxation oil and windfall gains and to reinstate control over natural resources.

Idubor and Asada state that currently Nigeria is using Joint Venture Agreements for 97% of its total crude oil production with a petroleum profit tax rate of 85%.[120]

As highlighted above, costs and the reimbursement of costs is very critical in the oil and gas revenue optimization. Costs can significantly reduce the size of the economic rent hence eroding the tax base.

In Nigeria, Idubor and Asada have noted that the allowable expenses which form the basis of costs for the International Oil Company comprise the following;[121]

a) Royalties for locally disposed chargeable oil incurred during the period in respect of oil and natural gas sold and actually delivered to Nigeria National Petroleum Company.
b) All non productive rents including rents incurred by the International Oil Company in respect of land and buildings under oil prospecting license
c) Specified customs and excise duties incurred during the year in respect of plant storage tanks, pipelines, tools, machinery and equipment essential for use in the oil companies operation
d) Gifts and donations
e) Interest expenses for monies borrowed by the International Oil Company as capital for carrying out petroleum operation and include interest on intercompany loans obtainable in

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[119] Atsegbua L., Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 20

[120] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 193

[121] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 194

the open market; that is the London Inter Bank Offer Rate by companies engaged in crude oil production in Nigeria.

f) Repairs for plant, machinery and fixtures used in carrying out petroleum operations. This includes the cost of renewal, repair or alteration of any implement, utensil or article so employed.
g) Bad debts or doubtful debts incurred by the International Oil Company in the accounting period for which the adjusted profits are being ascertained.
h) Any other expenditure (tangible drilling costs directly incurred in connection with drilling and appraisal of development well. This however excludes deductions allowed under any other provision of the Act.[122]
i) Contributions to pension schemes approved by the Board
j) All sums incurred by the International Oil Company in respect of Federal Government, state or local government council by way of customs duty, excise duty, stamp duty, education tax excluding tax imposed by the Petroleum Profit Tax Act, any other rate, fees or like charges.

The above are specific categories of allowable expenditures that are available to the International Oil Company operating in Nigeria's oil and gas industry.

The other allowable expenditure deductions include[123] all outgoings and expenses wholly, inclusively, and necessarily incurred for the purposes of petroleum operation. The Supreme Court of Nigeria held that;

i) Foreign exchange losses were losses incidental for Shell to pay debts for purposes of petroleum operations. The Supreme Court noted that this loss arose from the agreement between Shell and the Federal Government Directive and reasoned that if payment of tax had been made in local currency, no exchange losses would have been incurred.

[122] Section 10 of the Petroleum Profit Tax

[123] Shell Petroleum Development Company Ltd vs. Federal Board of Inland Revenue (1996) 8 NWLR part 466 at page 285

ii) Payment of central bank charges on the directive of the Federal Government were expenses incurred in the course of Shell's business which was petroleum operations hence a deductible expenditure

iii) Scholarship expenses where deductible expenses because it was statutory obligation to be observed as a condition to be performed by Shell, therefore it is expenses incidental to carrying on of Shell's business.

The above Supreme Court decision set a precedent for later cases such as *Gulf Oil Company Nigeria Limited vs. Federal Board of Inland Revenue.*[124]

The view expressed by Bina which I agree with, is still very alive because his opinion is that the International Oil Companies take up a large portion of the economic rent inform of payment for capital and entrepreneurship.[125] This places the Host Government in a disadvantaged position because the production costs are set very high in comparison to the production costs global standard set by the aging United States oil fields.[126] It should be noted that costs are pertinent part of profit maximization goal for the International Oil Companies while seeking to reduce available profits for the Host Government.

Atsegbua has argued that the costs in the oil and gas industry are well rooted in stabilization clauses which protect the interests of the International Oil Companies against unilateral change in the law of the host country.[127] Ya'u reveals that International Oil Companies are involved in enormous tax evasion and avoidance which hinders oil income growth. International Oil Companies are said to use different schemes to claim tax re-charges, technical fees, royalties and under reporting of profits to avoid paying tax in Nigeria.[128]

[124] (1997) 7 NWLR (part 514) at 699
[125] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 198

[126] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 198

[127] Atsegbua L., Acquisistion of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 26
[128] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

I agree with the views of the above 2 authors and opine that the Host Government should develop sufficient capacity and competence to verify and monitor International Oil Companies costs as well as operations in order to avoid overstatement of costs by the International Oil Companies.

Natural Resource Governance Charter studies show that provisions for cost recovery are fiscal instruments in their own right. They determine the extent and pace of investor recovery of costs under profit taxes or production sharing.[129]

The above group further argues that decommissioning costs are allowed to be deducted from the decommissioning fund established by the International Oil Company based on estimates of decommissioning costs. It arises in the event of advance field abandonment or mine closure.[130]

From the literature reviewed it is observed that allowable expenditure deductions are critical fiscal instruments in generation of tax revenues. Allowable expenditure deductions are a form of tax incentive that encourage or discourage investments in the oil and gas industry.

The impact of costs on oil revenue directly affect the size of the profits available to be charged to tax taking into consideration the general fiscal regime in place in a particular country.

Like Nakhle observed, the devil is in the detail of these costs[131] and availability of complete and transparent information about the dealings of the taxpayer as pointed out by Mirrlees is very important.[132] Otherwise all revenue can be lost in allowable expenditure deduction just like it seems to be the case with the Nigerian oil and gas industry.[133]

As pointed out by Bina, the costs in the oil and gas industry were set by the IOCs with the aim of maximizing their return on the capital invested in the oil and gas industry.[134] Its role if not well

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[129] Natural Resource Charter; Precept 4: Fiscal Regime and Contract Terms Technical Guide; https://resourcegovernance.org page 20

[130] Natural Resource Charter; Precept 4: Fiscal Regime and Contract Terms Technical Guide; https://resourcegovernance.org page 31

[131] Nakhle C.; Mining and Petroleum Taxation: Principles and Practice, Revenue Mobilization and Development, IMF Conference Paper December 2011 page 7

[132] J.A Mirrlees, Theory of Optimal Taxation (Nuffield College Oxford) page 1246

[133] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

[134] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 193

balanced will greatly reduce the size of the economic rent which is the tax base for the petroleum industry.

Objective 4

2.5 Approval and monitoring of petroleum costs and its effect on the oil and gas revenues

The problem is the conflicting mandate in audit of costs and the different reporting lines. The Uganda Revenue Authority (URA) reports to Ministry of Finance[135] while Auditor General Reports to Parliament of Uganda and other designated bodies[136] and Petroleum Authority of Uganda who approves costs reported to the Ministry of Energy.[137]

The second problem is inadequate technical capacity to approve and monitor costs[138] as well as audit and report accurate costs amidst hardships of transfer pricing challenges.[139] It is argued in this research that Uganda Revenue Authority may disallow approved costs for reasons that such costs are not incurred in the production of income or that it is not at arm's length transaction. Arms length transaction is that transaction which is between 2 independent parties who are on equal footing and the transaction is guided by the prevailing market conditions and price.

As studies will reveal, such challenges call for competent tax administration and efficient and capable Petroleum Authority of Uganda as well as a well functioning audit function as required by the Production Sharing Agreement. In absence of theses bodies with relevant technical competencies there will be no room for optimization of income tax and let alone revenue maximization by the Host Government.

Abiola and Asiweh define tax administration as government administrative structure that is entrusted with the responsibilities for tax policy implementation in the country.[140] Tax

[135] Section 4 of the URA Act
[136] Section 20 of the National Audit Act Number 7 of 2008
[137] Section 13 of the Upstream ActAct Number 3 of 2013
[138] Amaoko-Tuffour J. and Awusu-Ayim J.; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol. 4 December 2010 page 21-22
[139] Model Production Sharing Agreement of Uganda 2016 provides that petroleum operation cost must be approved by Petroleum Authority of Uganda. And the Audit of costs and compliance is to be done by the Auditor General or any appointed auditor of international repute.
[140] Abiola and Asiweh 2012 cited by Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

administration efficiency involves tax policy administration; modern and efficient tax processes (taxpayer registration, tax assessments and collections) and competent staff.[141]

I agree with Idubor and Asada that tax administration is central to revenue optimization in the oil and gas industry. They state that the International Oil Company have evasive attitude towards tax payment and that they do not want to pay royalties and taxes and this often invite tax audits.[142] Ya'u has noted that in Nigeria there are rampant cases of tax payment mal practices by International Oil Companies to the Federal Government and notes that tax evasion and avoidance hinders oil income growth for the Host Government[143]. Idubor and Asada further note that the accounts statements of the International Oil Companies are shrouded in mystery and this problem is exacerbated by slow dispute resolution mechanism in Nigeria which takes on average 20 years to resolve.[144]

Ya'u notes that the schemes for tax evasion and avoidance include claim of tax re-charges, technical fees, royalties and under reporting of profits in order to avoid paying taxes in Nigeria.[145]

According to Organization for Economic Co-operation and Development (OECD) 2011 report, tax administration efficiency allows government to generate more revenue using lower tax rates. Tax administration also reduces costs and ensures better services to businesses and citizens.[146]

Natural Resource Governance Charter notes that tax administration simplicity and efficiency are affected by lack of expertise from government. This can result in a tax gap. That is the amount government should receive and the amount it actually receives.[147]

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[141] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

[142] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195

[143] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

[144] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 196

[145] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

[146] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

[147] Natural Resource Governance Charter; Precept 4: https://resourcegovernance.org at page 4

It is argued by Natural Resource Governance Charter that the tax gap can be controlled through enhanced capacity of tax authority and other institutions as well as a simplified fiscal system[148]. This is consistent with the optimum tax theory advanced by Mirrlees.[149]

It is observed that administrative capacity of governments can be developed through developing capacity in compliance audits and simplifying sector fiscal regimes. Another observation is that when fiscal regimes are simple to administer, such fiscal regime will eliminate the opportunities for discretion and potential corrupt practices.[150]

It is observed by Odusola that the common problems in tax administration in Nigeria include low income tax revenue yield.[151] This is because of illiteracy and poor relations between the taxpayer and income tax authorities.[152] In addition to unqualified human resource personnel, deficient tax administration, complex tax legislation, taxpayer apathy, lack of a unified tax code, rampant tax evasion and avoidance, corruption and limited revenue services.[153]

As already noted above tax administration capacity to audit and assess oil companies has a direct effect on revenue generation and growth. An efficient tax administration with unified and simple tax laws will lead to an increase in revenue collection. The study will test this finding against tax administration effects on oil and gas revenues in Uganda.

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[148] Natural Resource Governance Charter; Precept 4: https://resourcegovernance.org page 5

[149] J.A Mirrlees, Theory of Optimal Taxation (Nuffield College Oxford) page 1246

[150] Natural Resource Governance Charter; Precept 4: https://resourcegovernance.org page 6

[151] Odusola A.; Tax Policy Reforms Nigeria: Research Paper No. 2006/03; United Nations University : ISSN 92-9190-767 page 21

[152] Odusola A.; Tax Policy Reforms Nigeria: Research Paper No. 2006/03; United Nations University : ISSN 92-9190-767 page 21

[153] Odusola A.; Tax Policy Reforms Nigeria: Research Paper No. 2006/03; United Nations University : ISSN 92-9190-767 page 21

Objective 5

2.4 Tax Rates and Its Impact on the Income Taxation in the Oil and Gas Industry Revenues

Tax rate is defined as the proportion or share of taxes that is applied on chargeable profits of a company.[154] It is argued that lower tax rate helps to reduce tax burden of larger businesses while high tax rates decrease compliance. It is further observed that tax evasion increases as marginal tax rates increase and that marginal tax rates have an effect of under reporting of income.[155]

The two different tax rates applicable to the Nigeria's oil and gas industry are categorically classified into 85% for normal petroleum profit tax and 65.75 for the new fields before production. The new field rate of 65.75% is applicable for 5 years before production. After the 5 years, the rate increases to 85%.[156]

The assessable tax for any accounting period of the company is 85% of its chargeable profit for that period.[157] Section 1(2) of the Petroleum Profit Tax Act provides for the rate of 65.75% for new fields before production. The study observed that the tax rate of 85% is the highest in the world and inflexible and it is a heavy burden to the International Oil Company.[158]

Studies on tax rates effect on tax compliance reveal inconsistent findings. Allingham and Sandmo (1972) Alm, Sanchez and De Juan(1995) and Mashud et al (2014) found that higher tax rates increases compliance.[159] While Freindland, Maital and Ruteberg (1987); Collins and Plumlee 1991, Alm, Jackson and Mckee 1992, Park and Hyun 2003 found that higher tax rates increases tax evasion.[160]

[154] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

[155] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

[156] Atsegbua L.; Acquisition of Rights under the Contractual Joint Venture in Nigeria; Journal of African Law Volume 37 Issue 01 March 1993 page 194

[157] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 194. The author was considering section 1 of the PPTA.

[158] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195

[159] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

[160] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 164

The study therefore seeks to find out what the impact of tax rates of 30% will be on the oil and gas industry revenues in Uganda. The tax rate of 30% chosen by Uganda seems calculated to fall within the world average rates of tax for petroleum industries which is between 30-35% of the chargeable profit oil.[161]

The right balance in my opinion is not to set a very high tax rate. It advisable that Uganda designs fiscal instruments for the oil and gas industry with a view to achieving a balance between revenue optimization by the government and a fair but adequate return on capital invested. Care must be taken in identifying, verifying and monitoring provisions for recovery of costs in petroleum production. According to Nakhle, this can be achieved through use of a combination of fiscal instruments including the use of profitability based taxes.[162]

2.6 Summary of the Literature objective by objective

Objective 1

The studies show that allowable expenditures deductions are fiscal instruments. This instrument is costs that directly impact on the revenue in the oil and gas industry. Extravagant and reckless costs can reduce the size of the profit available to be shared by the government. It has the effect of eroding the tax base by reducing the size of economic rent.

Studies reveal that there is need for transparent and complete information system in the oil and gas industry. Otherwise International Oil Companies will take advantage of the information gap by not availing complete information on costs incurred. This may lead to overstatement of costs and under reporting of income.

Objective 2

Petroleum Development Expenditure is a capital expenditure by nature and purpose. It is incurred by the Licensee in the development of an oil field so that oil and gas can be produced at the well head. As a general rule it should not ordinarily be a deductible expenditure according sound

[161] Amaoko-Tuffour J.and Awusu- Ayim J.; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal page 23
[162] Nakhle C.; Mining and Petroleum Taxation: Principles and Practice, Revenue Mobilization and Development, IMF Conference Paper December 2011.

principles of tax law.[163] Some exceptions are allowed with limitation so that the tax base can be preserved. Unfortunately the literature reviewed shows that it is an allowable expenditure deduction for the oil and gas industry in Uganda and Nigeria.[164] It is treated as the norm not as an exception to the general rule that capital allowances are not deductible.

Therefore this study observes that rather than act as an incentive, it has now taken the form of a right which hinders income tax optimization in the oil and gas industry. Development expenditures as an instrument can be used as tool for tax avoidance and evasion by the International Oil Company if the approved costs and the actual costs are not monitored and reconciled.[165]

Objective 3

Like Nakhle observed, the devil is in the detail of this costs and availability of complete and transparent information about the dealings of the taxpayer as pointed out by Mirrlees.[166] Otherwise all revenue can be lost in allowable expenditure deduction just like it seems to be the case with the Nigerian oil and gas industry.

As pointed out by Bina, the costs in the oil and gas industry were set by the International Oil Companies with the aim of maximizing their return on the capital invested in the oil and gas industry.[167] The role costs in petroleum exploitation if not well balanced will greatly reduce the size of the economic rent which is the tax base for the petroleum industry.[168]

Objective 4

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[163] Bakibinga D.; Revenue Law in Uganda: page 80

[164] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195

[165] Amaoko-Tuffour J.and Awusu- Ayim J.; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal page 22-23 paragraph 3.4

[166] Nakhle C.; Mining and Petroleum Taxation: Principles and Practice, Revenue Mobilization and Development, IMF Conference Paper December 2011.

[167] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 193

[168] Amaoko-Tuffour J.and Awusu- Ayim J.; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal page 22-23 paragraph 3.4

As already noted above tax administration capacity to audit and assess oil companies has a direct effect in revenue generation and growth.[169] It is my view in this research that efficient tax administration with unified and simple tax laws will lead to an increase in revenue collection.[170] The study will test this finding against tax administration effects on oil and gas revenues in Uganda.

Objective 5

As observed by Silvani and Baer, there is need to keep tax laws as simple as possible, aim for global tax with few exemptions, credits and rebates deduction, few rates for taxes on goods and reduce the possibility of non compliance through misclassification[171].

Studies show that a tax system with few taxes, a limited number of rates for each tax, limited exemptions and a broad base is much easier to administer in developing countries and result in higher tax compliance[172].

In conclusion, it is advisable that Uganda maintains the corporation tax rate of 30% as stated in the ITA. It will make Uganda competitive destination for International Oil Companies among its Africa regional oil and gas producing peers. As already noted the most critical job will be managing oil and gas exploitation cost. If the costs can be approved, monitored and verified by competent and efficient oil management team, the income tax revenue will be optimized.

[169] Amaoko-Tuffour J.and Awusu- Ayim J.; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal page 22-23 paragraph 3.4

[170] Odusola A.; Tax Policy Reforms Nigeria: Research Paper No. 2006/03; United Nations University : ISSN 92-9190-767 page 21

[171] Wallschutzkky, Ian: Achieving Compliance in Developing Countries: Bulletin for International Fiscal Documentation 1989 page 45

[172] Sivani and Baer 1997; Designing a Tax Administration Reform Strategy: Experiences and Guidelines; IMF Working Paper, Washington DC.

3.0 CHAPTER 3: RESEARCH METHODS

3.1 Introduction

This section will highlight how the study will be conducted to reach conclusive findings and recommendations for this research.

3.2 Legal Context and Research Setting

The study will focus on the oil and gas income taxation in the oil and gas industry in Uganda. The study will majorly concentrate on the ITA Laws of Uganda as amended. Attention will also be devoted to the Upstream Act[173]. The Upstream Act regulates the Production Sharing Agreements that provide details of expenditures for petroleum exploration, petroleum development and operating expenses for the oil and gas industry in Uganda. The study will analyze critically the cost recovery provisions of the 2016 Model Production Sharing Agreement and test it against the tax deductible expenditures contained in the ITA.

Relevant case laws that have interpreted provisions of the ITA regarding allowable expenditures and similar legislative developments in South Africa, Nigeria and England shall be concurrently adopted to advance a comparative research design where need arises.

3.3 Study design

The study will use comparative design and doctrinal research approach by analyzing taxation laws the oil and gas industry in Uganda and other jurisdictions (Nigeria) considered above. Consideration is also given to the ITA of Uganda dealing with expenses of deriving income, gains or losses on disposal of assets, capital deductions, petroleum exploration expenditure deductions, petroleum development expenditures and operating expenses.

Common law has been used to provide judicial interpretation of similar provisions of the ITA and distinguishing cases relevant legislations shall be instrumentally vital.

The comparative study will be conducted on the key variables for both Nigeria and Uganda's income tax fiscal instruments for the oil and gas industry. This will be undertaken with a view of

[173] Throughout the work is referred to as Upstream Act.

drawing conclusions on the major similarities and differences between the 2 income tax fiscal instruments.

It is expected that the analysis of the key income tax fiscal instruments, notably the ITA and the 2016 Model Production Sharing Agreement of Uganda inform a discussion of what the points of variances in each income taxation fiscal instrument are. An attempt is made to draw any theoretical and conceptual differences between the 2 instruments and how the difference (if any) will impact on the optimization of the income tax for the oil and gas industry in Uganda. The cases will provide a concrete basis upon which the research findings can be supported.

The study will analyze the provisions of the ITA, the Upstream Act, the Uganda Revenue Authority Act Chapter 196[174], and the Audit Act[175] amongst other legislations.

The study will further use the decisions from case law as secondary data. This will be thematically analyzed according to the research objectives with a view to making findings which either support conclusions drawn from literature or to identify any significant variances which affect the optimization of income tax revenue in Uganda's oil and gas industry.

The Model Production Sharing Agreement 2016 and the Production Sharing Agreement signed by Tullow Oil Uganda and the Government of Uganda in 2012 has been used as sources of secondary data in the study. The secondary data will be critically examined and relevant interpretation by courts will be used to confirm or reject the conclusions drawn from literature in respect of each objective.

3.4 Area of study

The research will focus on cost recovery provisions in the Income Taxation Act and the Petroleum Production Sharing Agreements in the oil and gas industry in Uganda with a view of devising means of optimizing income tax revenue generation from the oil and gas industry.

[174] Throughout the work referred to as URA Act.
[175] Throughout the work referred to as the Audit Act.

3.5 Population Size

The study will use two distinct Production Sharing Agreements. Namely the 2012 Production Sharing Agreement between Tullow Uganda and Uganda Government and the Model Production Sharing Agreement of 2016 in respect of income taxation in the oil and gas industry in Uganda.

3.6 Sample and Sampling Techniques

The data will be selected and only the cases relating to expenditures of deriving income tax will be considered. Particular focus will to identify cases on oil and gas exploration expenditure and petroleum development expenditure. Cases on capital expenditure deductions will form the back bone of this research.

3.7 Data Collection Strategy/methods

The data will be gathered from authoritative texts books, journal articles and internet websites. The study will collect common law cases from Uganda, South Africa, Nigeria and English courts. The materials gathered will be those relevant to income taxation. Specific attention will be given to materials that directly deal with deductibility of expenses when determining chargeable income. Where possible priority will be given to secondary data that directly deal with expenses of deriving income chargeable to tax in the oil and gas income industry.

3.8 Documentary review

3.9 Data Collection Instruments

Data will be gathered using reputable internet access networks like reputable research organization, official government websites and published annual law reports as well as case books and authoritative texts.

3.9.1 Data Analysis

The data will be analyzed thematically according to the research objectives. The study will draw conclusion from the data gathered, analyzed and interpreted in respect of each objective of the study. The data will be used as an input to support or disapprove the finding revealed by the literature reviewed in Chapter 2 of the study.

3.9.2 Ethics consideration

The study will focus on the relevant Acts of Parliament and other written laws, authoritative legal text books and case law. The research will ensure that anti plagiarism rules are strictly observed.

3.9.3 Anticipated methodological constraints/limitations

There will be difficulties in accessing the law reports from South Africa, England and Nigeria. This is particularly so because the law reports of those countries are not readily available in Uganda. Secondly accessing online law reports require subscription costly. Access to signed Production Sharing Agreements between Uganda and the Oil Companies will be difficult because of the strict confidentiality rules associated with those Production Sharing Agreements. Therefore the 2016 Model Production Sharing Agreement of Uganda will be used in addition to the Kanywataba Production Sharing Agreement of 2012 which was provided by the University.

3.9.4 Conclusion

With the above approach the research will progress smoothly and can be completed within the timelines required by the University

CHAPTER 4 RESULTS AND ANALYSIS

4.1 Introduction

The chapter will consider all expenditure deductions provided under the Production Sharing Agreements, the expenditures will be compared with the allowable expenditure deductions under

the ITA. The expenditures that are similar and the ones that vary under the Production Sharing Agreement and the ITA will be highlighted and its impact on optimization of income tax revenue in Uganda discussed.

Attempts will be made to identify major conflicting issues in the Production Sharing Agreements, ITA and Upstream Act, The Public Finance Management Act 2015 and common law as well as case laws.

The results will be analyzed to show how the provisions of the ITA in its current form and the cost recovery provisions in the Production Sharing Agreements will impact on the optimization of income tax revenue in Uganda.

The shortcomings as well as the strengths will be discussed in a comparative context with Nigeria as a bench country.

4.2 Recap of research objectives

The research set out to accomplish the following objectives;

1) To determine how deductions for petroleum exploration expenditures are applied as per the provisions of the ITA and explore the impact on income tax revenue optimization in the oil and gas industry in Uganda.
2) To examine how expenditures for petroleum development are provided for under the ITA and how this impact on oil and gas income tax revenue optimization in Uganda.
3) To understand how operating expenditure impacts the optimization of revenues from income tax in the oil and gas industry in Uganda.
4) To determine how the approval and monitoring of petroleum exploration, production and operating costs impact on income tax revenue optimization in the oil and gas industry in Uganda.
5) To establish how the current corporation income tax rate of 30% may be impacting on income tax revenue optimization in Uganda.

4.3 The Application of Secondary Data

The research solely relies on secondary data. The provisions of the Model Production Sharing Agreement 2016 and the Income Tax provisions have been considered in the table below. The

first 3 objectives are arranged chronologically by identifying key elements of exploration expenditure, development expenditure and operating expenses.

The same provisions are further tested for similarities or difference and a comment provided whether it negatively or positively affect optimization of income tax revenue in Uganda. Attempts have been made to identify the aspects of expenditure that negatively impact on optimization of income tax revenue in Uganda's oil and gas industry. The chapter identifies aspects that have positive impact on optimization of income tax revenue in Uganda.

Objectives 4 and 5 are analyzed differently based on statutory legal mandates in the respective legislations and Production Sharing Agreements. The purpose under these 2 objectives is to discover whether the legislations identified negatively or positively impact on optimization of income tax revenue in the oil and gas industry in Uganda.

ANALYSIS OF DATA

Objective 1

Exploration Expenditures and its impact on the income tax revenue from the oil and gas sector

Article 244(1) of the Constitution of the Republic of Uganda provides that Parliament shall make laws to regulate the exploitation of minerals and for sharing of royalties derived from exploitation of such minerals. In 2013, Parliament passed the Upstream Act to give effect to Article 244 of the Constitution of the Republic of Uganda.

The purpose of the Upstream Act is to regulate petroleum exploration, development and production. In addition this law established the Petroleum Authority of Uganda to regulate licensing and participation of commercial entities in petroleum activities in Uganda.

Section 4 of the Upstream Act vests all petroleum rights in the Government of Uganda to hold the same in trust for the people of Uganda. Section 5 of the Upstream Act prohibits any petroleum activity in Uganda without authorization or approval by the Government of Uganda. This authorization or approval is through issuing of licenses or permits to engage in petroleum activities.

Section 6 of the Upstream Act provides that the Government of Uganda may enter into an agreement with any person in respect of petroleum activities. Section 6 of the same Act provides that the Minister of Energy shall prepare Model Production Sharing Agreements for approval by Cabinet. The Model Production Sharing Agreement shall be laid by the Minister before the Parliament of Uganda.

Similarly Article 79(2) of the Constitution of the Republic of Uganda stipulates that it is the mandate of Parliament of Uganda to make laws. In this regard the ITA is enacted pursuant to Article 79(2) of the Constitution of the Republic of Uganda.

In this respect Part IX A of the ITA as amended contains special provision for taxation of petroleum operations. Part IX A of the ITA provides for petroleum exploration expenditure, petroleum development expenditure and other expenses incurred for purposes of petroleum operations. Below is consideration of petroleum exploration expenditure under the provisions of the ITA.

Section 89A of the ITA defines petroleum exploration expenditure to mean expenditure incurred by a licensee in undertaking exploration operations authorized under a petroleum exploration right.

Section 89GB of the ITA provides for items of expenditure considered as exploration expenditure under the ITA. This section provides for four items that exploration expenditure. These are costs of acquiring a depreciable asset, the cost of acquiring an intangible asset, loss carried forward in respect of a contract area from earlier years, contract exploration expenses not falling under depreciable or intangible asset expenditures.

The provision of section 89GB is framed in a very confusing language and is ambiguous. Section 89GB (1) of the ITA is quoted below;

"....If the cost of acquiring a depreciable asset is treated as petroleum exploration, section 27 applies to the asset on the following basis-

a) the asset is treated as belonging to a separate pool of depreciable assets; and
b) the depreciation rate applicable to the pool is 100%......"

The same confusion extends to section 89GB (2) to the cost of acquiring an intangible asset.

It can be noted that the use of the word if in the beginning of the section gives rise to two interpretations regarding the cost of acquiring depreciable assets. It can be deduced that the cost of acquiring a depreciable asset may be considered as petroleum exploration expenditure or it may not be considered the cost of exploration expenditure. Secondly, section 89 GB (1)(a) and (b) of the ITA provides that the assets will be placed in separate pools under section 27 and the rate of depreciation is 100%.

It should be noted that section 27 of the ITA places assets in separate pools and the relevant depreciation rate is provided is not 100%. All that can be deduced from the above section is that the cost of acquiring a depreciable asset is allowed at 100% not the depreciation rate provided under section 27 of the ITA.

This implies that the cost of acquiring a depreciable asset used in petroleum exploration is tax deductible 100%. This also implies that once the cost of acquiring the depreciable asset is approved, it will be allowed as the cost of exploration expenditure subject to verification of the cost to determine whether it was incurred in that year of income.

As Okoro and Obutte observed in the case of Nigeria's oil and gas industry, ambiguous tax provisions are a subject of costly litigation.[176]Further, it was noted by Amaoko-Tuffour and Awusu-Ayim that failure by the Host Government to verify costs in the oil and gas industry because of its complexity of the oil and gas industry leads to cost overstatement and profit stripping by International Oil Companies.[177] The unclear provision of section 89GB of the ITA may therefore negatively impact on the optimization of income tax revenue in Uganda's oil and gas industry.

Section 89GB(3) of the ITA widens the scope of exploration expenditure to include all other expenses incurred for purposes of exploration which do not fall under the cost of acquiring intangible assets and the expenditures incurred in acquisition of tangible assets.

[176] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol. 7 Issue 2 February 2018 page 11

[177] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol. 4 December 2010 page 23

It can be observed that the list for items considered as other exploration expenditures is not limited by the ITA.[178] A review of Section 65 of the Upstream Act indicates that exploration of petroleum must be pursuant to the terms and conditions set out in the exploration license. The licensee is required to submit as well as commit to minimum work programs in the primary exploration term and any extensions thereto.[179]

Section 65(3) of the Upstream Act provides that the exploration work program must be approved by Petroleum Authority of Uganda.[180]

As observed above, question that remains is whether the approved exploration costs become actually the exploration expenditure deduction for purposes of income tax computation. It will be noted that detailed provisions for the exploration expenditure is contained in the Production Sharing Agreements.

The 2016 Model Production Sharing Agreement provides a comprehensive list of what constitutes exploration expenditure. Under Section 2 of Annex C to the Agreement the costs must be necessary, appropriate and economical. It must be incurred for search and appraisal of discovery of oil and gas in a contract area.

The costs considered include the costs of all surveys (aerial survey, geological survey, geochemical survey, paleontological survey, topographical survey, seismic survey), studies and interpretation of data from the survey, core hole drilling, well drilling, labour and materials and services in drilling exploration wells or cost of appraisal of new petroleum reservoirs , cost of facilities used solely as access roads, the cost of geological and geophysical data for exploration activities, a portion of service costs allocated to exploration activities on equitable basis and consistently applied, a portion of all general and administrative expenses allocated to exploration activities based on projected budget expenditure and subject to adjustment on the basis of the actual expenditure at the end of the calendar year, any other contract expenses incurred prior to the commencement of commercial production in a development area.

[178] Section 89 GB(3) of the ITA
[179] Article 4.5 of the 2016 Model Production Sharing Agreement
[180] Article 4.5 of the 2016 Model Production Sharing Agreement

There are some key points to be noted under the provisions of the Production Sharing Agreement which will impact on the optimization of income tax revenue in the Uganda's oil and gas industry in significant ways, these are;

a) The costs must be necessary, appropriate and economical for search and appraisal of discovery of oil and gas in a Contract Area.
b) Service costs must be allocated to exploration activities on equitable basis and consistently applied.
c) Administrative expenditures allocated to exploration activities must be based on projected budget expenditure and must be adjusted on the basis of actual expenditure at the end of the calendar year.
d) Any other contract expenses incurred prior to commencement of commercial production

The above provisions are restrictive in nature requiring that oil and gas exploration costs must be necessary, appropriate, and economical and allocated to exploration activities on equitable basis. The above wordings are meant to ensure that costs of oil and gas exploration are managed within those parameters. Therefore its main aim is to sieve out wasteful costs of petroleum exploration and remain with only what is reasonably and necessarily incurred in petroleum exploration.

The above provision is well intentioned and takes care of the challenges of cost overstatement by International Oil Companies that would otherwise erode the taxable profits from the oil and gas industry. The challenge that exists is that the ITA does not adopt the same wordings of the Production Sharing Agreement. The case of **Uganda Electricity Distribution Limited and Umeme Limited vs. Uganda Revenue Authority TAT Application No. 40 of 2018** the Tax Appeals Tribunal held that an agreement between the parties does not supersede the provisions of the tax statute.

In this case the wordings of the Production Sharing Agreement no matter how well intentioned will not be used as a substitute to regulate and control costs of oil and gas exploration in Uganda. This is because section 22(1) of the ITA read together with provisions of Part IXA of the ITA simply provides that the expenditure must be incurred in the production of income included in the gross income. It does not state that the exploration expenditure must be necessarily incurred in the production of income included in the gross income. Therefore the ITA in its current form will

negatively impact optimization of income tax revenue by failing to control exploration expenditures.

It should be noted that the provisions of the ITA only provide in section 22(1) for deduction of;

> *"..all expenditures and losses incurred by the person during the year of income to the extent to which the expenditures or losses were incurred in the production of income included in gross income…"*[181]

The Supreme Court of South Africa in **Ackerman Ltd vs. CSARS**[182]defined expenditure incurred to mean the undertaking of an obligation to pay or the actual incurring of liability.

The ITA therefore introduces the core elements for allowable deductions as follows;

a) All expenditures and losses incurred by the person
b) During the year of income
c) In the production of income included in gross income.

In contrast to the above, the Production Sharing Agreement provides that the expenditures must be necessary, appropriate and economical in the production of oil and gas. Secondly the Production Sharing Agreement provides for the approval of such costs by Petroleum Authority of Uganda based on the work program and budget submitted by the Authority under Article 5 of the Model Production Sharing Agreement.

In light of the differences in interpretation of allowable expenditures in both the ITA as well as the Production Sharing Agreement, it is noted that the ITA has special provisions for taxation of oil and gas in Uganda. Section 89G (2) of the ITA makes part IXA of the Act to resonate some superiority in comparison to other provisions of the ITA in the event of a conflict.

The sections states:

[181] Section 22(1) of the ITA
[182] 73 SATC page1(2011) 1 SA (SCA)

"….where there is any inconsistency in the taxation of a licensee referred to in clause(1) between this part, other parts of this Act, any petroleum agreement, the provision of this part shall prevail…."

The question to be considered is that are the conflicting wordings in the Production Sharing Agreement which require that the costs must be necessary, appropriate and economic have any relevance in the application of expenditures of deriving income from oil and gas operation? There is a high unlikelihood that the answer will be in the affirmative. The provisions of part IXA of the ITA are more important than other provisions of the ITA. This implies that any expenditure provided for under part IXA of the ITA will be final.

It is observed that it is not necessary to take serious interest in other expenses of deriving income contained in the different provisions of the ITA if the provisions of part IXA of the ITA wholly incorporate all the contract expenses under the Production Sharing Agreement.[183]

For example section 89GB (3) provides that the licensee shall be allowed a deduction for petroleum exploration expenditure (not falling under intangible asset deductions and tangible asset deduction) in the year of income in which the expenditure is incurred.[184]

It is noted by this research that if all expenses of deriving income in the oil and gas industry is deductible without regard to whether it is necessary, appropriate, economical and actually incurred in the production of income included in gross income, then income tax optimization cannot be achieved in the oil and gas industry in Uganda. It should be noted further that the higher the cost of producing the oil and gas the lower the share of the chargeable oil and gas available for production sharing and the lower the profit available to the licensee for taxation by the Host Government.[185] This is what Amaoko-Tuffour and Awusu-Ayim refer to as profit stripping which in turn reduces income tax available to the Host Government.[186]

[183] See Section 89GB(3) of the ITA
[184] Section 89GB(3) of the ITA
[185] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23
[186] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23

In order to optimize income tax revenue from the oil and gas industry in Uganda, not all approved costs should be allowed as tax deductions, but only the costs necessarily incurred by the Licensee as a taxable person in the production of income included in gross income.

The case of **Port Elizabeth Electric Tramways Co. Limited vs. CIR**[187] Watermeyer AJP considered the wording of the statute "actually incurred" and distinguished it from the "wording necessarily incurred". He stated that the word actually incurred widens the scope of deductible expenses. Court explained that one man may conduct his business inefficiently and extravagantly actually incurring expenses which another man does not incur in similar circumstances. Court observed that such expenses are not necessary but they are actually incurred and therefore deductible. Court further notes that actually incurred does not necessarily mean that such expenses are actually paid out. Court notes that a taxpayer who accrues expenses for stocks purchased but not paid and for services rendered but not paid is entitled to deductions of such liabilities.

From the above case, it can be realized that the ITA under section 22(1) only provides for expenditures incurred and not necessarily incurred. The provision therefore widens the scope of deductible exploration expenditures which is a potential for income tax loss in the oil and gas industry.[188] Suffice to note that all approved costs for exploration contained in the work program and budget becomes deductible expenses according to section 89GB (3) of the ITA.

The section 22(1) of the ITA requires that the expenditure must be incurred in the year of income in which the expenditure was incurred. The case of **Concentra (Pty) Limited vs. CIR**[189] the taxpayer sought to deduct expenses incurred in previous years of income. The taxpayer was only able to consider and approve the previous years' directors travel expenses in the current year of income and sought to deduct it on the ground that the expenses could not be deducted because there was need to maintain the company's cash flow. Court said the previous year's expenses were not deductible and held that a taxpayer could not defer recognition of expenditures for income tax purposes by making payment in later years of assessment. Court pointed out the basis of income tax law as the assessment of yearly income, the amounts earned and the expenses incurred.

[187] 8 SATC page13
[188] Port Elizabeth Electric Tramways Co. Limited vs. CIR; 8 SATC page13
[189] 12 SATC page 95

It was court's observation that once the taxpayer postpones liabilities incurred because of shortage of funds in that year and takes it to another year of assessment, the entire system of taxation would be affected. Court said that the prudent practice is for the taxpayer to ascertain all its expenditures for the year of income and present it in their balance sheet for each year. If not the company loses the opportunity to use such expenditure in that year of assessment.

The case of **Caltex Oil (S.A) Limited vs. SIR**[190]Court of Appeal of South Africa held that it is only at the year-end that receipts and accruals on the one hand and expenditure actually incurred on the other hand can be determined. Further that a liability that remains unpaid at the end of the year of assessment is only relevant for later years. However a portion of the debt paid in a year of assessment is what represents the quantum of expenditure actually incurred.

Nationale Pers Bpk vs. KBI [191]the Court of Appeal of South Africa considered payments made before the date the liability accrued and held that an advance payment of expense before liability to pay has arisen does not render an advance payment an outlay of money an expenditure.

Finally a review of Article 11.4 of the Model Production Sharing Agreement reveals that aggregate exploration expenditure is recoverable by the Licensee upon commencement of their commercial production. Therefore exploration expenditures from the time such expenditure was incurred until the time commercial production commences is aggregated annually and recoverable 100% for that particular calendar year. The Licensee is entitled to recover the exploration expenditures out of cost petroleum for a specific Contract Area. [192]

Secondly, the exploration expenditure is recoverable in any year after the start of commercial production. In this respect, all exploration expenditures incurred by the licensee is recoverable 100% according to the Production Sharing Agreement and the ITA.

It is worth noting that petroleum income taxation according to the special provisions for taxation of petroleum deviates from the general rule that only expenditures incurred by the taxpayer in the year of income to produce income included in the gross income is allowed.

[190] 37 SATC page1
[191] 48 SATC page 55
[192] Article11.1 of the 2016 Model Production Sharing Agreement

It is opined in this study that the deviation from the general rule that only expenditures incurred in that particular year of income in respect of the oil and gas industry is a good exception to the general rule. This is because the provisions of the ITA allowing exploration costs to be recovered in the subsequent years helps in balancing the interest of the International Oil Company by guaranteeing them recovery of the costs of their investments in the oil and gas industry in Uganda while allowing the Host Government to attract direct foreign investments in the oil and gas industry. What is important is that the costs must be clearly presented in the balance sheet of the Licensee for it to be allowed as tax deductible expenditure.[193]

Tax being a creature of the statute, the provisions of part IXA of the ITA on special taxation of petroleum operations goes against the normal principles of taxation that expenditures are deductible in the year of income in which it is incurred. The provisions for carry forward and recovery of expenditures from previous years of income as provided for in Article 10.10 of the Model Production Sharing Agreement sets a new statutory rule for income taxation of petroleum operations compared to the taxation of other businesses.

The safety net seems to be that the Licensee is obliged to file quarterly provisional estimates of cost petroleum (which include exploration expenditures) within 30 days of the end of a calendar quarter. The estimates must show contract expenses actually incurred, the corresponding cost petroleum to be lifted by the Licensee and the balance thereof. This must be followed by detailed accounts for the calendar year showing adjustments. Any discrepancy between the contract expenses and the cost petroleum which is not resolved is to be referred to arbitration for determination.

In conclusion, the fact that all contract expenses relating to exploration of oil and gas in Uganda are allowed as tax deductible expenditures, this provides evidence that without sufficient capacity the Host Government or an independent auditor appointed by the Host government, income tax revenue loss can easily arise through cost overstatement by the Licensee. This equally implies that optimization of income tax revenue is unlikely to be achieved under the current ITA.

OBJECTIVE 2

[193] A position consistent with the decision of court in Port Elizabeth Electric Tramways Co. Limited vs. CIR 48 SATC page 55

Development Expenditure and its impact on the income tax revenue optimization in the oil and gas industry in Uganda.

Petroleum development expenditure is specifically provided for under section 89 GC of the ITA. It includes the cost of an intangible asset used in petroleum production. Section 89 GC (1) of the Act, states that the useful life of the intangible asset is computed as the lesser of the expected life of the asset used in petroleum development operations or 6 years.

Section 89GC (2) of the ITA provides for deductibility of the cost of acquiring tangible assets used in petroleum development operation. The deduction is allowed on a straight line basis over the expected useful life of a petroleum development operation to which the expenditure relates or 6 years.

The words petroleum development operation means a petroleum activity defined in the Upstream Act. Section 2 of the Upstream Act defines petroleum activity to mean planning, preparation, installation or execution of activities related to petroleum including reconnaissance, exploration, development, production, transportation, storage and cessation of activities or decommissioning of facilities.

The definition of petroleum development operation is too ambiguous and widens the scope of deductible expenditure beyond the cost of acquisition of tangible assets. The contextual understanding of the section 89GC (2) and (4) is that it relates to the depreciable assets under section 27 of the ITA which place depreciable assets in 4 classes and sets the depreciation ceiling for each class to which an asset falls.

Under class 1 depreciable assets (computers and data handling equipment) the rate is 40%, class 2 (automobiles, buses and mini-buses with a seating capacity of less than 30 passengers, goods vehicle with lad capacity of less than 7 tonnes, construction and earth moving equipment) the rate is 35%, class 3 (buses with seating capacity of 30 or more passengers, goods vehicle designed to carry or pull loads of 7 tonnes or more, specialized trucks, tractors, trailers and trailer mounted containers; plant and machinery used in farming, manufacturing or mining operations) the rate is 30% and class 4 (rail cars, locomotives and equipment, vessels, barges, tugs and similar water transportation equipment, aircraft, specialized public utility plant, and any other depreciable asset not mentioned in any other class) the rate is 20%.

Section 89GC (3) and (5) of the ITA expressly refers to depreciable assets unlike section 89GC (2) which generally provide for petroleum development operation. It seems clear from the reading of section 89GC (5) that both depreciable assets under section 27 of the ITA and petroleum development operation is allowed a depreciation deduction on a straight-line basis. This means all kinds of development expenditure whether of capital nature or revenue nature are classified as allowable as deduction.

The formula for computation of the value of a depreciable asset and the amount of the development expenditure is: AXB/C;

Where A is the amount of the cost of the asset or the amount of the expenditure

B is the number of days in the period beginning on the date of commencement of commercial production and ending on the last day of the year of income in which commercial production commenced

C is the number of days in the year of income in which the commercial production commenced.

All that can be observed is that all petroleum development expenditure whether relating to the acquisition of tangible assets, intangible assets or any other expenditure incurred at the petroleum development phase is deductible at the commencement of commercial production.

This means that section 27 of the ITA categorizes assets in separate pools with different depreciation rates, an approach unlikely to apply in petroleum taxation income. This approach could be augmented by section 89GB (2) that makes Part IXA of the ITA on taxation of petroleum operations superior to other parts of the Act.

In brief, all approved development expenditures must be allowed as tax deductions. Attempts must only be made to verify and audit costs to determine whether it was incurred. Once a finding is made that the cost was incurred; the tax deductibility of expenditure for income tax purposes is sealed and not debatable. This is irrespective of whether the expenditure is necessary, appropriate, and economical in the circumstances. All that matters is that petroleum development expenditure must be incurred by the taxpayer. It is also immaterial that the expenditure relate to year of income in which the expenditure is incurred.

The above ambiguity is so much amplified to the extent that even petroleum development operation is treated as a depreciable asset. In light of this ambiguity as to what actually constitutes petroleum development expenditure, it will be argued in this research that income tax revenue optimization will not be achieved in the oil and gas sector in Uganda. [194]

It is further observed that all contract expenses constituting petroleum development expenditure in the context of the Production Sharing Agreement and the ITA are deductible.[195] It is argued that once the work program and budget is approved, the taxable costs are determined at that point without any further discussions. What remains to be done are verification of the expenses incurred and it will simply be allowed as tax deductible costs.

It is further argued that the role of cost verification or audit is to be done by the Auditor General or an independent auditor appointed by government. Uganda Revenue Authority as the administrator of all central government taxes has no serious role but to approve the audit report of the government auditor and allow the petroleum development expenses incurred as tax deductible costs. The ITA in its current form therefore disempower Uganda Revenue Authority as the verifier and auditor of all expenses incurred by the taxpayer in the production of income included in gross income.

It is therefore unclear but highly likely that how Uganda Revenue Authority may not disagree with the Government Auditors report in respect of Contract Expenses. It is also debatable whether the oil and gas appointed government auditors will disagree with the taxpayer on costs approved by Petroleum Authority of Uganda.

The above dilemma suggests institutional controversy. This institutional controversy is problematic given its likelihood of causing income tax revenue loss. In such circumstances it is argued in this research that the function of oil and gas cost control through cost approval, cost verification and allowable cost determination is likely to result in a conflict that will negatively impact optimization of the income tax in the oil and gas industry in Uganda.

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[194] Okoro J., Obutte P.; Tax Incentive as a tool for marginal field development in Nigeria: International Journal of Innovative Research and Development, Vol. 7 Issue 2 February 2018 page 11
[195] Section 89 GC(2) of the ITA

The question for debate still remains how is Uganda Revenue Authority supposed to carry on its mandate if all approved contract expenses are tax deductible expenses?

Mindful of the above arguments, it is necessary to consider what petroleum development expenditure is in the Model Production Sharing Agreements. The items of petroleum development expenditure are as follows; the cost of drilling wells completed as production wells and wells for the purposes of producing petroleum reservoir already discovered,[196] the cost of drilling wells for injection of fluids into petroleum reservoir to enhance recovery of petroleum, cost of well completion by installation of casing or equipment to make the well a producing well or injection well, the cost of all facilities (field gathering system, field production and treatment units, wellhead equipment, sub surface equipment and natural gas separation facilities, enhanced recovery system for petroleum, offshore platforms,[197] petroleum storage facilities, field access roads for production activities, cost of petroleum transportation facilities installed up to delivery point and includes pipelines, compressors and storage facilities,[198] a portion of all general and administrative costs allocated to development based on projected budget expenditures adjusted to actual expenditures at the calendar year end and any other expenses agreed upon by the parties prior to commencement of commercial production in a development area but excludes the costs of activities carried on beyond the delivery point.[199]

It is to be clarified that the petroleum development expenditure is limited to the upstream and midstream activities[200]and does not extend to downstream activities.

What lessons can we draw from Nigeria in respect of petroleum development costs and its allowance or disallowance?

As studies have shown, Idubor and Asada have noted that the accounts statements of the international oil companies are shrouded in mystery and the problem is worsened by slow dispute

[196] Section 2.2, Section C, Annex B to the 2016 Model Production Sharing Agreement
[197] Section 2.2, Section C, Annex B to the 2016 Model Production Sharing Agreement

[198] Section 2.2(e), Section C, Annex B to the 2016 Model Production Sharing Agreement

[199] Section 2.2, Section C, Annex B to the 2016 Model Production Sharing Agreement

[200] Section 2 of the Petroleum (Refining, Conversion, Transmission and Midstream Storage Act) Act 4 of 2013

resolution mechanism in Nigeria which takes about 20 years on average to resolve.[201] Another challenge that Ya'u identifies as leading to revenue loss is under reporting of profits in order to avoid paying taxes in Nigeria.[202] Odusola points out that poor relation between the taxpayer and the tax authorities as well as unqualified human resource among others lead to low revenue yield.[203]

The above position may be experienced in Uganda because the oil and gas industry is at its infancy and the human resource to approve, verify and audit costs many not yet be available with the requisite capacity to monitor and control the development costs in the oil and gas industry in Uganda. This implies that the government functionaries to approve monitor and verify development costs in the oil and gas industry may not be readily available with requisite skills and sufficient numbers to be able to regulate the oil and gas development costs. Therefore failure to control oil and gas development costs may lead to income tax revenue loss in the oil and gas industry in Uganda. Thus optimization of the income tax in the oil and gas industry may not be achieved under the current income tax fiscal regime in Uganda.

Objective 3

The impact of operating expenses on the income tax revenue optimization in Uganda

The operating expenditures discussed in this objective is drawn from section 22(1) of the ITA titled expenses of deriving income and other expenses provided for under the provisions of the ITA.

Section 22(1) (a) of the ITA provides for deductibility of all expenditures and losses incurred by a person during the year of income in the production of income included in gross income. This point has been exhaustively discussed under the objective and the implications of the same on income tax revenue maximization in the oil and gas industry in Uganda.

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[201] Idubor R., Asada: *Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization*; Vol 37 of 2015 (ISSN 2224-3240) page 188

[202] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

[203] Odusola A.; Tax Policy Reforms in Nigeria: Research Paper No. 2006/03; United Nations University: ISSN 92-9190-767 page 25

In brief the special provision for taxation of petroleum operations departs from the general rule which states that only expenditures incurred in the year of income in the production of income is deductible. The operating expenses in the oil and gas industry in Uganda are carried forward until these are recovered in full.

It is also not a requirement in the oil and gas industry that the expenditures must relate to the production of income included in the gross income in that year of income in which the expenditure is incurred.

Finally all contract expenses that are falling under the heading of operating expenses are recoverable 100%. This means literally that the operating expenses are 100% tax deductible as long as it is approved and verified as incurred in the petroleum operations.

The other operating expenses provided for under section 22(1) (b) of the ITA are;

a) the amount of any loss incurred by a person on disposal of a business asset during the year of income irrespective of whether the asset is on a capital or revenue account;
b) 2% deduction of income tax payable for private employers who prove to Uganda Revenue Authority that 5% of their fulltime employees persons with disability;

The expenditure on the provision of meals and refreshments are provided for under section 23 of the ITA.[204] For the expenditure to be deductible, the taxpayer must have incurred the expenditure in the production of income included in gross income.

The section sets two conditions for the expenditure on meals and refreshments to be deductible. First, the value of the meals and refreshments must be included as part of the employees' employment income as a benefit in kind.[205] Secondly the meals and refreshments are provided by the employer to full time employees on equal terms on premises operated by or behalf of the employer solely for the benefit of the employees.[206]

The other form of operating expenses is bad debts written off under section 24 of the ITA. The condition for is deductibility is that the debt claim was included in the person's gross income in

[204] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 102
[205] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 102
[206] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 102

the year of income. The second condition is that the taxpayer must have taken all reasonable steps to pursue payment and the person reasonably believes that the debt is irrecoverable.[207]It is highly unlikely that the bad debt provision will be applicable to the International Oil Companies because the oil and gas is sold for cash in the international market and there is a provision that require the International Oil company to account for the oil and gas sales at the well head not after the delivery point.[208]

Section 25 of the ITA provides for deduction of interest incurred in respect of a debt obligation to the extent that the debt obligation has been incurred in the production of income included in gross income.[209] It must be noted that the interest deductions allowed under the 2016 Model Production Sharing Agreement limits the interest on loans borrowed by International Oil Companies to 50% of the loan borrowed for the development phase of the oil and gas industry.[210] The interest rate should not exceed the London Inter Bank Offer Rate and the loan is limited to 50% of the total financing requirement. The 50% limit comprises all loans including loans from affiliated and non affiliated companies.[211]

Another interesting deviation from the provision of section 25 of the ITA is that the loans may not be used to produce income included in gross income. This explained by the fact that the development phase of the oil and gas industry does not produce any oil and gas, therefore no chargeable income can be obtained at this phase.

The implication of section 25 of the ITA is that it is not yet amended to include the restrictions imposed on borrowing by the Production Sharing Agreement. If not urgently attended to the conflict that arises between the interpretation of section 25 of the ITA and Section 2(l) of the 2016 Model Production Agreement will most likely lead to income tax revenue loss through allowing open ended borrowing by the International Oil Companies.

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[207] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 78

[208] See Article 31 of the 2016 Model Production Sharing Agreement read together with Section 98 of the Upstream Act Act, Number 3 of 2013

[209] Bakibinga D.; Revenue Law in Uganda: Law Africa Publishing (U) Limited 2016 page 97

[210] Section 2(l), Annex B to the 2016 Model Production Sharing Agreement

[211] 2(l), Annex B to the 2016 Model Production Sharing Agreement

The problem is exacerbated by the fact that the 2012 Production Sharing Agreement signed between Tullow Uganda and the Government of Uganda applies prevailing commercial and not the London Inter Bank Offer Rate (LIBOR) on borrowing by Tullow Uganda at the Development phase. This means that interests on loans are still deductible under the current provisions of the ITA. This is most likely to negatively impact on the optimization of income tax revenue in the oil and gas industry.

In Nigeria for example, the Idubor and Asada have noted that interest expenses for monies borrowed by the International Oil Companies a capital for carrying out petroleum operations and intercompany loans obtainable in the open market at London Inter Bank Offer Rate is deductible by companies engaged in oil and gas production in Nigeria.[212]

The provision of section 25 of the ITA is open just like the Nigeria's treatment of interest expenses which is not limited to the development phase. In fact the Nigeria's interest treatment is better than Uganda's position because the interest rate is set at London Inter Bank Offer Rate while Uganda's ITA is silent on what interest rate is applicable.

Therefore if the provision of section 25 is not amended, it will cause conflict which will be resolved in favor of the International Oil Company following the TAT ruling in **UEDCL and Another vs. Uganda Revenue Authority**[213] which held that an agreement between the parties does not substitute the provisions of the taxing Act hence leading to income tax revenue loss.

The cost of repair of property occupied or used by the person in the production of income if included in the gross income is allowed as a deduction under section 26 (1) of the ITA. Section 26(2) of the ITA provides a depreciation deduction for minor capital equipment whose value is less than 50 currency points. This excludes returnable containers.[214]

The cost of scientific research and expenditure is provided for under section 32 of the ITA. This expenditure must be incurred during the year of income and in the course of business of the

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[212] Idubor R., Asada: *Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization*; Vol 37 of 2015 (ISSN 2224-3240) page 193

[213] TAT Application Number 40 of 2018

[214] Section 2(k) of the Model Production Sharing Agreement may absorb such expenditure hence harmonizing section 26(1) of the ITA with section 2 of the Model Production Sharing Agreement.

taxpayer and the income from it should be included in the gross income. The provision of section 32 is not in tandem with provisions of section 2(n) of the 2016 Model Production Sharing Agreement. The Model Production Sharing Agreement requires that the expenditure on research should be approved by the Government before it is spent by the Licensee. Further the research expenditure must be related to development of the new equipment, material and techniques for use in the searching for development and producing petroleum directly related to the conduct of petroleum activities under the Production Sharing Agreement.

We note that the provision of the 2016 Model Production Agreement restricts the research to that of a particular Agreement in respect of oil and gas production being undertaken in Uganda. Mean while section 32 of the ITA deals with general scientific research into new ways of production. It has the potential of allowing any expenditure not necessarily related to oil and gas production in Uganda. The section therefore will negatively affect optimization of the income tax revenue from the oil and gas industry in Uganda. It should be noted that the 2012 Production Sharing Agreement signed between Tullow Uganda and the Government of Uganda did not require prior approval by the Government.

The 2016 Model Production Agreement restriction enables the research expenditure cost to be controlled by the Government. The challenge that will have to be overcome is the need to realign the ITA with the provisions of the 2016 Model Production Sharing Agreement in order control the cost of oil and gas operation. Even when the Act is amended there might arise a need to renegotiate the 2012 Production Sharing Agreement which did not require government approval prior to the research expenditure.

Training or tertiary education expenditure is allowed as a deduction under section 33 of the Act. The training must not exceed five years and must be spent on a citizen or on a permanent resident of Uganda. It has a potential of allowing cost of training a non citizen employees of the Licensee who are permanent residents of Uganda. It is finding in this research that section 33 of the ITA wider than the provisions of Section 2(j) of the 2016 Model Production Sharing Agreement. Section 2(j) of the Model Production Sharing Agreement restricts the training to Licensee's Ugandan employees engaged in petroleum operations.[215] The ITA may negatively affect

[215] The provision of Section 2(j) of the 2016 Model Production Sharing Agreement is couched in similar terms to that of the 2012 Tullow Uganda and the Government of Uganda Production Sharing Agreement

optimization of the income tax revenue by increasing taxable costs of oil and gas operations and reducing the profit oil available for taxation in Uganda.

Charitable donations are allowed for a gift made to exempt organization during the year of income under section 34 of the ITA. This provision is not consistent with section 3.2 (e)(i) of the 2016 Model Production Sharing Agreement which prohibits donations and charitable contributions by International Oil Companies.[216] Therefore section 34 of the ITA negatively affects optimization of income tax revenue through increase of oil and gas operational cost with the result that the profits will reduce because the costs are high.

Finally, carry forward of losses is provided for under section 38 of the ITA. This is allowed for any year of income where the total amount of income included in the gross income of a taxpayer is less than the total amount of deductions allowed to the taxpayer. The loss carried forward is allowed as a deduction in determining the taxpayer's chargeable income.

The provisions for carry forward of losses for the oil and gas industry is presented in the Production Sharing Agreements as carry forward of expenditures reimbursable by cost oil or cost gas.[217]

One of the questions that the research will attempt to answer is: Is carry forward of losses the same as carry forward of expenditures? Does it have the same tax impact on the oil and gas income tax revenue in Uganda?

The answer to the above questions seems to be that carry forward of losses and carry forward of contract expenses may mean one and the same thing. This is because of the special nature of the oil and gas industry where it is impossible to get out oil and gas from underground without expenditures on exploration and development. In this case the expenditures are recoverable 100% in the subsequent years following commencement of commercial production.[218] Carry forward of expenses becomes a new statutory rule, an exception to the general rule that expenses are deductible only in the year of income in which it is incurred. The position from the courts which I

[216] The 2012 Tullow Uganda and Government of Uganda Production Sharing Agreement did not prohibit charitable donation and gifts by International Oil Companies.
[217] Article 11.10 of the 2016 Model Production Sharing Agreement provides for carry forward to subsequent years if not recovered in that particular calendar year. Cost oil is defined in Article 1.1.2.1 to mean the total available crude oil from a contract area which the Licensee is entitled to take in a particular period for recovery of contract expenses.
[218] Article 11.10 provides for recovery of contract expenses incurred in the oil and gas operations/activities.

agree with is that once the expenses are presented as liabilities in the balance sheet of the taxpayer in for that particular year of income then it will be allowed as a deduction in the subsequent years of income.[219]

Consideration of the operating expenses under the 2016 Model Production Sharing Agreement of Uganda

Paragraph 2.3, section 2 Annex C of the Model Production Sharing Agreement 2016 has detailed provisions on operating expenses. The operating expense must all be necessary, appropriate and economical expenditure incurred in the Petroleum activities after the start of commercial production.

The operating expenses comprise of intangible drilling activities and include the cost of labor, consumable materials and services having no salvage value. The costs must be incurred in drilling wells or deepening of production wells. The costs may be incurred before or at the start of commercial production. The above costs exclude the cost allocated to exploration expenditures or development expenditures. It also excludes tariff charges imposed by a pipeline company associated with transportation of petroleum from the delivery point to the Seaboard Terminal point of export. It should be emphasized that the pipeline and transport of petroleum activities are categorically classified under midstream oil and gas operations.[220]The rationale of excluding the pipeline tariff charges seems to be that the pipeline company may at any time increase the tariffs in collusion with the Licensee. Therefore it is wiser for the Government not to allow such costs at the outset.

Service costs

Paragraph 2.4, section 2 of Annex C to the Model Production Sharing Agreement states that service costs should be allocated regularly to exploration expenditures, development expenditures and operating expenses.

Service costs consist of all necessary, appropriate and economical direct and indirect expenditures in support of petroleum activities in a contract area. The costs include warehouses, piers, marine

[219] The case of Concentra (Pty) Limited vs. CIR 12 SATC page 95.
[220] Section 9 of the Petroleum(Refining, Conversion, Transmission and Midstream Storage) Act Number 4 of 2013

vessels, vehicles, motorized rolling equipment, aircraft, fire and security stations, workshops water and sewage plants, power plants, housing, tools and equipment used in petroleum activities.

It is the finding of this research that the ITA does expressly not include service costs in its definitions. One may argue that service costs are generally included in expenses of deriving income included in gross income.[221]

Service costs may properly be called expenses of generating income or expenses of which will increase revenue generation capacity. Watermeyer CJ in **New State Areas Ltd vs. CIR**.[222] states that expenditure of a capital nature may occur when the taxpayer acquires property, plant, tools respectively as a means of production which he uses in income producing operations. These items may as well be used to expand and improve the existing earning capacity of the business.

The service costs are therefore expenditures meant to increase the revenue generation capacity by enabling the oil and gas to produced and sold to earn revenue. As mentioned earlier the cost are not expressly mentioned in the ITA but it would qualify under section 22(1) of the ITA as amended.

General and administrative expenses

It must be necessary, appropriate, economical and verifiable and must be regularly allocated to exploration expenditures, development expenditures and operating expenses. The items include all main office, field office and associated general and administrative costs incurred in relation to petroleum activities in a Contract Area includes supervisory, accounting and employee relations service carried out by licensee in Uganda.[223]

General and administrative expenses also comprise annual overhead charge for services rendered by affiliated companies to support and manage petroleum activities in a contract area. The expenses include financial, legal and accounting services provided by affiliated companies of the licensee. It excludes service charged separately by affiliated company of the licensee.

There is a general limitation on service costs charged by the affiliate. The annual charge shall be licensee's verifiable expenditure limited to 1% of the contract costs. This cost is from the effective

[221] Section 22(1) of the ITA
[222] 14 SATC page 115
[223] Section 2.5 of the 2016 Model Production Sharing Agreement of Uganda

date of the Production Sharing Agreement until the date of approval of the first field development plan.[224]

The subsequent charge after the first approved field development plan is a rate or amount agreed upon between the government and the licensee. It shall be based on the verifiable expenditures.

This provision is very wide and can be subject to abuse because it does not mention what specific items are included under associated general and administrative expenses? What is the auditor supposed to look for under this item? Will these be detailed in the approved work program and budget? What if the amount or rate is not agreed upon, what happens? Will the licensee's rate apply or not? This is a weakness that can lead to the flood gate of all sorts of expenses hence leading to revenue loss.

Recoverable expenses

The Model Production Sharing Agreement 2016, section 3 provides for recoverable and non recoverable costs. The costs should be classified under exploration expenditures, development expenditures and operating expenditures. Service costs and general and administrative costs under section 2 is to be apportioned to exploration, development and operating expenses.

Briefly the items falling under recoverable costs include costs associated with acquisition of surfaces rights in force in a contract area, labour and associated labor costs, offices, camps, warehouses and other facilities, transportation costs in respect of petroleum operations, charges for services by third parties and affiliated companies, costs of materials, rentals, taxes excluding income tax imposed on licensee, duties and local government charges and fees in respect of right of way, contributions and assessments levied by government or local government in relation to petroleum activities.[225] This exclude royalties, state participation and government share of profit petroleum. Insurance premia and losses charged in similar way as competitive insurance companies, legal expenses including cost of litigation and related legal services necessary or expedient for producing, perfecting, retention and protection of the contract area excludes claims arising out of health, safety and environment issues, legal expenses for in-house lawyers included

[224] Section 2.5(b) (i) of the 2016 Model Production Sharing Agreement of Uganda

[225] Section 3.1, Annex B of the 2016 Model Production Sharing Agreement

under licensee's labor costs, training cost incurred by licensee on training Ugandans, interest and other financial charges incurred on loans raised by the licensee to finance the development activities.[226]

The interest is limited to 50% of the total financing requirement inclusive of loans from affiliates and the rate should not exceed London Inter Bank Offer Rate; approved expenditure on research for development of new material and techniques for use in search and development of technology for producing petroleum directly related to the conduct of petroleum activities in the contract area; ecological and environmental charges for measures to avoid noise, waste and prevention of environmental damage and in the conduct of petroleum activities.[227]

The cost of leasing of property or equipment and the cost should not exceed the cost of purchase of the leased item. The lease should not be obtained from an affiliated company of the licensee, the cost of acquiring, leasing, operating and maintaining communication system and payments into decommissioning fund.[228]

Non recoverable costs

According to section 3.2 of the Model Production Sharing Agreement, the following costs are not recoverable; the costs incurred before the effective date, the costs incurred in acquiring or transferring any interest in the agreement or license issued under the Act or the Agreement.

Section 3.2 also entails signature and other bonuses; costs incurred beyond the delivery point including petroleum marketing costs and the tariff charges, cost of provision of bank guarantee and any other payments made there under upon failure to honor the bank guarantee;

The other non recoverable costs under section 3.2 mentioned above include the cost of failure to comply with contractual obligations under the agreement; the amounts spent on indemnities required for fulfillment of the contractual obligation of the licensee; legal and other costs incurred in resolving a dispute between the parties to the agreement;

[226] Section 3.1, Annex B of the 2016 Model Production Sharing Agreement
[227] Section 3.1, Annex B of the 2016 Model Production Sharing Agreement
[228] Section 3.1, Annex B of the 2016 Model Production Sharing Agreement

Last but not least section 3.2 also provide for the non recoverable cost to comprise of the cost of arbitration including litigation in Uganda between the parties; costs incurred as a result of non compliance by the licensee of the obligations under the contract (includes cost arising as a result of licensee's negligent acts or omission, willful misconduct of the licensee's contractor or subcontractor and agents; royalty paid to the government, income tax imposed in accordance with the laws of Uganda; government's share of petroleum as determined under the agreement;

Finally other non recoverable cost costs in contained under section 3.2 annex B of the 2016 Model Production Sharing Agreements are fines and penalties imposed under the laws of Uganda or elsewhere; interest on loans raised by a licensee to finance exploration activities; commission paid to intermediaries by the licensee, donations and charitable contributions; any other expense incurred without the approval of the authority.

Question to be asked is what happens when expenditure is allowed by the ITA and not allowed under the Production Sharing Agreement? The simple answer is that the ITA provisions will prevail.[229] In this regard, it may be argued that framers of the Part IX A of the ITA, the special provision for taxation of petroleum industry in Uganda, simply intended to make the Production Sharing Agreement a part of the ITA. Therefore all contract expenses are deemed tax deductible expenses and this may lead to revenue loss. Therefore the ability for government to approve, verify and audit the operating expenses requires very skilled, competent and well trained multi disciplinary team comprising of engineers, certified accountants, lawyers, economists, geologists among others be able to approve, monitor, verify and audit costs in the oil and gas industry. In the absence of this broad base of professional optimization of income tax revenue in Uganda may not be realized.

In conclusion, operating expenses will follow the general section 22 allowable deductions provided for under the ITA and other all items of expenditure which aid petroleum operations. Thus expenses on minor capital equipment, bad debts deductions, expenditure on meals and refreshments and training expenditure has been considered.

The Production Sharing Agreement provides the details of specific items of operating expenses. The Production Sharing Agreement provides for separate treatment of expenses in respect of

[229] See the case of UEDCL and Anor. Vs. URA. TAT Application Number 40 of 2018

exploration, development and operating expenses. The agreement emphasize that the operating expenses must be necessary, appropriate, economical and verifiable for it to be allowed as a contract expense. The same wordings are not included in the ITA and yet the restrictions provided for in the Production Sharing Agreements actually aid the optimization of income tax revenue in Uganda.

The study found out that the Production Sharing Agreement according to section 89GB (3) of the ITA seems to allow all sorts of contract expenses as tax deductible expenses. This deviates from the tax principle that tax is a creature of the statute and in case of conflict the statute provision is to be followed.

Unfortunately, this study reveals that the entire Production Sharing Agreement was made part and parcel of the ITA without thinking of all the conflicts that may arise with its incorporation by implication. The end result is that Part IXA of the ITA which incorporates the Production Sharing Agreement by implication creates several conflicts with other parts of the ITA. The end result of the conflict is that the provisions which do not fall under Part IX A of the ITA provides for tax deductions which simply increase the cost of oil and gas operation in Uganda.

It would be safe to conclude that the Production Sharing Agreement is incorporated by reference into the Act and should be read and interpreted almost as an annexture to the ITA.

The challenge with this system is that the tax administrative functions of Uganda Revenue Authority to audit costs will simply be cosmetic attempt to verify and audit costs in the oil and gas industry. It is argued in this study that once the costs are approved, verified, monitored and audited by Petroleum Authority of Uganda, Uganda Revenue Authority will have no role to play in the industry.

In conclusion the ITA in its current form will negatively impact optimization of income tax revenue in the oil and gas industry in Uganda because of the numerous conflicting provisions in the Act whose effect is to allow non recoverable expenses provided for in the Production Sharing Agreement to be recovered under the provisions of the ITA.

Objective 4

Approval and monitoring of petroleum exploration, production and operating expenses and its impact on income tax revenue optimization in the oil and gas industry in Uganda

As revealed by the previous objectives, the approval, monitoring and verification of costs in respect of petroleum activities is very critical in controlling and managing of the contract expenses provided for under the Production Sharing Agreements and the ITA.[230] Article 5 of the Model Production Sharing Agreement places the responsibility for approval of costs on Petroleum Authority of Uganda.[231] The obligation to verify costs incurred in petroleum operations will also be Petroleum Authority of Uganda or an independent auditor of international repute appointed by the Government.[232]

It is argued in objective 4 that the ITA incorporates the Production Sharing Agreement by implication into the Act. This means that all the approved costs contained in the work program and budget and other approved costs in respect of field development expenses may be allowed as tax deductible expenses.[233]

It is argued in this research that once the approved costs become allowable costs, the balance between maximization of returns on investment by the International Oil Company and the Host Government's objective of maximizing revenue tilts in favor of the International Oil Companies.

The above argument is in agreement with Bina's study that the International Oil Companies have set a very high global price for labor, capital, and entrepreneurship in the oil and gas industry so that the size of the economic rent is significantly reduced in favor of high profitability by the International Oil Company.[234]

Article 5.1 of the Model Production Sharing Agreement provides that the licensee must prepare and submit a detailed annual work program and budget at least 60 days prior to commencement of

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[230] Section 10 of the Upstream Act Act, Number 3 of 2013
[231] Section 10 of the Upstream Act Act, Number 3 of 2013
[232] Section 10(3) of the Upstream Act Act, Number 3 of 2013 require that Petroleum Authority of Uganda should, to the greatest extent possible consult and co-operate with ministries, departments and agencies of government having duties, aims and functions related to those of the Authority.

[233] Section 10(2) of the Upstream Act Act, Number 3 of 2013; also Section 6(2) of the Petroleum(Refining, Conversion, Transmission and Midstream Storage) Act Number 4 of 2013 has similar provisions
[234] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 193

each calendar year. The work program is submitted to the Petroleum Authority of Uganda for review and approval. The work program sets out the exploration and development activities the licensee proposes to carry out in the ensuing calendar year. The estimated costs of the activities must be provided in the budget attached to the work program.[235]

The work program and budget prepared and submitted must conform to the minimum work program expenditure as a requirement under article 5.2 of the Model Production Sharing Agreement 2016. The minimum work program requires that expenditure on preliminary geological, geophysical and geochemical studies and drilling one well must not be less than USD 3.5 million.

It is noted that it is not known how the minimum expenditure of USD 3.5 million is arrived at for purposes of ITA. One possible explanation offered by Bina is that these are minimal global prices set by the United States oil and gas industry based on aging petroleum fields and simply transplanted in the other parts of the world like Uganda.[236]

Another question that arises is what are the actual costs incurred in such circumstances? It is not known whether Petroleum Authority has technical capacity to review and approve costs taking into consideration the fact that Uganda's oil and gas industry is at its infancy. This is a similar fear expressed by Amaoko-Tuffour and Awusu-Ayim in respect of the Ghana petroleum industry that control and verification of costs is a problem for African oil producing countries because the oil and gas industry is complex in its operations.[237]

It is argued in this study that without the technical capacity to review and approve costs, all that will be presented by the licensee will pass unchecked. It is more interesting to note that Article 4.7(b) of the 2016 Model Production Sharing Agreement require that a Licensee who does not spend according to the minimum exploration work program must pay to the government the amount unspent but approved as minimum work program expenditure. This implies that the

[235] Section 10(2)(b, c and d) of the Upstream Act Act, Number 3 of 2013
[236] Bina C,. The Laws of Economic Rent and Property: Application to the oil industry; American Journal of Economics and Sociology vol.51 No. 2, 1992 page 193

[237] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 22-23 paragraph 3.4

Licensee must find all possible ways of utilizing the funds required to be spent on the minimum work program.

It is argued that forcing the Licensee to spend a certain minimum amount on a specific work program may lead to creative accounting or simply overstatement of petroleum activity costs. Once the costs increase without sufficient checks and balances, the revenues that follow will reduce and the size of the profit oil will equally reduce. Therefore approval of work program and budget is the foundation for taxation in the oil and gas industry. If poorly managed the possibility of profit stripping by International Oil Companies may be realized.[238]

The unresolved issue of who will verify the costs must be answered if optimization of income tax revenue is to be achieved. The Petroleum Authority of Uganda should verify costs for its correctness and accuracy.[239] The Petroleum Authority of Uganda who will receive the final report on the actual expenditures the licensee has incurred.[240] The licensee, with justifications, is at liberty to amend any aspect of the work program and budget relating to exploration operations as long as it is consistent with the licensee obligation under the agreement.[241]

Article 7 of the Model Production Sharing Agreements requires the licensee to keep all records, reports and data for inspection by the government. The above records and data must be given by the Licensee to the Host Government upon request.[242] Upon giving notice of at least 15 days prior written notice, the Government or its authorized representative shall have full and complete access to the Contract Area at all reasonable times with a right to observe petroleum operations. The licensee is obliged to furnish the government with records of daily operations and its interpretation.[243] The licensee is under duty to assist government to access the Contract Area and render all reasonable assistance to carry out its duties.

From the above, it's clear that the Host Government is at the mercy of the licensee in respect of data generated and the interpretation of such data. Secondly, the competence of the government

[238] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23
[239] Section 10(2)(h,i,j,k,l and m) of the Upstream Act Act, Number 3 of 2013
[240] Section 10(2) (h) of the Upstream Act Act, Number 3 of 2013
[241] Article 5 of the 2016 Model Production Sharing Agreement
[242] Section1.5, Annex B of the 2016 Model Production Sharing Agreement of Uganda
[243] Section 1.5, Annex B of the 2016 Model Production Sharing Agreement of Uganda

to offer an alternative interpretation of data may be a challenge at this material point. One does not expect a trainee Ugandan to offer any better interpretation of technical data generated by the Licensee including accounting records. As Idubor and Asada observes, the International Oil Company's accounts are shrouded in mystery and without technical capacity and expertise, the local labour force or trainee Ugandans will not be capable of appreciating the practicalities of the petroleum industry operations.[244] Therefore the International Oil Companies my evade taxes because of their long term expertise in the oil and gas industry compared to the inadequately trained Ugandan work force working as watch dog in the oil and gas industry.

Section 1 Annex C to the Model Production Sharing Agreement requires a licensee to submit within 90 days from the effective date a proposed outline of charts of accounts, operating records and reports. The outline should be presented in compliance with international financial reporting standards and consistent with international petroleum industry best practice. The records mentioned above should be kept in the Ugandan office and made available for inspection and use of government and its representatives in carrying out its supervisory role.[245]

The government shall within 90 days from the date of receipt of the outline approve the proposed outline or request for revision of the proposal for conformity with required standard. It is noted that where government recommends revision of the proposed chart of accounts, the Licensee shall within 180 days after effective date of the agreement agree on the outline charts, operating records and reports, the accounting systems and procedures to be developed.[246]

After wards the licensee is obliged to prepare and submit to the government for its review and approval comprehensive charts of accounts relating to accounting, recording and reporting functions. The government will examine the Licensee manuals and review the procedures for use in the agreement. Where the government and licensee fail to agree within 180 days, the Minister shall direct on the format of the charts of accounts to be adopted.[247]

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[244] Idubor R., Asada: Appraising Taxation and the Nigerian Oil Industry; Journal of Law, Policy and Globalization; Vol 37 of 2015 (ISSN 2224-3240) page 195
[245] Section 10(2) (i) of the Upstream Act Act, Number 3 of 2013
[246] Section 10(2) (i) of the Upstream Act Act, Number 3 of 2013
[247] Section 10(2) (i) of the Upstream Act Act, Number 3 of 2013

Article 28 of the Model Production Sharing Agreement grants the government the right to audit and inspect the petroleum operations of a Licensee. The Host Government has unfettered right at any time to audit the books or activities of the licensee, its contractors and subcontractors.[248]

The records should reflect all revenues, costs and expenses relating petroleum activities. The records must conform to the international financial reporting standards and the best petroleum industry practices. The Licensee is required to submit regular statements and reports relating to petroleum activities.[249]

The Licensee must report all expenditures, production, prices, sales, receipts, cost recovery, production sharing and receipts of payment to the government arising from petroleum activities in a contract area. The licensee must submit the records to the government within 90 days after the close of each calendar year detailed accounts showing contract expenses and contract revenues. The accounts must be audited and certified by an independent chartered accountant or certified public accountant of international standing registered in Uganda and acceptable to both parties.

The government through Petroleum Authority of Uganda must first approve the scope of the audit. The government may exercise its authority to review and audit licensees books and records directly or through an independent accountant of international standing appointed by government.

The Licensee is required under section 1 paragraph 1.2 Annex B to submit statement of petroleum activities. The statement must be disaggregated into production per well, per producing field, per production license and per contract area. This should be accompanied by the costs statements, expenditures and income. It should be disaggregated per license and accumulated per contract area. The Licensee must prepare cost recovery statement, profit sharing statement, local procurement statement, end of year statement and budget statement.[250]

The Model Production Sharing Agreement 2016, Article 28 read together with section 1 Annex B provides a good safeguard for the audit and verification of all the accounting records for the oil

[248] Section 10(2) (i) of the Upstream Act Act, Number 3 of 2013
[249] Section 1.2 Annex B of the 2016 Model Production Sharing Agreement
[250] Article 28 of the Model Production Sharing Agreement

and gas production. It provides that the audit and inspection function can be done by the government or an independent accountant of international standing appointed by government.[251]

This is a good stop gap measure especially where there will be lack of technical capacity in respect of the accounting and audit function by the government. Yet the challenge remains that the technical capacity in the petroleum operations where data is generated and interpreted may not be catered for.

It is therefore not clear how long it will be for Uganda to acquire the competence and expertise to fully comprehend the oil and gas operations and to be able to undertake and guide the process of oil and gas production. This means that the data and accounting information presented will be provided by the licensee and there may be no data to contrast and compare the same by the Host Government. This can be a fertile ground to justify costs that otherwise would not be justified hence negatively affecting optimization of the income tax revenues from oil and gas industry in Uganda.

In light of the above, an example can be drawn from failure by Uganda Revenue Authority to ably audit telecom companies leading to massive tax losses. This may be the case with the oil and gas industry income taxation. It must always be borne in mind that the higher the cost of oil and gas operations the lower the revenue available inform of profit oil.[252] Once profit oil is reduced by costs, the government share of production equally reduces by the same proportion and so is the share of profit oil of the licensee available for income taxation.[253] Therefore the likelihood of profit stripping to occur and this will negatively affect optimization of the income tax in Uganda's oil and gas industry.

The question that needs to be answered is who in government will audit and verify oil and gas costs and accounting records? Section 73 of the Public Finance Management Act 2015 provides for petroleum reserve fund and petroleum revenue investment reserve. The Auditor General is

[251] Section 10(2) (i) of the Upstream Act Act, Number 3 of 2013
[252] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23
[253] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23

mandated to examine and audit books of accounts and financial statements of accounts from petroleum reserve fund and reports prepared by the Accountant General.

In light of the above, it is the finding of this research that the Auditor General's mandate does not extend to audit of petroleum operations by Licensees unless the Petroleum Authority of Uganda request for assistance.[254] In this case the audit and verification will be done by Petroleum Authority of Uganda.[255]

It is a finding in this research that the Petroleum Authority of Uganda is the Government body that approves work programs and budgets of the Licensees. It is also Petroleum Authority of Uganda that should verify and monitor the approved costs. In this case the regulator of the Licensee is supposed to guarantee that the costs are brought under check and managed well. There is a likely risk at this point of regulatory capture where the regulator acts under the influence of the Licensee and the regulator can no longer act independently.

It is argued in this study that where Petroleum Authority of Uganda and the Licensee become 'bed fellows,' the inspection, audit and verification of costs will not be conducted with utmost skill, diligence and professionalism. The loss of ability to independently verify and audit approved costs will lead to income tax revenue loss for Uganda's oil and gas industry.

The government auditor may request the Licensee to provide audit certificate from the statutory auditors of affiliated companies attesting that such rates do not include a profit element and have been consistently and reasonably applied.[256]

The audit and inspection shall extend to the operations beyond the delivery point affecting the measurement and valuation of petroleum. The licensee is required to cooperate with the government and its statutory auditors and must provide reasonable facilities and assistance. [257] At conclusion of each audit, the government and licensee shall endeavor to settle outstanding matters and a written report must be provided within 3 calendar months of the conclusion of each audit.

[254] Section 10(2) (i) of the Upstream Act.

[255] Section 10(2) (i) of the Upstream Act.

[256] Section 1.2 Annex B of the 2016 Model Production Sharing Agreement of Uganda
[257] Section 1.2 Annex B of the 2016 Model Production Sharing Agreement of Uganda

The government upon receipt of a report from the auditors reserves the right to conduct investigations notwithstanding the lapse of 36 calendar months.[258] The investigations must be commenced within 30 days and be concluded within 90 days from the date of commencement of investigations. The investigations report must be circulated within 60 days from the date of its conclusion. All adjustments resulting from the audit must be made by the licensee and reported to government promptly. All information obtained during audit and inspection must be treated with confidentiality.[259]

In conclusion, the responsibility to approve petroleum operation expenditures, the mandate to audit the Licensee in respect of costs and revenue resulting from petroleum production is a function of the Petroleum Authority of Uganda. The office of the Auditor General is not directly involved in oil and gas operations audits. The provision that the service of an independent accountant of international standing is used as a stop gap for lack of technical expertise or in a bid to avoid conflict of interest between the regulator and Licensee may not be sufficient.[260]

In the event of regulatory capture as argued before, the likely challenge will be that the audit report will be presented to Petroleum Authority of Uganda and the Petroleum Authority of Uganda reserves the right to make all the necessary adjustments in respect of costs in the oil and gas industry to the disadvantage of the Host Government. The risk of regulatory capture of Petroleum Authority of Uganda by the powerful international oil and gas companies may be possible hence negatively affecting optimization of the income tax revenue from the oil and gas industry.[261]

It is noted that if the audit and inspection function is not reviewed and allocated to the Auditor General to supervise, inspect, audit, verify and investigate the petroleum operations the risk of income tax revenue loss may become a reality.

The use of an independent accountant or accounting firm appointed by the Host Government does not provide fool proof audits. In Uganda the recent case of Crane Bank and Bank of Uganda

[258] Section 1.2 Annex B of the 2016 Model Production Sharing Agreement of Uganda
[259] Section 1.2 Annex B of the 2016 Model Production Sharing Agreement of Uganda
[260] See Section 1.2 Annex B of the 2016 Model Production Sharing Agreement of Uganda

[261] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

revealed that even international accounting firms may not be adequate.[262] In South Africa for instance KPMG admitted its failure to carry out its duties diligently and facilitated corruption in South Africa. In Uganda Crane Bank auditor KPMG failed to properly audit and advise Crane Bank Uganda operations.[263]

Therefore the risk of income tax revenue loss is highly likely and yet the role of Uganda Revenue Authority to audit for tax purposes may not succeed in light of the intricacies involved in approval and audit of costs of petroleum operations. This is coupled with weak provisions of the ITA as amended which absorb all petroleum contract expenses as tax deductions in addition to allowing costs not prohibited by the Production Sharing Agreements. This research finds that optimization of income tax revenue in Uganda's oil and gas industry is highly unlikely under the current income tax legal regime and related laws discussed herein.

Objective 5

The impact of tax rates on income tax revenue optimization in Uganda

Section 7 of the ITA provides a tax rate of 30% for all companies. The rate is stipulated in part 2 of 3rd Schedule to the Act. Tax rates are important in revenue collection because the higher the rate of tax, the higher the income tax available for collection by Uganda Revenue Authority.

As Ya'u points out tax rates are applied to the chargeable profits of the company.[264] A lower tax rate reduces burden on business while a higher tax rate decreases compliance. Ya'u further observes that tax evasion increases as the marginal tax rate increases.[265] Studies show that high tax rates have the effect of under reporting of income. As observed in objective 4 of this study, high petroleum expenditures will reduce the size of profit oil available for sharing under the

[262] Meera Investments Limited vs. Crane Bank in Receivership HCCMA No. 320 of 2019 where Bank of Uganda failed to properly supervise Crane Bank and the Bank was taken over by Bank of Uganda this is despite the Audit by reputable KPMG Accounting firm.
[263] Meera Investments Limited vs. Crane Bank in Receivership HCCMA No. 320 of 2019
[264] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162
[265] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

Production Sharing Agreement. Under reporting of profits means that the costs are over stated and this leads to income tax revenue loss by way of tax evasion by International oil companies.[266]

Nigeria petroleum income tax rate is 85% compared to Uganda's 30% and Ghana's 30%. As Nakhle observes the best practice is not to set a very high tax rate but ensure that all fiscal instruments in the oil and gas industry are structured to achieve a balance of revenue optimization by government and a fair and adequate return on capital invested by the International Oil Company. The right balance Nakhle observes is to use a combination of fiscal instruments including the use of profitability taxes like it is the case with income tax for the oil and gas industry.[267]

The challenge revealed by the literature is that despite the low tax rate of 30% for International Oil Companies in the oil and gas sector the costs are most likely to be overstated if the Host Government does not have sufficient and competent manpower to approve, verify and audit the costs in the oil and gas industry. The extravagant and uncontrolled contract expenses which is turned into tax deductible expenses means that it may not possible to optimize income tax revenue in the oil and gas industry.[268]

In contrast with the Nigeria's petroleum profit tax of 85% the deductions allowed to Licensee is equally extravagant such that the high tax rate does not translate into significant income tax revenue yields.[269] Uganda has tried to deviate from the Nigerian situation by excluding certain key expenditures which are allowable in Nigeria. The case in point is that Uganda does not treat royalties, bonuses and income tax paid elsewhere as a tax deduction. By so doing Uganda is trying to protect the size of the economic rent that may be eroded by uncontrolled contract and tax deductible expenses.

The research finds that both Nigeria and Uganda may fail to manage the costs of petroleum operations which can easily be over stated leading to reduction in the available chargeable profits.

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[266] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23

[267] Nakhle C.;Petroleum Taxation: Sharing the oil wealth: A Study of Petroleum Taxation yesterday, today and tomorrow page 27 (Routledge Studies in International Business and World Economy)

[268] Section 89 GB(3) of the ITA

[269] Ya'u A., Determinants of Petroleum Profit Tax Compliance among Oil Companies: International Journal of Advanced Science and Technology Vol. 28 No.20 of 2019 page 162

The research also noted that if there is no human and technical capacity to approve, monitor and verify cost of petroleum operation, a lower tax rate simply leads to low income tax revenue.[270] This seems to explain why Nigeria applies 85% of the tax rate on International Oil Companies with the hope that it will optimize its income tax revenue in the oil and gas industry.

In the circumstance it would be important to ask the question: do tax rates matter if you have no control over costs? The answer is most is most likely to be in the negative. It is argued in this research that the Host Government must carefully study the design of the income tax fiscal regime and carefully negotiate fiscal instruments that can achieve a better income tax yield.[271] If all petroleum operation expenditures are unchecked, the size of profit oil is likely to be too small. Therefore tax rate of 30% provided for under the ITA will most likely be meaningless.

In conclusion Uganda's income tax rate may not be able to optimize revenue from oil and gas industry if the cost of petroleum operation is not controlled by the Host Government.

CHAPTER 5 CONCLUSIONS AND RECOMMENDATIONS

1. Carry forward of expenditures for previous years in petroleum taxation is an exception to the taxation principle that only expenditures incurred in the year of income is deductible against the year's gross income.
2. All contract expenses in the petroleum operation are allowed as a tax deduction with minor exceptions.
3. Approved costs of petroleum operation expenditures forming tax deductible expenditure
4. The higher the cost of producing income, the lower the chargeable income available for taxation and the lower the income tax available to the host government

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[270] Amaoko-Tuffour J., and Owusu-Ayim J; An Evaluation of Ghana's Petroleum Fiscal Regime; Ghana Policy Journal Vol 4 December 2010 page 23

[271] Nakhle C.;Petroleum Taxation: Sharing the oil wealth: A Study of Petroleum Taxation yesterday, today and tomorrow page 27 (Routledge Studies in International Business and World Economy)

5. Aggregate petroleum expenditure is recoverable from cost petroleum 100% upon commencement of commercial production in any calendar year.
6. The mandate to approve, monitor and audit costs in oil and gas industry is on Petroleum Authority of Uganda. It is not clear what Uganda Revenue Authority will audit if all approved costs are verified as cost incurred in petroleum operations. The Auditor General's office is limited to audit of petroleum refund and petroleum reserve fund.
7. Uganda Revenue Authority's role in the audit of oil companies must be set clearly in the law otherwise its role will greatly be reduced to accepting the audit reports presented by other government departments.

5.1 RECOMMENDATIONS

1. Not all approved costs should be allowed as deductions but only costs which are necessary, appropriate and economical and incurred by the Licensee in the production of income included in gross income.
2. The ITA should be urgently amended to include the words that the expenditure must be necessary, appropriate and economical as provided in the Model Production Sharing Agreement. This will restrict the scope of allowable expenditures and it will lead to income tax revenue maximization.
3. Petroleum income taxation requires a special legislation designed to achieve optimal income taxation just like it is the case with Nigeria and Ghana. The law must be simple and clear to avoid ambiguity and related interpretation challenges.
4. There is need to strengthen the office of the Auditor General to audit petroleum operations and not Petroleum Authority of Uganda. This will be useful in separation of the duties of Petroleum Authority of Uganda as a regulator and the audit function in order to avoid regulatory capture and eventual oil and gas revenue loss.
5. It is recommended that a diverse and interdepartmental audit team be set up and led by the Auditor General and deputized by Uganda Revenue Authority if a proper audit is to be carried out on oil companies.
6. Non recoverable cost in the Production Sharing Agreements must be harmonized with the provisions of the ITA to avoid tax disputes which may be resolved in favor of the licensee.

7. Uganda should redesign its fiscal instruments to reduce on the extravagant contract expenses to what is necessary, appropriate and economical and a bench mark set for same.

5.2 AREAS FOR FURTHER RESEARCH

The research recommends the following as areas for further research;

1. Who is better placed among the Host Government Departments to audit and supervise the audits of International Oil Companies in Uganda?
2. A study needs to be undertaken to find out whether the expected revenues from the oil and gas in the Albertine Graben is better than the revenues to be obtained from the tourism sector in the long run. This takes into account the amount of environmental damage and the opportunity cost of the likely loss of wild life, flora and fauna in the Albertine Graben as well as any environmental damage caused by the petroleum activities in the region.
3. A study needs to be undertaken to find out why the previous governments in Uganda did not pursue the oil and gas extraction in the Albertine Graben.

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