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When the Hunters Learn to Shoot Without Missing, the Birds Learn to Fly Without Perching: protecting source taxation in Uganda's upstream oil sector from artificial profit shifting

Brian Collins Ocen[1]

Abstract:

This paper examines the phenomenon of artificial profit shifting as a component of illicit financial flows. Uganda's upstream oil sector involves a rent sharing regime with the non-resident international oil companies. The involvement of international oil companies creates taxing rights for host governments. Unfortunately, these rights can be susceptible to artificial profit shifting - an aggressive strategy of tax avoidance which contravenes applicable anti-abuse tax laws and therefore falls within the prescriptive envelope of illegality. This paper discusses the unique opportunity for the application of anti-abuse tax laws and the need for judicial cooperation in doing so, as a tool against artificial profit shifting; whose negative impact on the tax-to-GDP ratio continues to undermine Uganda's efforts in domestic resource mobilisation to alleviate poverty.

Keywords: Illicit Financial Flows, Artificial Profit Shifting, Anti-Abuse Rules, Judicial Cooperation, Resource Colonialism.

Introduction

This paper traverses themes of taxes and taxation, and their effect on poverty alleviation in developing countries. Rodrik states that "the captains of the world economy have conceded that progress in international trade and finance has to be measured against the yardsticks of poverty alleviation and sustainable development" (2002, p. 29). Because the majority percentage of domestic resource mobilisation by government is typically supported by taxes (Henderson and Poole, 1991, p. 598), tax is inevitably a fundamental feature in poverty alleviation for developing states.

According to the OECD's revenue statistics on Uganda, since 2000 Uganda's tax-to-GDP ratio has never exceeded 11.8%, which it reached in 2018 (OECD, 2020). Yet in that same year, Uganda's tax-to-GDP ratio was still below that of neighbours Kenya and Rwanda; and similarly below the broader Common Market for Eastern and Southern Africa (COMESA) (World Bank Group, 2018, p.v).

The impact of Illicit Financial Flows (IFFs) on least developed countries such as Uganda is associated with a low tax-to-GDP ratio and continued reliance on official development assistance (aid) and/or debt**.** In 2015, a high level inter-governmental report noted that Africa was

[1] The author is a final year LLB student at Makerere University, Uganda. An earlier version of this paper was awarded second place in the Amartya Sen Prize 2020, with the presentation of the award taking place during a virtual ceremony at the ASAP Global Conference in November 2020. The views expressed in the paper are solely those of the author.

estimated to have lost more than $1 trillion in IFFs, an amount that equals the official development assistance received by the continent within the same timeframe (High Level Panel, 2015, p.13). Most recently, the Africa Growth Initiative at Brookings has also noted that between 1980 and 2018 sub-Saharan Africa haemorrhaged US$1 trillion in IFFs (Signe, Sow, and Madden, 2020, p.2).

There is no clarity on what the tax contribution to the net value of Uganda's oil will be. What is speculated is that the net present value of Uganda's oil will be US$2 billion annually for at least the next 26 years (Lakuma, 2018, p.2). Whatever the tax contribution will be, it will undoubtedly be significant in raising Uganda's tax-to-GDP ratio. It is also important to note that the US$2 billion is more than the US$1.7 billion that Uganda gets as development assistance annually (Kamugisha, 2010, p.3)

Unfortunately, multinational companies have proven themselves capable of employing impermissible aggressive tax avoidance strategies characterized by artificial profit shifting. In recent years, no company has provided a more dramatic example than Heritage Oil and Gas Limited (hereafter 'Heritage') in its operations in Uganda's upstream oil sector. This essay focuses on Heritage's operations in Uganda, in order to highlight artificial profit shifting as a tax-related component of IFFs in the country's nascent upstream oil sector.

Uganda's upstream oil sector

The upstream oil sector involves the search for and recovery of crude oil, as well as its production. This includes the phases of exploration, drilling and production (Devold, 2013, p.4). Owing to the capital intense nature of the upstream oil sector, which requires advanced technology, this sector involves partnership with international oil companies (IOCs) to carry out its operations (Johnston, 2003).

With the involvement of IOCs, a suitable fiscal regime is needed. A fiscal regime is a set of instruments or tools that determine how the revenues from oil and mining projects are shared between the state and the companies (Gudmedstad, Zolotukhin and Jarlsby, 2010). The fiscal regime must aim to take into account the risks borne by the IOC and its need for a rate of return commensurate to that risk, while also providing revenue to the state which owns the resource (Energy Charter Secretariat, 2008, p.8).

In 2006 discoveries of 6.5 billion barrels of oil, of which 1.4 to 1.7 billion are economically recoverable, were made in Uganda. Although Uganda also engages a local content policy in the oil sector designed to try and enhance the benefits for local people beyond revenue to include jobs and the creation of businesses, revenue collection from the sector remains the key issue.

A significant source of revenue for the host country is from the taxation of the profit oil share of the IOC, as well as taxation of other activities of the IOC within the host country. Uganda operates a contractual petroleum fiscal arrangement known as the Production Sharing Agreement (PSA). Under this type of contractual arrangement, the government remains the owner of oil and gas resources and awards the IOC a license to exploit the oil and gas (Tordo, 2007).

Under Uganda's Model Production Sharing Agreement (hereafter MPSA), the contractor is compensated in kind through cost oil, which is the portion of the total value of available crude oil required to recover costs, as well as through profit oil, which is the portion of available crude oil after costs have been recovered (Government of Uganda, 2012, Article 12). This means that, after deducting cost oil to cater for costs incurred by the IOC, the remaining production is profit oil (Bindemann, 1999, p.14). According to Article 12 of Uganda's MPSA, the apportionment of profit oil is on a sliding-scale set in favor of the government and based on cumulative production.

Article 13 of the MPSA also makes room for corporate income taxation of the profit oil of the IOC in accordance with Uganda's Income Tax Act. Aside from corporate income tax charged on profit oil of the IOC, other forms of taxes the government collects include capital gains tax, in case of transfer of assets by an IOC, and stamp duty on documents processed by an IOC.

Uganda also operates a hybrid PSA, where the IOC pays what is typically considered a tax on production, i.e. royalties covered by Article 9 of the MPSA. Further, the IOC pays non-tax revenues, i.e. a signature bonus paid upon obtaining a license to explore and a production bonus upon obtaining a license for production under Article 8 of the MPSA.

Finally, Uganda's production sharing regime is also combined with a form of equity participation known as carried equity participation as provided for by article 10 of the MPSA.[2]

Therefore, under this production sharing agreement model, the total share of government revenue take is the sum of: (i) revenue from the government share of profit oil; (ii) corporate income tax on the IOC share of profit oil; (iii) royalty payments by the IOC; (iv) bonus payments; and (v) a percentage of the NOC's share of the profit oil under the state equity participation provisions.

The history of the tax dispute between Heritage and the government of Uganda, which forms the nucleus of this paper, dates back to 1997, when Heritage was contracted by the government of Uganda to explore for oil in Uganda. After discovering commercially viable amounts of oil later in 2006, Heritage sold its interests to Tullow Oil (hereafter 'Tullow'). Typically, under Uganda's income tax laws, the sale by Heritage to Tullow was subject to a capital gains tax, i.e. a tax charged on the transfer of assets. However, in order to avoid this tax, Heritage resorted to the extensive use of artificial profit shifting mechanisms to illegally avoid the capital gains tax due to the government of Uganda.

What is Artificial Profit Shifting?

Profit shifting occurs when multinational corporations use tax planning tools as a vehicle to transfer profits from high tax jurisdictions to low tax jurisdictions. Although profit shifting is not illegal, it is subject to certain legal qualifications or limitations (Klemm and Liu, 2019, p.5). It violates such legal requirements when "it is associated with practices that artificially segregate taxable income from the activities that generate it", at which point it becomes "artificial profit shifting" (OECD, 2013, p.10).

Artificial profit shifting is a tax-related component of IFFs. Global Financial Integrity defines IFFs "as movements of money and value from one country to another that are illicitly earned, illicitly transferred, and/or illicitly utilized" (2018, p.3). The background to artificial profit shifting is a delicate balance between the legitimate individual rights of tax payers and the abuse of those rights by tax payers.

[2] Carried equity participation means that a National Oil Company (NOC) can enter into a joint venture with an IOC whereby the IOC agrees to advance funds to the NOC for the development to production stages, after which the NOC spends equally with the IOC and compensates the IOC for the funds advanced.

What do we mean by the aforementioned statement?

In principle, tax is strictly levied in accordance with statute. This is a well-established legal principle of tax administration and tax interpretation, captured by common law jurisprudence of Cape Brady Syndicate V IRC (1921) in which the court held that, "there is no presumption as to tax. [...] one can only look at the language used [in the statute]" (p.71).

This requirement of legal certainty enables the function of the rule of law, the purpose of which is to guard against arbitrary abuse of power by tax authorities. This also forms the basis for the legitimate individual rights of tax payers. The basis for the legitimate individual right of the tax payer (whether it be a natural person, i.e. an individual, or an artificial person, i.e. a company) is therefore the principle of certainty that entitles a tax payer to pay only what the law prescribes - nothing more and nothing less.

This certainty provides a significant benefit to tax payers, namely the benefit of tax planning. Tax planning involves organising your affairs in such a way that you pay the least amount of tax under the statute. It is achieved by legally minimising one's taxable income. In Union of India and Another V Azadi Bachao Andolan and Another (2003), the supreme court of India held that tax planning cannot be treated as illegal. Vogel, adding the weight of his scholarly reputation to that position, writes that such a rule "applies, if not universally, at least within all Western constitutional democracies" (1986, p.79). But he adds that "nevertheless, tax planning inevitably reaches a point beyond which it cannot be tolerated within a legal system if it is intended that the system be just" (p. 79)

Generally, for tax planning to be valid, it must be exercised in a manner that does not involve dubious devices (Vodafone International Holdings B.V v Union of India and Another, 2012, para. 56). Therefore, similar to the "misuse of rights" legal concept postulated by Lord Sumption in Prest V Petrodel Resources Limited (2013) (hereafter the Petrodel case) as a concept that forms the basis for the lifting of the veil in company law, tax law has also developed the doctrine of the abuse of tax laws to distinguish permissible from impermissible tax avoidance. (Garbarino, 2014, pp. 216-217; Baker, 2013, p.8).[3] In the Petrodel case, Lord Sumption defines the misuse of the legal concept of rights as one which "extends not just to the illegal and improper invocation of a right but to its use for some purpose collateral to that for which it exists" (Prest vs. Petrodel, 2013, para 17).

At an international level, abusive tax planning involves the use of formal arbitrage to defeat the distributed taxing rights of contracting states. The distribution of taxing rights among contracting states is captured under both the 2017 Update to the OECD Model Tax Convention on Income and on Capital (hereafter Update to the OECD Model Tax Convention) and the 2017 UN Model Double Tax Convention between Developed and Developing Countries (hereafter UN Model Tax Convention). One main objective of the model conventions or treaties is to eliminate double taxation on income obtained in international business. One of the ways to eliminate double taxation is to divide the taxing rights between resident country and source country.

[3] The lifting of the veil refers to a principle in company law which forms a justification for courts to sidestep the corporate personality of companies when inquiring into purported misdeeds of the company, in order to establish who the company's directors are, for purposes of attributing fault for the company's misdeeds.

What is source taxation?

Under the international taxation regime, foreign companies with significant activities in a country are typically only taxed on the income from sources within that country. This is captured under Article 7 of the Update to the OECD Model Tax Convention. This is the concept of source taxation, which must be distinguished from resident taxation, which is captured under Article 4 of the Update. According to the resident taxation principle, if a company or person is classified as a resident, tax authorities of their place of residence have full taxing power over their worldwide income. In other words, a resident country claims the right to tax income that a company earns regardless of where in the world that income is generated.

In recognizing that a company may be taxed multiple times, the resident country that claims to tax on a worldwide basis gives a credit or exemption for taxes paid to other governments, in order to eliminate double taxation. This is generally covered under articles 23A and 24B of the Update to the OECD Model Tax Convention. And additionally, the commentary to article 23A also states that where there is a double tax treaty, such treaty will take precedence over domestic law in the determination of the method of grant of a credit or an exemption. Otherwise, the type of credit or exemption a company gets to prevent double taxation depends on the domestic tax law in its country of residence.

Source-based taxation is consistent with a benefits perspective on justifying tax jurisdiction, since source jurisdictions provide significant benefits to corporations that carry on business activities within them. Such benefits include the provision of infrastructure or education, as well as more specific government policies such as keeping the exchange rate stable or interest rates low. These benefits justify source-based taxation in the sense that the host country's government bears some of the costs of providing the benefits that are necessary for earning the income.

Tax planning to avoid source taxation

Tax rates differ from one country to another, as a matter of principle - because states are sovereign and hence have the right to impose their own tax rates, which they may do, for example, to offer more attractive tax rates for investors than competing states, but also due to practical considerations - because each state has varying economic needs and therefore each country's tax system is designed with different objectives. For instance, it is true that one objective of taxation is to raise revenue, but it is also the case that the government uses the tax system to encourage investment in certain types of assets or in certain specific industries (James, 2009, p.1). Against the background of differing tax regimes, multinational companies are able to use formal arbitrage to significantly reduce their tax liability.

For multinational corporations, whereas the ability to operate in several jurisdictions presents exposure to the taxing rights of more than one country, it also presents extensive opportunities for tax planning. When tax liability appears to be unavoidable, for a company looking at tax planning opportunities, it can lower the tax liability by reducing the tax base or the tax rate, the elements that determine the tax payable.

For international taxation planners and multinational entities, the tax planning tool kit to achieve this typically involves: i) avoiding a taxable presence in relation to the activities performed by subsidiaries in the high tax source country; ii) reducing the tax base in high tax source countries by means of deductible payments to other subsidiaries in low tax jurisdictions; iii) ensuring no taxable profits at the level of the parent company in the parent company's residence country; and finally: iv) using hybrid mismatch arrangements that take advantage of differences in legal regimes such as residence rules, to provide particular benefits in eliminating the taxes that may be payable by intermediate subsidiaries.[4]

Such a tax planning tool kit, if merged with other harmful practices such as treaty shopping, transfer mispricing, and sham transactions, results in artificial profit shifting, an aggressive strategy of tax avoidance which contravenes specific and general anti-avoidance rules and hence falls within the prescriptive envelope of illegality (UN, 2017, pp.76-83).

A critical analysis of the tax planning tool kit of Heritage reveals extensive artificial profit shifting. A case study of the protracted tax dispute between Heritage and the government of Uganda provides excellent material for a discussion of artificial profit shifting. In this case, the tax planning tool kit of Heritage contained ingredients that violated Uganda's anti-tax abuse laws.

Heritage Oil and Gas Limited: Artificial Profit Shifting in Uganda – A Case Study

Source taxation rules require that a source country can only tax a foreign business if the business has a permanent establishment in the source country. If this is not the case, taxation by a source country can only be justified if the income being generated by the foreign business comes from immovable property. When it comes to income derived by a resident of a contracting state (residence country) from immovable property situated in the other contracting state (source country), such income may be taxed in that other state (source country) (OECD, 2017, Article 6, para1). In such a case, the source country has the right to tax income accrued in the source country (full taxing right), while the residence country, which has only a limited taxing right, is obliged to apply measures to eliminate double taxation, such as the credit method or the exemption method.

Uganda's Income Tax Act Cap 340 provides the basis of source taxation rights over income derived from sources in Uganda, including proceeds of the disposal of an interest in immovable property located in Uganda (Government of Uganda, 1997, section 79 (e)). In Heritage Oil and Gas Limited v Uganda Revenue Authority (2011), Heritage had attempted to establish that it had no rights in immovable property in Uganda. However, the tribunal found that Heritage was liable to pay tax on income from the sale of its interest in immovable property in Uganda.

Heritage contended that the exploration licences it had been granted did not confer on it any right to take possession or ownership of any oil from the exploration areas or to create any rights in respect of the land, and that therefore it had not derived income from immovable property.

[4] An example of a hybrid mismatch arrangement is provided by a high profile tax avoidance scandal involving Apple. The tax planning tool kit used by Apple involved the incorporation of a holding company in Ireland, a country whose residence rules required effective management, and yet Apple maintained its effective management in the USA, a country that did not provide under its law for effective management but rather incorporation as the basis for tax residence. By taking advantage of such a mismatch arrangement, Apple was able to create a holding company which, although incorporated in Ireland, was resident in neither Ireland nor the USA for tax purposes. This enabled what has come to be known as stateless income. See BBC Panorama (6 November 2017). Paradise Papers: Apple's secret tax bolthole revealed. https://www.bbc.com/news/amp/world-us-canada-41889787

However, the tribunal found that the income generated by Heritage was income from interests in immovable property in Uganda. Heritage was therefore obliged to pay to the government of Uganda capital gains tax of approximately US$405 million from the sale of its interests to Tullow.[5]

However, the basis on which the case was determined did not give the tribunal the opportunity to determine matters of artificial profit shifting, specifically of abuse of the Uganda Mauritius Double Tax Agreement which Heritage was widely thought to have abused to try to avoid taxes by shifting its profits artificially to Mauritius. The artificial profit shifting mechanisms involved in Heritage's tax planning tool kit included:

i) The use of sham transactions without substance.

The case facts revealed that, while Heritage was incorporated in the Bahamas prior to the sale of its interests to Tullow, it was later registered in Mauritius in 2010, although it carried out no commercial activity in Mauritius (Heritage V URA, 2011, p.5).

The revelations from the Panama Papers later showed how in fact Heritage had re-domiciled to Mauritius only 11 days before the sale of its interest to Tullow, just to avoid the capital gains tax due on the transaction.[6] This move meant that Heritage would benefit from the Uganda Mauritius Double Tax Agreement which would ensure that Heritage, being resident in Mauritius for tax purposes, could not be taxed in Uganda. For Heritage, the fact that Mauritius is a low tax jurisdiction having a double tax agreement (DTA) with Uganda made it a perfect destination to which to shift profits, even though Heritage in fact had no physical presence in Mauritius.

The use of sham transactions means that a company will involve the use of 'mail-box companies', also often referred to as 'paper companies'. These companies do not exist in reality but only on paper. Such transactions are considered to violate the sham doctrine and substance rules under Action 5 of the Base Erosion Profit Shifting (BEPS) Action Plan (OECD, 2013, p.18).

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

Treaty abuse means that a company takes advantage of a tax treaty between two countries in order to facilitate what is commonly referred to as double non-taxation, i.e. when the company is taxed in neither the country where it generated/sourced the income nor where it is resident.

While appearing as a witness in Tullow Uganda Ltd v Heritage Oil and Gas Ltd and Another (2014) in the High Court of Justice, Queens Bench Division Commercial Court, the court discovered that Mr. Paul Richard Atherton, the director of Heritage, had given false evidence on oath to the Tax Appeals Tribunal of Uganda, in that he had stated that the re-domiciling from the Bahamas to Mauritius was "not purposely done to take advantage of the benefit Mauritius could offer in light of the transaction with Tullow", when in fact the re-domiciling was purposely done to take advantage of the Uganda-Mauritius DTA (para 51).

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[5] This figure excludes US$30 million which was another tax assessment subject to another tax dispute between the Uganda Revenue Authority and Heritage (Heritage Oil and Gas Limited v Uganda Revenue Authority, 2010). The focus of this paper is the tax dispute in relation to the assessment of US$ 405 million.

[6] BBC (8 April 2016). Panama Papers: How Jersey-based oil firm avoided taxes in Uganda. https://www.bbc.co.uk/news/amp/world-africa-35985463

International tax rules also require that entities must not structure transactions to purposely derive a tax benefit from DTAs. This rule is captured by "the principal purpose test" under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, also known as the Multilateral Instrument (MLI) (OECD, 2018, Article 7 (1)).

Although international taxation has currently developed legal rules to address concerns of tax abuse, these legal rules sill merely act as a deterrent. This is primarily because there is a paucity of judicial precedent to signal judicial cooperation with anti-abuse tax rules. It becomes increasingly difficult for tax authorities to enforce the anti-abuse rules without the certainty of judicial cooperation.

In Heritage's case, because it had no assets in Uganda by the time of the tribunal's decision, the government of Uganda used its enforcement mechanisms to issue agency notices on Tullow, which had purchased the interest of Heritage, and appointing Tullow as Heritage's agent in respect of its tax liability. Tullow ultimately made a payment to the Government of Uganda pursuant to those notices. It then commenced proceedings against Heritage in order to obtain a contractual indemnity, pursuant to a provision in the Sale and Purchase Agreement that gave Tullow the right to an indemnity in respect of capital gains tax imposed on Heritage but charged to Tullow by the Government.

Protecting Source Taxation against Artificial Profit Shifting with Judicial Cooperation

The international taxation framework captured under UN Model Tax Convention makes allowance for domestic anti-avoidance rules, as well as judicial doctrines to address tax abuse (UN, 2017. p.72).[7]

Because anti-tax abuse rules have moved from the realm of law referred to as *lex ferenda*, i.e. the law 'as it ought to be', to the realm of law referred to as *lex lata*, i.e. the law 'as it is', it is imperative that courts provide the doctrinal precedent necessary to support the applicability and enforcement of these rules.

Anti-avoidance rules may be either general or specific. Specific Anti-Avoidance Rules, also referred to as Targeted Anti-Avoidance Rules, are designed to deal with particular transactions. Common Specific Anti-Avoidance Rules include: transfer pricing rules, thin capitalization rules or rules limiting interest deductibility, limitation of benefit rules/clauses, and controlled foreign company rules (UN, 2017, p.76).

The General Anti-Avoidance Rule (GAAR), on the other hand, is intended to prevent abusive arrangements that are not dealt with through the Specific Anti-Avoidance Rules. The GAAR is underscored by the UN Model Tax Convention (UN, 2017, Article 29 para. 9). Several countries have already implemented the GAAR to combat abusive tax avoidance. These include India, Italy, Australia, Canada, China, Germany, South Africa, the United Kingdom, Belgium, France, New Zealand, the United States and the Netherlands.

However, without judicial cooperation through judicial decisions that establish anti-avoidance doctrinal precedents, the anti-avoidance rules will lose their deterrence effect. Nonetheless, while the need for anti-avoidance doctrinal precedents is critical, it should not be at

[7] Judicial doctrine refers to a court's reasoning in support of its decisions. This reasoning takes the form of principles. When judicial doctrine is laid out by a court through one of its decisions, it becomes doctrinal precedent and hence a source of authority in settling subsequent disputes.

the expense of impartiality or independence of the judiciary, lest litigants lose faith in the courts as custodians of justice. The judiciary must ensure that neither side violates the equity principle, either through arbitrary tax administration by the tax authorities or through illegal tax planning activities by taxpayers.

It must be mentioned that, standing in the way of judicial cooperation in the applicability of anti-avoidance rules may be the absence of anti-avoidance rule(s) in the relevant DTA. Because DTAs generally override domestic tax statues, if artificial profit shifting involves the abuse of a treaty, it may go unchecked even if there exists a GAAR in the domestic law provisions (Baker, 2013).

For that reason, states which are not a party to the MLI should rethink their position. The MLI is a good option because it avoids the burden of lengthy renegotiation of double tax treaties. Action 15 of the BEPS Action Plan (OECD, 2013) establishes that the BEPS Action 6, which deals with the prevention of treaty abuse as a minimum standard, is to be implemented through the MLI. Article 6 of the MLI incorporates/appends its provisions automatically into the bilateral tax treaties of its states parties.

Conclusion

As a result of post-colonial resource nationalization and a general recognition of the principle of permanent sovereignty over natural resources by the international community, specifically under United Nations General Assembly Resolution A/RES/3171 (1973), states have taken up resource nationalistic identities (Stevens, 2016, p.4). However, resource colonialism threatens to rare its ugly head in a different fashion.

IFFs by international companies in the oil sector remain a concern. To understand the significance of this problem to poor countries like Uganda, it is important to bear in mind that the amount of capital gains tax involved in the Heritage dispute "is more than the Ugandan government's annual health budget" (Myers, 2010, p.2). Some commentators have gone as far as asserting that such tax avoidance (which oversteps the threshold of legality) by IOCs in developing countries "perpetuates and reinforces 'resource colonialism'" (Evans et al., 2013, p.17).

The proper applicability of anti-avoidance rules protects the legitimate right of the individual tax payer while preventing the abuse of that right by tax payers themselves. Hence these anti-avoidance rules, along with judicial cooperation, are necessary to curtail the ever-increasing use of artificial profit shifting by multinational entities to reduce their tax liabilities.

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