

2 November 2015

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Dear Davis Committee members

RE: SUBMISSION ON THE DTC REPORT ON MINING TAXATION

Attached is the SAIT response document to your mining tax committee report. We trust that the input provided will be viewed as constructive. This report was based on discussions with various tax professionals within the mining sector.

Sincerely

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RESPONSE COMMENTS

Overview

1. While the report is a valiant attempt at a complete review of the mining income tax regime, we strongly note that the taxation of mining cannot be reviewed in isolation from other regulatory concerns nor should the analysis be undertaken on an instrument-by-instrument basis in terms of tax. As your committee is fully aware, the mining industry in South Africa has been in decline for many years.
2. This decline is admittedly partly attributable to external factors (e.g. commodity prices and aging marginal mines). However, government regulatory uncertainty cannot be removed from the equation. Much of this uncertainty stems from never-ending piecemeal government intervention. The main culprits have been the Department of Mineral Resources, the National Treasury (with the royalty regime and now the pending carbon tax), the Department of Labour, the Department of Trade and Industry, the Department of Environmental Affairs as well as failings within Eskom. The combined effect of these never-ending interventions can be seen in South Africa's global competitiveness ranking (with South Africa now ranking as 62 out of 117 countries in the most recent Frasier Institute mining survey). The Davis Tax Committee should not create further disruption in this regard.
3. As stated in the Davis tax committee report, it should be remembered that mining is a long-term business that requires a large upfront capital investment. The start-up period for the extraction of many minerals can be from 3-to-5 years. Once production begins, profit is far from certain due to the changing nature of the commodity cycle. Capital investment often occurs at the height of a cycle with production underway only after a period of decline.

4. It is well-known that South African mining had a credible performance from 2000 to 2008 but missed the boom years due to government intervention. The commodity cycle is now over and economic demand is set to remain subdued for at least 5 years. In the meantime, disruptive government intervention appears to be increasing. The net result is a continual decline in mining investment. Tax policy initiatives to promote new investment in the mining sector will probably have little or no effect. Any tax policy initiatives should instead focus on preventing a further decline. While the sector has unfortunately been reduced to a smaller scale, it should be remembered that the mining sector still remains a critical player in terms of export when considering South Africa's balance of trade.

Mining CAPEX allowances

5. It is understood that the current 100 per cent CAPEX allowance under section 36 (with corresponding ring-fencing) is far from ideal. The CAPEX regime appears to stem from reactive government tax policy. The 100 per cent upfront allowance is arguably over-generous. This "over-generosity" was then curtailed with the imposition of per mine ring-fencing of the allowance (subsections (7E) and (7F) of section 36). This anti-avoidance was then mitigated by the 25 per cent escape hatch (subsection (7G) of section 36).
6. The above policy confusion stems from Government's desire to encourage future investment in mining versus the need for revenue.
 - The 100 per cent CAPEX regime effectively means that mining companies will not be taxed in respect of a mine until gross revenue exceeds aggregate multi-year investment. Annual profits are ignored until this multi-year aggregate is exceeded. This deferral differs from the taxation of most businesses. The initial concept was designed on the basis that the initial sunken CAPEX is fixed within the country at permanent risk to global mining investors.

- Without ring-fencing, the losses of one mine can offset profits of another. Ring-fencing ensure that Government will receive some share of tax even if a mining company is perpetually expanding within South Africa (via brownfield or greenfield mining investment or upscale beneficiation). While this approach admittedly protects the fiscus, the inability to use the losses of one mine to offset income from another acts as a hindrance to further investment. This hindrance was seen as too great, which resulted in the 25 per cent escape hatch.
 - Given the above policy confusion, there is something to be said for shifting the mining CAPEX regime to a more standardised (e.g. manufacturing format) as a matter of theoretical consistency and simplicity. This change will create some winners and losers.
 - That said, we note that further policy changes will only create more uncertainty. It should further be noted that new mining investment has dried up and further significant new investment into local mining sector is doubtful given the overall political and regulatory uncertainty existing within the South African environment. Therefore, it is questionable whether the effort to create a new regime is desirable and / or outweighs the costs of further disruption (including the complexity associated with required transitional rules). We would accordingly suggest that the regime be left in place as a matter of stability to avoid further perceptions of piecemeal government intervention.
7. One big issue overlooked by the report is the current nature of ongoing mining CAPEX. Most additional mining CAPEX now occurs only to maintain operations. Many of these CAPEX expenses are more akin to repair (but for the creation or acquisition of new ancillary facilities). This repair is arguably deductible under section 11(a) or 11(d) – all of which is fully deductible when incurred without any ring-fencing.

8. Despite the “repair-like” nature of ongoing mining APEX, many mining companies are treating these expenses as normal section 36 CAPEX as a matter of administrative simplicity. This treatment exists despite the fact that this simplicity comes at the cost of section 36 ring-fencing. Tracking the exact nature of ongoing CAPEX investment on the ownership registrar is simply too time-consuming and expensive. However, if the regime were changed to a 40:20:20:20 regime as proposed, many mining companies would be forced into preserving the upfront deduction for these repairs, thereby undertaking the tracking necessary. It is doubtful whether the revenue forecasting associated with the practical treatment of mining maintenance has been taken into account. Placing repair on a 40:20:20:20 basis would also be unfair since no other industry is limited this way (and would place the local mining industry into further decline).

Social and labour plan infrastructure

9. The Mineral and Petroleum Resources Development Act requires mining companies to undertake a social and labour plan as a condition for acquiring and maintaining mining licenses. The purpose of these plans is to uplift the local community (including the upliftment of employees) or even to migrate a local community to a different area. These plans require financial commitments that can be recurring or of a capital nature. Capital expenditure for the benefit of the community includes roads, schools, community centres and sewage/water treatment facilities.
10. Ongoing expenditures will typically be deductible under section 11(a) via case law (see the *Warner Lambert* decision, which involved expenditure required by the Sullivan principles) and should be deductible as a concomitant business expenses. At issue is social capital expenditure. Capital expenditure can only be deductible at a 10 per cent per annum rate to the extent that the expenditure falls under paragraph (d) of the section 36(11) “capital expenditure” definition. These expenditures must be directed solely toward employees or to facilitate mineral expenditure. All other social and labour plan capital expenditures are simply not deductible (see paragraph (e) of the section 36(11) “capital expenditure” definition).

11. We do not believe that capital expenditure required by social and labour upliftment should be treated less favourably in tax terms. These costs are an involuntary imposition by government and effectively operate as a “quasi-tax” or as sunken costs for a mineral license with the denial of a deduction acting as an implicit double tax. Most capital expenditure license costs are fully deductible (see (see paragraph (e) of the section 36(11) “capital expenditure” definition) and social / labour capital expenditure should be seen in the same light.
12. We would accordingly request that capital expenditure for mining social and labour plans be treated as akin to all other mineral capital expenditure (either the current 100 per cent ring-fenced deduction or the proposed 40:20:20:20 regime). In the very least, the 10 per cent spread of paragraph (d) of the capital expenditure should be expanded to include all social and labour plan costs as opposed to the limited items currently selected.
13. Even though some relief exists for low-cost residential mining employee housing (see paragraph (f) of the section 36(11) “capital expenditure” definition), the regime was not designed in line with practical application. Further work is required in this area, including the potential application of the VAT.

Annual environmental rehabilitation

14. Relief for environmental expenditure is spotty. A specific regime exists for deductible payments to a closure rehabilitation trust / company with the regime effectively acting as a semi-government controlled deductible reserve. Environmental rehabilitation that occurs during the life of mine may also be deductible under section 11(a) as long as the costs are not of capital in nature.

15. The first short-coming associated with environmental tax relief is the failure to provide any allowance for environmental treatment, recycling and waste disposal assets (see paragraph (e) of the section 36(11) “capital expenditure” definition) during the existence of mining operations. Ongoing environmental expenditure should be encouraged as opposed to delayed reclamation. We would suggest that these capital expenditures be allowed at least on par with CAPEX environmental expenditure for manufacturing (see section 37B).
16. Post-operational mining expenditure should also be allowed as a deduction. Many companies incur additional environmental expenditure after mine closure (not funded by post-rehabilitation companies or trusts). These expenses could be used to offset profits from other mines (under the current 25 per cent ring-fence escape hatch of section 37(7G) or under the Davis proposed 40:20:20:20 regime).

Special rules relating to gold

17. We agree that some form of relief is required for deep-level gold mines. These mines are costly to maintain and suspension of operations effectively means permanent closure. Therefore, we concur that the gold formula should be retained in some form.
18. However, we suggest that “truly equivalent” relief is better suited for the royalty regime. The cost structure of deep level mines reduces profits, which directly translates into lower income tax (without regard to the gold formula). The royalty fails to contain the same level of relief for the cost of deep level mining (which effectively have less value due to the expensive location). Marginal deep-level mines must always pay a royalty even when unprofitable, thereby pushing these mines into a deeper loss. This is the situation calling for relief – not mines operating at a low-level of profit.

19. We further agree that the automatic 10/12 per cent uplift for unredeemed gold mining CAPEX allowances should be removed (see paragraph (c) of the capital expenditure definition of section 36(11)). Excessive unused losses often create opportunities for avoidance (see section 103(2)), and this upliftment has no justification that is unique to gold mining.

Contract mining

20. Contract mining has become a growing commercial practice in the mining industry. The drivers for contract mining are increased efficiency and changes to the regulatory landscape. Contract mining is not being performed for tax avoidance.
- *Traditional contract mining:* The owners of the mine may find that not all mining can be directly conducted by themselves with greatest efficiency. Even large mines may find that certain specialised activities can be farmed-out at reduced cost. Medium size mines often do not have the resources to conduct mining solely with their own employees and equipment, especially exploration companies designed to discover (but not extract) mineral resources. The farm-out of activities additionally provides the mine with enhanced flexibility to contract resources as needed as opposed to permanently hiring employees / owning equipment on regular basis.
 - *Section 11 contract mining:* Section 11 of the Mineral and Petroleum Resources Development Act, 2002 (as amended) requires the Department of Minerals and Energy to provide approval for any transfer of a mine from one party to another. This approval can often take up to three years after the initial contract for sale. In order to overcome this delay, sellers and purchasers often enter into contracts for early access. Under these contracts, the purchaser is allowed to conduct all mining activities on the mine to be sold and reap all interim profits before actual transfer. The net effect is to shift all net income / loss attributes of the mine before section 11 approval.

- *BEE contract mining*: The BEE codes require that each mine be owned at least 26 per cent by BEE owners. However, many BEE owners with mining title do not have the resources to actually conduct mining and are unable to obtain finance (e.g. from the banks) without finding commercial partners possessing stronger financial balance sheets. In order to reduce the cost of entry, many BEE empowered companies own only the actual mine rights as opposed to the underlying equipment and operational resources. These empowered companies often farm-out most activities on a contract basis.
21. At a commercial level, contract mining can be based on a variety of terms. Traditional contracts provide payment to the contract miner based on hours spent or weight / quality of ores extracted. Other forms of contracts provide the miner with a percentage of the total value of the ores extracted or net profit produced. SARS has informally expressed concern in regards to the latter form of contracts because beneficial ownership appears to have shifted from the mine owner to the mining contractor.
 22. A second issue for SARS is one of control. The mining tax regime was designed on the implicit basis that the owner and operator were largely a single taxpayer. The growing split between ownership and activity was not envisioned. Concerns exist that this lack of control could result in duplicated allowance claims or artificial income shifting.
 23. At a definitional level, the allowance rules for mining differ from manufacturing. In the case of the 40:20:20:20 regime manufacturing, the party claiming the allowance must have “acquired” (i.e. be the owner) of the asset and bring the asset “into use” for manufacturing or a similar process. In effect, the party must be the owner and user of the asset. A specific exclusion exists for banking, financial services, insurance or rental businesses mainly to prevent financial leasing. The net result is that the 40:20:20:20 manufacturing regime is only eligible for owner-operators (but certain manufacturing lessors can still receive the flat 20:20:20:20 allowance regime).

24. On the other hand, the mining regime technically appears to be aimed much more at the activity of “mining operations” or expenditures for certain mining costs “in relation to” any mine or mines (sections 15 and 36). The mining regime does not appear to have any specific requirement that the party claiming the allowance must own the mine (or even the mining equipment).
25. We understand the need expressed in the Davis Tax Committee report for clarification of the mining allowance but doubt whether the proposed “mining contract models” are required. We also do not believe that the section 36 mining regime needs to be completely converted into the section 12B/12C manufacturing regime to resolve the issue.
26. In terms of SARS control, the basic issue is the lack of an “ownership” rule. Mining allowances (whether in a 100% upfront form or the proposed 40:20:20:20 form) should be limited to the owners of mining equipment. This limitation would ensure that only one party can claim the allowance. No reason exists to require that the owner of the equipment must also be the owner of the underlying mine. (It should be noted that the owner of manufacturing equipment currently need to be the owner of the underlying manufacturing plant to claim the section 12C allowance).
27. In terms of artificial income shifting, financial leases should be excluded. At issue is whether a non-financial services owner of a mine can claim an allowance for directly owned equipment utilised by third parties on a contract basis. More information is needed in this regard.
28. Care should be taken not to create rules that undermine legitimate commercial practices sought to mitigate regulatory burdens imposed by the Department of Mineral Resources. While National Treasury opposes incentives for BEE (e.g. lower rates for BEE empowered companies), National Treasury has been careful not to add tax costs on top of regulatory costs. For instance, the group relief threshold was reduced from 80 per cent to 70 per cent in recognition of the fact that BEE minorities often hold between 26-to-30 percent of shares in mining groups. Therefore, contract miners that own mining equipment should be eligible for mining allowances in respect of that equipment even if they do not own the mine as a result of the BEE mining codes or section 11 of the Mineral and Petroleum Resources Development Act.

Transfer pricing allegations***a. Transfer pricing methodology and sales / marketing units***

29. One mining tax area falling outside the report is the issue of transfer pricing for mineral exports. This issue will perhaps be addressed in the BEPS reports but is best addressed in the mining context given the industry expertise require for a full understanding of business practices.
30. The main transfer pricing issue in the mining sector is the issue of external marketing locations. The export of minerals can be facilitated by a global / regional sales and marketing team and this facilitation gives rise to tax disputes.
31. From a revenue authority perspective, the existence of these global / regional sales teams in low tax locations raises obvious BEPS concerns. African officials have additionally expressed concerns about “illicit” tax flows. We further understand that certain global mining companies have acquiesced to transfer pricing challenges in this regard amounting to millions in Rands.
31. On the other hand, the use of an external global / regional sales team for mining can be validated in commercial non-tax terms. Mineral production does not correlate easily with sales cycles. Production requires long-to-medium lead times. Output can suddenly face a sales-cycle mismatch with demand and price dropping after production. Therefore, a quality sales force nearer to market demand is required to match output with business intermediate demand. Key buyers in the market (i.e. the top 20) change greatly from year-to-year.
32. A second issue is price and developing country efforts toward pursuit of a “sixth method.” This desire is based on the understanding that mineral commodities often carry a listed global price. This listed global price would suggest that commodity sales by mining producers require little or no price negotiation. The problem with this over-simplicity, however, is that listed prices exist only for minerals of certain grades. Deviations from these grades trigger penalties (i.e. subtractions). Sales negotiations often entail the quantum of penalties.

33. In practical transfer pricing terms, at issue is whether a sales force could only be measured in “cost-plus” terms as opposed to other methodologies. A cost-plus view would suggest “employee cost plus a margin” as opposed to an allocable number associated with gross market sales.
34. Given the above, we would request that further examination by the Davis Tax Committee be undertaken in respect of this issue. What is needed are business mining sales experts to create an understanding of commercial non-tax practices. At issue are the guideline rules of thumb that should be used for mineral transfer pricing. Errors in these rules will give rise both to revenue shortfalls and /or to over-collections to the detriment of a viable mining industry. The key is to obtain the right balance.

b. Connected person definition

35. A key related issue in the case of transfer pricing is the definition of connected persons. Many transfer pricing disputes involve entities that are legally “connected” under section 1 of the Income Tax Act but not commercially connected. More specifically, many mining subsidiaries are only 70 per cent owned with a strong independent BEE minority.
36. Transfer pricing is predicated on the assumption that two related parties are operating as a single economic unit (e.g. company group entities that are wholly owned by the same shareholders directly or indirectly). The existence of this single economic unit means that the parties are indifferent as to which of the connected persons ultimately claims overall profits. Indifferent parties can accordingly shift profits amongst themselves to reduce global tax without incurring any adverse commercial effects.

37. In the case of mining, 70-per cent owned subsidiaries are commercially independent and an artificial deprivation of profits from the BEE owners would trigger governance violations under company law. The BEE minorities will seek to maximise their share of profits by retaining those profits within the 70-per cent subsidiary. A shift of profits to another entity within the mining group would represent a real commercial loss. Hence, the facts and circumstance analysis required by transfer pricing must take this key factor into account.

Mineral royalty

38. As stated above, any review of mining requires a collective overview rather than a single instrument overview. The mineral royalty is a key tax instrument impacting the industry. The rules for mining income tax must be correlated with the rules for mineral royalties (including the Diamond Export Levy). The purpose of the mining income tax is to properly capture profits while the royalty is designed to ensure that local countries capture a share of the gross value of minerals extracted. Both must work *in tandem* and must exist at globally competitive rates.
39. At a more parochial level, the Mineral and Petroleum Resources Royalty Act gives rise to continual disputes and confusion in terms of the deemed sale price determination. The table for the refined versus unrefined first saleable state for all minerals needs to be re-examined in line with commercial practices. Expenditures allowed for the royalty rate adjustment are often inconsistent with the first-saleable state analysis. We believe this and other aspects of the royalty must be included within the mining report as a matter of credibility.