South African Institute of Tax Professionals

10 March 2017

The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
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BY EMAIL: policycomments@sars.gov.za

RE: Mineral Royalty - Treatment of Transport, Insurance and Handling Expenses
Draft Binding General Ruling

1. Introduction

We write to comment on the draft binding general ruling (BGR) that aims to provide clarity on the treatment of expenditure incurred in respect of transport, insurance and handling of refined and unrefined minerals.

The draft BGR deals with the question of what it means that gross sales and EBIT, respectively, must be determined without regard to any expenditure incurred in respect of transport, insurance and handling after the mineral was brought to a specified condition or to effect the disposal of that mineral (hereinafter referred to as the "expenditure beyond the specified point").

We submit that the requirement contained in section 5(3)(c) in relation to EBIT means that the "expenditure beyond the specified point" must be ignored as a deduction (even though it is a deduction for purposes of the Income Tax Act). Equally, we submit that the requirement contained in section 6(3)(a) and (b) in relation to gross sales means that the "expenditure beyond the specified point" must reduce the receipts and accruals (even though it is included in gross income for purposes of the Income Tax Act).

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Support for this view is found in the Draft Explanatory Memorandum to the fourth draft Mineral and Petroleum Royalties Bill which states at page 21 that:

> *"In no event are transport, insurance or handling costs deductible to effect the disposal of mineral resources. This exclusion matches the exclusion of these items from the gross sales calculation (see section 6(3)).* (our underlining)

This is confirmed at page 27 in relation to the exclusion of transportation, insurance and handling costs from EBIT (see section 5(3)):

> "The determination of both gross sales and EBIT excludes transportation, insurance and handling charges. This exclusion is necessary so as not to penalize minerals that are located far from markets or an export port. Transport, insurance and handling charges for the transportation of minerals, in the conditions as per Schedules 1 and 2, between buyer and seller are excluded." (our underlining)

In other words, minerals that are located far from markets or an export port should not be penalised. This would be the case if the "expenditure beyond the specified point" that these taxpayers incur and pass on to their customers as part of their price, formed part of gross sales.

Further on page 97 of the 2010 Explanatory Memorandum of the Taxation Laws Amendment Bill, section 6A of the Royalty Act was introduced to "ensure that higher grade ores are fully subject to the Royalty while ensuring that the Royalty does not become an implicit charge of beneficiation of otherwise lower grade ores". Should a royalty effectively be imposed on the transport, handling and insurance cost, it will result in a royalty on these cost.

We note that the Draft Explanatory Memorandum was tabled in Parliament by the Minister of Finance with the fourth draft Mineral and Petroleum Royalties Bill on 21 August 2008. The Minister pointed out that the first draft was published for comment by National Treasury as far back as 20 March 2003.

He also said that:

> *"Based on extensive research and practical considerations it was decided that the tax base will be the value of the minerals mined, i.e. gross sales less the transport costs between the seller and the buyer of the final product (mineral)."*

Although the Draft Explanatory Memorandum was not published as a final version, it accompanied the final version of the bill and should be properly taken into account in the interpretation of the Act.

Clause 98(1)(e) and clause 99(1)(a) of the Taxation Laws Amendment Act No. 17 of 2009 amended the wording of section 5(3)(c) and section 6(3). The wording previously provided for the matching exclusion of "any amount received or accrued to effect the disposal of that mineral resource".

The reason for the amendment was explained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 (submitted to the Standing Committee on Finance 10 September 2009) as follows:

> *"The proposed amendment clarifies that the calculation of gross sales disregards the transport, insurance and handling expenditure that is incurred to effect the disposal of a mineral resource."*

These amendments make it clear that the amount to be excluded from EBIT and gross sales need not to be "received" or "accrued" as initially provided in the legislation but merely that the expenditure must be "incurred".

In conclusion, we submit that the amount of "expenditure beyond the specified point" that is excluded from the deductible expenses for EBIT purposes should similarly be excluded from gross sales

(matching exclusion). This interpretation is in line with the stated policy position as explained in the Draft Explanatory Memorandum.

2. Draft ruling

We are concerned that:

1. The draft BGR given does not clearly confirm the above matching of the amount of "expenditure beyond the specified point" for purposes of the EBIT and gross sales exclusions respectively.

2. The ruling increases the onus of proof that is on the taxpayer in terms of the governing legislation.

2.1. Matching reduction of gross sales and EBIT by "expenditure beyond the specified point"

It is concluded in relation to the meaning of "without regard to" under point 3 that:

> *"Consequently, when one considers the context in which the phrase "without regard to" is contained, the appropriate dictionary meaning would be "disregarding" and the present tense "disregard" is to exclude or ignore something. It does not imply that there must be a deduction in respect of transport, insurance and handling expenses that have been incurred after the mineral resource is brought to the condition specified or to effect the disposal of that mineral resource."*

If this paragraph means that the "beyond the specified point expenditure" must reduce the gross sales rather than be a deduction, we agree that it is more neatly put. The wording could be easily understood and it should be clarified in the BGR that the "expenditure beyond the specified point" should reduce the gross sales even though it is not, technically, a tax deduction.

It is stated under treatment of transport, insurance and handling costs under point 4 that:

> *"All expenditure in respect of transport insurance and handling incurred after the mineral resource is brought to the condition specified in Schedule 1 or 2 must not be taken into consideration when calculating gross sales and EBIT."*

This paragraph again confirms that the amount of "expenditure beyond the specified point" must reduce both the gross sales and EBIT.

It is stated in the ruling under point 5 that:

> *"...the expenditure incurred in respect of transport, insurance and handling –*
>
> - *after the mineral resource is brought to the condition specified in Schedule 1 or 2; or*
> - *to effect the transfer of that mineral resource,*
>
> *must not be taken into account when determining gross sales and EBIT for purposes of calculating the royalty percentage. Such costs will not qualify as a deduction in the determination of gross sales or EBIT." (our underlining)*

The underlined sentence does not seem to make sense. It should be clarified that such costs must reduce both the gross sales and EBIT. In other words, it is excluded from both the gross sales and expenditure, even though it is not technically a deduction.

2.2. Onus of proof

It should be noted that mining companies negotiate their sales agreements with their customers based on reference sales delivery terms (Incoterms) used in international trade. These Incoterms are almost always used for price negotiation and embedded in the sales contracts. The Incoterms

determine to what extent/point the seller is responsible for the transport, insurance and handling of the goods. Incoterms include for example:

- FOB Free-on-board
- CIF Cost-insurance-freight
- CFR Cost-and-freight
- EXW Ex-Works
- DAP Delivered-at-place

When Incoterms are negotiated, tax considerations are often the last consideration as there are more important commercial considerations. In addition, our mining companies are often price takers who cannot dictate these terms but have to accept the terms that the buyers dictate.

Based on mining royalty queries and audits, we are concerned that some SARS officials do not seem to understand how Incoterms work. They also do not seem to understand that it is wholly uncommercial for mining companies to split their prices in their agreements and on their invoices to show any detail other than the above terms (e.g. FOB). Mining companies cannot do so to meet SARS requirements as it could seriously impact their international competitiveness.

Various taxpayers should be neutral for royalty purposes regardless of which Incoterms they use as the tax base for the royalty is the value of the minerals mined, i.e. gross sales less the transport costs between the seller and the buyer of the mineral. In other words, whether the taxpayer delivers the goods FOB (and incur the transport, insurance and handling expenditure up to the port) or whether the goods are collected by the customer on an EXW basis at the seller's premises (hence the seller incurs no transport, insurance and handling expenditure) the gross sales for royalty purposes should be the same. The reduction of the gross sales by the amount of the "expenditure beyond the specified point" should achieve this intention. Two taxpayers should not have a different royalty liability simply because of using different Incoterms.

At a policy level, the royalty is not about transport and handling, but the real value of the mineral extracted should be subject to the royalty.

In terms of onus of proof, the ruling contains the following questionable prerequisites that all have to be met before the sales price can be adjusted:

- The costs must be on charged – does this imply a separately visible direct charge?
- The extractor must prove that the costs were taken into account and included in the price – how can this be done if SARS does not accept the use of Incoterms as proof?

We are of the view that the increased burden of proof set out in the ruling is not a reasonable burden and that it should be sufficient if taxpayers can prove that they have incurred the "expenditure beyond the specified point" to then use that amount to reduce both the EBIT and gross sales. The mere existence of the expenditure itself should be sufficient proof. In addition, it would be inconceivable to suggest that "expenditure beyond the specified point", when incurred by the mining company, would not be 'on-charged' or recovered from the buyer, given the significance of such costs in today's economic environment. The treatment of "expenditure beyond the specified point" by industry has always been in line with the legislation and the draft explanatory memorandum and we submit that the approach followed by SARS in recent times is misguided and misplaced.

We are concerned that you are trying to amend the legislation by way of interpretation. Lastly, it is noted that the BGR will be applicable in respect of a mineral resource transferred on or after 1 March 2010. We are concerned that this matter is only now pursued by SARS some 9 years after the explanatory memorandum was issued (which is still in draft), and in which no mention was made about the onus of proof of on-charging of 'expenditure beyond the specified point', and some 7 years after the legislation came into force.

3. Process

You would be aware that the interpretation of this issue is the subject of a motion for a declaratory order to the High Court and that the case is set to be heard on 9 May 2017. We suggest that the finalisation of this BGR be postponed until after the case has been heard so that the High Court's findings can be properly taken into account. Any BGR issued at this stage would be premature.

4. Conclusion

We have a significant concern that if a reasonable and practical interpretation is not followed. Any such interpretation would represent an undue royalty burden would fall on mining companies, that is not in line with the legislation.

We welcome the opportunity to comment on the draft ruling and look forward to future engagements. In this regard, we request a meeting with SARS to discuss our comments on this draft BGR.

Yours sincerely

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Chair of the Mining Tax Technical Work Group

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