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Mining and the environment: Tax incentives encourage orderly planning*

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Synopsis

This paper outlines the tax provisions that became effective in January 1992, which allow a working mine to make tax-deductible contributions to a dedicated environmental body that is itself not subject to tax. Such a body will then provide a source of funding for the mine's future environmental expenditures.

It is concluded that the establishment of such environmental bodies is a financially sound, tax-effective route, allowing mines, prospectors, and quarry operators to provide for future environmental rehabilitation.

Background

Until recently, major problems existed with regard to the funding of environmental expenditures during a mine's closure period and immediately after. More specifically, no legal provision was made for a tax deduction for the setting aside of funds by a mine for future rehabilitation. Furthermore, even if a mine did make an internal provision for rehabilitation, such funds could prove inadequate for the purpose. Also, the mine could divert the funds to other uses in the event of emergencies, and could be accessed by creditors in the event of a mining company's insolvency. Finally, even if adequate funds were available, rehabilitation expenditures during the closure phase were not tax-effective owing to potential dispute as to their tax deductibility and the low (or non-existent) level of taxable income against which such expenditure could be deducted during the closure phase.

In January 1992, the new tax provisions that became effective overcame these difficulties. The provisions allow a working mine to make tax-deductible contributions to a dedicated environmental body that is itself not subject to tax. The environmental body will provide a source of funding for the mine's future environmental expenditures, without relieving the mine of its statutory obligations. In time, given adequate contributions, this body will be able to fully fund these expenditures. The relevant provisions (which extend to mining-related activities) are discussed in some detail below.

Conditions for Tax-deductible Contributions

Any amount paid by a taxpayer engaged in mining, prospecting, quarrying, or similar operations to certain bodies (referred to here as environmental bodies) in respect of anticipated environmental (and related) obligations is deductible under the following circumstances, as outlined in section 11(hA) of the Income Tax Act.

- The amount paid must not be allowable as a deduction in terms of any other provision of the Income Tax Act.
- The environmental body must be a body referred to in section 10(1)(cH) of the Income Tax Act, and the body's funds must be used as contemplated in the section.
- Only so much of the amount paid as is reasonable in the special circumstances of the trade (i.e. mining, prospecting, etc.) may be allowed.

Qualifying Environmental Bodies

An environmental body to which such contributions can be paid[1] is a company, society, association, or trust, whether or not registered under any law[2], that fulfils the following criteria.

- The sole or principal object of such body is to receive, hold, and apply moneys contributed to such body in order to discharge any of the following or like obligations imposed upon any person in terms of any law relating to mining operations, namely
  - the rehabilitation of disturbances of the surface of land and the prevention and combating of pollution of the air, land, sea, or other water, where such disturbances and pollution are connected with mining, prospecting, quarrying, or similar operations;
  - the protection of the surface of land and water sources and the making safe of undermined ground and of dangerous excavations, tailings, waste dumps, and structures, of whatsoever nature, made in the course of mining, prospecting, quarrying, or similar operations; and
  - the demolition or removal of any building, structure, or other thing erected or constructed in connection with mining, prospecting, quarrying, or similar operations, the removal of any debris or other objects, and the restoration, as far as is practicable, of the surface to its natural state.

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- Such body is, under its constitution[3], not permitted to distribute any of its profits or gains to any person, and is required to utilize funds solely for investment or the objects for which it has been established.
- In terms of the constitution[3] of such body, it will, upon its winding-up or liquidation, be obliged to give or transfer its assets remaining after the satisfaction of its liabilities to some other body with objects similar to those of the said body. (The section of this paper dealing with the termination of environmental bodies comments on this aspect.)
- The Commissioner has approved such body on such conditions as he may deem necessary to ensure that the activities of such body are wholly or mainly directed to the furtherance of its sole or principal object.

Qualifying Contributions

Environmental bodies fulfilling the above criteria are exempt from income tax in respect of their receipts and accruals[1].

As already mentioned, only so much of the contribution paid as is considered reasonable is allowable. Furthermore, reasonability must be assessed in the context of the special circumstance of the trade. The first point to note is that these provisions do not appear to confer a discretion on the Commissioner for Inland Revenue; rather, they allow the courts to examine the reasonability or otherwise of the contributions paid. Secondly, it is of interest that, since the provisions of section 82 of the Income Tax Act place the onus to prove that any amount is deductible on the taxpayer, the onus to prove the reasonability of the contribution rests on the taxpayer. In the event of a dispute with the tax authorities, the taxpayer would have to justify the contribution by reference to factors such as the estimated future costs relating to the environmental activities detailed above, the estimated economic life of the mining (or related) operation, the expected future cash flow resources of the operation, and the like.

Probably the clearest illustration of a reasonable contribution would be an amount determined by dividing the present value of future environmental work (not already provided for) by the estimated remaining life of the operation, as illustrated by the following:

	R000's
Present value of cost of future environmental work[4]	40 000
Current value of funds held by the environmental body[5]	7 000
	33 000
Estimated remaining life of operation (years)	11
Contribution paid for current year	3 000

This calculation is simple, but the components are dynamic, and must be re-assessed each year. The first factor, the future cost, must be re-assessed in the light of changing environmental regulations and mores, as well as the past year's operations and technological advances. The second factor will reflect the change in the fund's capital due to the prior year's contribution, as well as investment growth. The final factor (the estimated remaining life) must be continually reviewed in the light of current and expected future mineral prices, new discoveries in relation to the orebody, and technological advances that improve recovery yields.

In the light of these requirements, can it be said that any contribution that deviates significantly from the result of the type of calculation above is 'unreasonable' and thus not allowable as a tax deduction?

The position of an 'underpayment' is particularly interesting. Even if it could be clearly demonstrated that a mine's current contribution to its environmental body was insufficient, can it be said to be unreasonable if there are sound business reasons for the low contribution level, for example, poor trading conditions or a drop in the tax base? It is considered that this cannot be the case since the special circumstances of the operation have dictated the level of contribution. To take the matter one step further, even if the directors simply reduce the current level of contribution if they feel that the future cash flows will be more than sufficient to allow for increased contributions, it seems that it may be difficult to disallow the contribution on the basis that it is unreasonable. While there is a basis for disallowing excessive deductions, there is no precedent in our income tax law for disallowing 'inadequate' contributions, assuming that such a contribution could be termed inadequate, which may itself be rather difficult to prove.

In the case of an 'overpayment', it may also be rather difficult to establish that such a classification is accurate. For example, the directors may well want to pay larger contributions in good years for fear that cash resources may be constrained in future lean years. Can it be said that financial prudence renders such payments unreasonable? It is considered not. However, assuming that there is some objective way of proving unjustified overpayment, the wording of the Act must certainly enable the tax authorities to disallow the excess that is unreasonable, or the wording of the 'reasonable' restriction in section 10(hA) would be meaningless.

Investment Policies

Until recently, the Commissioner for Inland Revenue required approved environmental bodies to invest only in interest-bearing deposits with registered banks. Following discussion with the Chamber of Mines in 1993, investments in certain insurance policies were also allowed. After continued discussions during 1993, investments in listed securities and commercial paper were also approved, subject to certain conditions. These conditions are as follows.

The general rule is that environmental funds will be permitted to invest only in interest-bearing deposits with a bank as defined in the Banks Act, 1990 (Act No. 94 of 1990), provided that the Commissioner for Inland Revenue shall have the discretion to permit such fund to invest in

(a) Listed securities on a licensed stock exchange as defined in section 1 of the Stock Exchange Control Act, 1985 (Act No. 1 of 1985) ('listed securities') or in commercial paper issued or secured by issuers classified from time to time by the Treasury as defined in the Exchequer Act, 1975 (Act No. 66 of 1975) ('commercial paper'). Any such investments in listed securities or commercial paper shall be subject to the following requirements.

  (i) Not more than 75 per cent of the annual contribution and 75 per cent of the total income earned by the fund during previous years shall be permitted to be invested in listed securities. In the 'transition year', 75 per cent of the accumulated funds may be so invested.

  (ii) No single investment of the fund shall constitute more than 20 per cent of the total assets of the fund.

  (iii) No fund shall be permitted to invest in more than 10 per cent of the equity or market capitalization of any listed company.

  (iv) For the purposes of calculating the annual contribution to be made to the fund, the value of the investments in listed securities shall be deemed to be 80 per cent of the market value of such investments at the time of calculation of the contribution.

  (v) No trading in listed securities or commercial paper shall be permitted.

  (vi) Full details of the valuation of the listed securities and commercial paper, and details of purchases and sales of such instruments, shall be disclosed to the Commissioner at the end of each year when the calculation of the contribution to be made is submitted to the Commissioner.

(b) Insurance policies underwritten by an insurance company registered under the Insurance Act, 1943 (Act No. 27 of 1943), in terms of which investments in equities or other securities may be held. Such investments must have a minimum guaranteed rate of return and have flexible maturity dates linked to the closure phase of the contributing mine. Such policies shall also be subject to prescribed conditions to be negotiated with the Commissioner for Inland Revenue.

Termination of Environmental Bodies

As already noted, the constitution of the environmental body must provide that, on its winding-up or liquidation, it is obliged to transfer its net assets to a similar body. As a consequence, it may not refund contributions to the mine that contributed the surplus.

It is considered that this restriction (which simply mirrors the restriction placed on various other tax-exempt[6] bodies) is illogical since (unlike other bodies referred to) an environmental body[7] will have a life clearly limited to the life of the wasting asset to which it is dedicated, namely the mine in question. Since it is inevitable that a mine will seldom be able to estimate the exact funding required to finance the environmental expenditures to which the fund is dedicated, overfunding will occur from time to time. In the circumstances, it is logical that a refund to the contributing company be allowed, once the Director-General of Mineral Affairs is satisfied that all of the required environmental work has been undertaken. In these circumstances, the refund should be subject to tax, perhaps at the average tax rate at which the contributions were made.

References

1. Section 10(1) (cH) of the Income Tax Act.
2. Other than a co-operative falling under the Co-operative Act no. 91 of 1981.
3. If the body is a trust, the relevant document is the instrument that established the trust.
4. There could well be a strong argument that this should be reduced by the present value of the mine's expected residual value of net assets at closure. However, this residual value may be difficult to estimate accurately.
5. Para. (a)(iv) of the section on investment policies gives a qualification of this valuation.
6. For example, research bodies and accommodation bodies in terms of section 10(1) (cB) and (cF) of the Act.
7. Or, where the body has separate funds each dedicated to a particular mine, the fund.

Pending such an amendment to the Income Tax Act, there is a method of catering for such surpluses without adverse effect on the contributing company, and this is for the company to arrange for the surplus to be transferred to another qualifying environmental body in return for a consideration payable by the mining company benefiting from the transfer. The consideration payable will be of a capital nature in the hands of both parties, and will not be taxable in the hands of the recipient, nor deductible in the hands of the payer. In the circumstances, the consideration should be valued as the present value of the after-tax savings by the payer that came about because of the increase in the assets of the payer's environmental body as a result of the fund transfer, so reducing the payer's future liability to fund this body.

Conclusion

The establishment of an environmental body by mining, prospecting, quarrying, or similar operations is a financially sound, tax-effective route for providing for future environmental rehabilitation. The financial advantages flow because the operation can set aside dedicated funds at a time when it is generating cash, and invest these in a dynamic environment. The tax advantages flow because the contribution will be tax-deductible, while the income of the environmental body is not taxable. The mining industry benefits because of the ability to provide efficiently for inevitable environmental expenditures; the State benefits because such provisions minimize potential calls on the Exchequer; and the people of South Africa benefit by virtue of an improved environment.

It behoves every mine, prospector, and quarrying operator to seriously evaluate these provisions if they have not yet done so. ◆