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MINING TAX: INCOME TAX CAPITAL ALLOWANCES GRANTED TO SOUTH AFRICAN GOLD AND NATURAL OIL MINES*

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SUMMARY

Since its introduction in 1956, the capital allowance has been increased and its scope widened. At present the allowance is 10% in respect of two categories of gold mine (post-1973 and other deep level mines) and 6% in respect of natural oil mines. The allowance is a significant incentive encouraging the development of new mines, to the benefit of both the fiscus and the South African economy as a whole. A strong case can be made for increasing the amount and the scope of the allowance. The Margo Report recommendation that the allowance should possibly be replaced with a system of direct grants is, in theory, neutral. However, practical difficulties exist with cash grants and there is concern with the implications elsewhere in the Margo Report that the capital allowance is excessive and that, as a consequence, such direct grants will represent an effective reduction in this incentive. I believe that the best course of action would be the retention (and enhancement) of the capital allowance and the expansion of its scope.

1. BACKGROUND

Capital allowances were introduced into the Income Tax Act for the first time in 1956 at a rate of 5% p.a. simple interest. Today the allowance stands at 10% p.a. compound interest. A full history of the capital allowance is given in part 2 below.

The Margo Commission Report[1] recommended at para 14.89 that the possibility of direct grants to new and ultra-deep level mines to be investigated and that, if grants are found to be "feasible", capital allowances should be eliminated from the tax system.

This paper examines the history of this allowance, discusses its effectiveness and evaluates the Margo Commission proposal.

2. HISTORY OF THE CAPITAL ALLOWANCE[2]

2.1 The Income Tax Act No. 55 of 1956

This act introduced the capital allowance. The allowance amounted to 5% p.a. simple interest to the time of first production and was granted to "deep level gold mines" which were mines:

- for which a lease had been granted after June 30, 1956, the principal object of which was to mine gold bearing ores believed to exist at depths below 7 500 feet from the surface; and
- in respect of which at least 7 years would elapse from the date shaft sinking examinations were commenced to the date on which stoping below 7 500 feet would commence.

2.2 The Income Tax Act No. 61 of 1957

This Act altered the system of computing the 5% interest from simple interest to compound interest. Furthermore, the capital allowance was improved in that it could be claimed to the end of the year immediately preceding that in which the mine first became liable to income tax, instead of simply up to the time of first production (the previous position).

2.3 The Income Tax Act No. 78 of 1959

This act introduced a new category of gold mine, namely "any other deep level gold mine". This category of mine was defined to be a mine with a primary object of mining for gold at vertical

* Paper as presented to the Marais Technical Committee on Mining Tax as part of a Chamber of Mines submission.

1 Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, RP 34/1987, under the chairmanship of Mr Justice C S Margo

2 The following papers proved most useful in compiling this information: A A van Jaarsveld, "Capital expenditure redemption provisions in mining tax", University of the Witwatersrand, 1986; J W Shilling, "Historical Review of certain aspects of the taxation of gold mines in the Transvaal and Orange Free State", University of the Witwatersrand, 1982 and J C Thoms, "Historical Review of Gold Mining Tax since 1925", Anglo American Corporation of South Africa Ltd., 1967

depths exceeding 7 500 feet. There were no specifications regarding the date of the lease or the period which might elapse between shaft sinking examinations and stoping at depth.

This new category of mine was granted a capital allowance of 5% for 10 years from the commencement of the year of assessment during which it was recognised in this category.

2.4 The Income Tax Act No. 58 of 1962

This Act consolidated the previous acts (it is still "the principal Act" today) and changed the category "deep level mine" to "new deep level mine."

2.5 The Income Tax Act No. 72 of 1963

This act introduced a further category of mine insofar as capital allowances are concerned, namely, a "new gold mine" which commenced production of gold on or after March 20, 1963. This category of mine was awarded a 5% capital allowance.

2.6 The Income Tax Act No. 90 of 1964

This act increased the capital allowance for the category of new gold mines created by the 1963 Act from 5% to 6%.

2.7 The Income Tax Act No. 55 of 1966

This act introduced a further category of gold mine, namely, a "post-1966 gold mine". This new category of mine was awarded a 8% capital allowance.

2.8 The Income Tax Act No. 85 of 1974

This act introduced a further category of gold mine, namely "post-1973" gold mines. This new category of mine was awarded a 10% capital allowance.

2.9 The Income Tax Act No. 104 of 1980

This act increased the capital allowance for "any other deep level gold mine" (see the 1959 act above) from 5% to 10%.

3. THE CURRENT POSITION (May 1988)

3.1 Rate of the allowance

The various changes referred to above are summarised in *Annexure A* which also sets out capital allowances currently available.

3.2 The allowance base

There are two steps in computing the base against which the abovementioned percentages are applied. The first step is the determination of what I have called *basic capital expenditure*, and the second is the *modification* of that basic capital expenditure.

Basic capital expenditure is[3]:

(a) expenditure on shaft sinking and mine equipment and, in the case of a natural oil mine, the cost of laying pipelines from the mining block to the marine terminal or the local refinery, as the case may be (i.e., broadly speaking, general capital expenditure); and

(b) expenditure on development, general administration and management (including any interest or other charges payable after December 31, 1959, on loans utilised for mining purposes) *prior* to the commencement of production or during any period of non-production (i.e., broadly speaking, pre-production or non-production expenditure).

The second step is to modify the abovementioned basic capital expenditure as follows[4]:

(i) Take the basic expenditure referred to in (a) and (b) above and adjust as follows:

- in the case of Category B mines, none of the expenditure in paragraph (b) can be taken into account[5].
- in the case of all other categories of mine (i.e. categories A to F, excluding B), the interest and other charges on loans referred to in (b) above cannot be taken into account[6].

(ii) *add* the amount (if any) allowed to rank as capital expenditure on the change of ownership of mining property[7].

3 Section 36(11)(a) and (b) of the Income Tax Act (I.T.A.)

4 Section 36(11)(c)(i)-(iv) I.T.A.

5 For the obvious reason that category B mines are producing mines, and that pre-production expenses are irrelevant.

6 It follows that interest or other charges on loans utilised for mining purposes during the production period will qualify for the allowance.

7 This type of expenditure is dealt with in section 37 I.T.A.

(iii) *add* expenditure incurred during any period of production on development of any reef on which, at the date of such development, stoping has not yet commenced.

(iv) *add* the aggregate of (i) to (iii) computed to the end of the previous tax year.

3.3 Restrictions on the Allowance

The following restrictions applied to the allowance:

(a) The period of the allowance is restricted as discussed in note 4 to the table in *Annexure A*.

(b) The allowance discussed in 3.2 above is not calculated for any period during which mining operations are not carried on in accordance with the terms of the relevant lease[8].

(c) The capital base is not taken into account for the purpose of determining the capital allowance provided for in section 26(2) of the Mining Rights Act, or for the purpose of determining the share of mining lease profits payable to the State (see discussion in 4 below)[9].

(d) The provisions of section 26(3) and (4) of the Mining Rights Act, apply *mutatis mutandis* for the purpose of determining the unredeemed balance of the aggregate of the amount referred to in (i) to (iv) in 3.2 above (see discussion in 4 below)[10].

(e) No capital allowance is granted in respect of any tax year during which a mine is an assisted gold mine[11], as defined in Gold Mines Assistance Act, 1968.

3.4 Computation of the allowance

The allowance is computed by applying the applicable interest rate in accordance with the table in *Annexure A* to the base as computed in 3.2 above. However there are two points to bear in mind:

- The allowance is taken into account as a deduction in determining taxable income – this is similar to the lease position discussed in 4 below.
- The allowance is also taken into account in determining the Profit to Revenue ratio (i.e. the "x" factor) which is one of the determinants of the income tax rate in the various gold mining formulae – this *contrasts* with the lease position discussed in 4 below.

4. THE LEASE CAPITAL ALLOWANCE

A lease in respect of precious metals over unproclaimed private land must provide for[12]:

"The payment by the holder of the lease to the State, in addition to taxation, a share of the profits derived from the working of the lease area, which share shall be on a scale fixed in each case by the Minister on the recommendation of the Board, or, in lieu of a share of profits, of such royalty or other consideration as the Board may recommend;"

In turn, a capital allowance is granted to *all mines* (i.e., not merely the categories of mines in the table under 3.1 above) which pay a share of profits to the State as lease consideration[13].

The capital allowance rate is 6% p.a., compounded.

The capital allowance base is the amount of unredeemed capital expenditure incurred in prospecting and mining operations in the development and exploitation of the lease area by the holder of the lease and his predecessors in title, but excluding any interest and other charges on loans referred to in (b) in the discussion of basic capital expenditure in 3.2 above (i.e. pre-production interest and related charges). For obvious reasons, the income tax capital allowance does not itself form part of the capital expenditure on which the lease capital allowance is based (see restriction (c) of 3.3 above).

Regarding the method of calculating the allowance, the rate of 6% is simply applied to the base as determined above. However there are two further points to note, namely:

- The allowance is included as a cost in arriving at profits subject to lease consideration, similarly to the income tax position.
- The allowance is not taken into account in calculating the profit to revenue ratio (i.e. the "x" factor) which is one element of the formula which determines the lease *rate* which is applied against the profit figure mentioned above. This *contrasts* with the income tax position.

8 Section 36(11)(c)(aa) I.T.A.

9 Section 36(11)(c)(bb) I.T.A.

10 Section 36(11)(c)(cc) I.T.A.

11 Section 36(11)(c)(ff) I.T.A.

12 Section 26(1)(a)(iii) of the Mining Rights Act (M.R.A.)

13 Section 26(2) M.R.A.

A further contrast with the income tax position is that the lease allowance is claimable for an indefinite period.

5. DISCUSSION OF THE MARGO COMMISSION PROPOSAL

The capital allowance provides a significant incentive for new mining development. A simple illustration of the effect of the income tax allowance is that unredeemed capital expenditure of R1 million p.a. over ten years would be transformed into a tax deduction of R17 531 000 at the end of that period, given a 10% p.a. capital allowance. This would, of course, be supplemented by the lease capital allowance. Where the cost of capital of a gold mine is more than 10%, the income tax allowance partially compensates for the delay before a tax deduction is achieved and where the cost of capital is less than 10%, the allowance not only fully compensates for the delay but adds an incentive for such development.

Professor D G Krige[14] has argued convincingly that, regardless of the tax formula or flat rate applied and of the average yield potential of new mines, the total tax potential on mines proceeded with will in fact increase as the capital allowance rate is introduced and increased until the allowance reaches a level in the range of between 15% and 20% p.a. This, he states, is due to the tax from the additional mine's opened up (following the lowering of the flotation pay limit as the capital allowance is increased) more than compensating for the reduction in taxes to be paid by the more profitable mines.

Since the capital allowance only applies to unredeemed capital expenditure, it is to some extent a form of compensation for ring-fencing as capital expenditure on a new qualifying mining project which might otherwise have been allowed against the taxable income of sister mines will instead be carried forward, attracting the capital allowance as a consequence. Furthermore, the allowance is an incentive to new mining ventures which are not connected with South Africa's large mining groups, since these mines would not have the same opportunity of making use of a huge tax base provided by sister mines, should ring-fencing be abolished.

The Margo Report Recommendation discussed in part 1 above does not address any of these issues and, on the face it, appears to be totally neutral. Few would argue against a new system which guaranteed an incentive by way of direct grant, which is the exact equivalent in value of a tax allowance which it replaces. However, there is no such thing as a guaranteed grant. Where major capital investment decisions are made, it is extremely important that the fiscal consequences of the decisions are certain. The Income Tax Act provides a large measure of certainty and, in regard to the capital allowance, the record since 1956 has been one of expanding and improving the allowance. This degree of relative certainty would be lost if a system of direct grants was installed.

Further to this point, it is of great concern that, even though the Margo Report recommendation as discussed above was neutral, elsewhere in the report, the Margo Commission was anything but neutral on the subject: in para 14.44 it was bluntly stated that the capital allowances are an *exceptionally expensive* method of purchasing an increase in the tax base. This strongly implies that the system of direct grants which the Margo Commission had in mind is one which would be a *far inferior* incentive for new mining development than the current capital allowance. In these circumstances, the theoretical advantages and disadvantages of grants versus tax allowances are side-issues; the allowance as it exists must be favoured over a more restrictive system of grants.

It is interesting that at the same paragraph, the Margo Commission commented that, in the context of the capital allowance, the policy of granting generous allowances and then having to restrict their application by ring-fencing contains an element of the ridiculous, like depressing the brake and the accelerator at the same time. This comment shows a lack of understanding of the capital allowance: ring-fencing does *not* restrict the capital allowance in any way; on the contrary, the capital allowance is, as stated above, to some degree a compensation for ring-fencing (even though never envisaged as such) as it applies, by definition, only when the tax base is insufficient to absorb the capital expenditure. It is also interesting to note that this element of the ridiculous did not prevent the Margo Commission from recommending the Minimum Tax on Companies, which operates specifically as a brake on allowances.

The current capital allowance is an effective incentive for the development of new mines, and thus works in the best interests of the South African economy as a whole. It is suggested further that the allowance should, given the current state of gold mining, be enhanced rather than restricted, and that consideration should be given to extending it to other types of mines.

14 D G Krige, "An analysis of potential benefits to the State of realistic adjustments to the mining tax structure", Journal of the South African Institute of Mining and Metallurgy, July 1979, Page 357.

ANNEXURE A

TABLE: MINING CAPITAL ALLOWANCES

CATEGORY OF MINE[1]	DATE OF INCOME TAX ACT							
	1956	1957	1959	1963	1964	1966	1974	1980[4]
A. NEW DEEP LEVEL[2] GOLD MINE	5%	5%[3]	5%	5%	5%	5%	5%	5%
B. OTHER DEEP LEVEL GOLD MINE			5%	5%	5%	5%	5%	10%
C. NEW GOLD MINES (post March 20, 1963)				5%	6%	6%	6%	6%
D. POST-1966 GOLD MINES						8%	8%	8%
E. POST-1973 GOLD MINES							10%	10%
F. NATURAL OIL MINES				5%	6%	6%	6%	6%

Notes

1. These categories are defined in more detail in Annexure B. Because of the nature of these definitions, the only gold mine categories of any relevance in 1988 are categories B and E.

2. Defined before 1962 simply as a "deep level mine".

3. The interest rate computation was simple interest in 1956 and compound interest thereafter, for all categories of mines.

4. The 1980 position reflects the current position (i.e. May 1988) as well.

5. The allowance for category B mines is for 10 years from the beginning of the tax year in which the mine is recognised to be a category B mine. For all other categories, the allowance is for the period from the end of the month in which expenditure is incurred (or is deemed to have been incurred) to the end of the last tax year which reflects an assessed loss from the mine.

ANNEXURE B

CATEGORIES OF MINE, FOR CAPITAL ALLOWANCE PURPOSES

(adapted from section 1 of the Income Tax Act)

A. **NEW DEEP LEVEL GOLD MINE:** means any new gold mine in respect of which –

(a) the Governor-General, the State President or the Minister of Mines has after June 13, 1956, on the recommendation of the Mining Leases Board signified in writing his decision to grant a lease of the right to mine for gold; and

(b) the Government Mining Engineer is satisfied that, at the time the decision to grant the lease was signified, the principal object was to mine gold bearing ores believed to exist within the lease area at depths below a vertical depth of 7 500 feet from the surface; and

(c) the Government Mining Engineer is at the time the decision to grant the lease is signified, of the opinion that a period of at least seven years will elapse from ~~the~~ date upon which shaft sinking excavations commence to the date of deep level production.

B. OTHER DEEP LEVEL GOLD MINE: means any producing gold mine (other than a new deep level gold mine) in respect of which the Government Mining Engineer has upon application made to him recognised that its principal object is the mining of gold bearing ores at vertical depths exceeding 7 500 feet from the surface and in respect of which he is satisfied, at the time the application is lodged with him, that mining at such depths has commenced or will be commenced within a period of five years.

C. NEW GOLD MINE: means an independent workable proposition in respect of which the Governor-General, the State President or the Minister of Mines has, after February 28, 1946, on the recommendation of the Mining Leases Board signified in writing his decision to grant a lease of the right to mine for gold, and includes any other gold mine which, in the opinion of the Government Mining Engineer, is an independent workable proposition which was established as such after the said date but does not for the purposes of paragraph (c) of the definition of 'capital expenditure' in sub-section (11) of section thirty-six include any mine which commenced the production of gold before March 20, 1963.

D. POST-1966 GOLD MINE: means an independent workable proposition in respect of which the State President or the Minister of Mines has, after August 17, 1966, on the recommendation of the Mining Leases Board signified in writing his decision to grant a lease of the right to mine for gold, and includes any other gold mine which, in the opinion of the Government Mining Engineer, is an independent workable proposition which was established as such after the said date.

E. POST-1973 GOLD MINE: identical to D, except that the date is January 1, 1974.

F. NATURAL OIL MINE: this term is not defined. However "natural oil" is defined to be: any liquid or solid hydrocarbon or combustible gas existing in a natural condition in the earth's crust, but does not include coal or bituminous shales or other stratified deposits from which oil can be obtained by destructive distillation, or gas rising from marsh or other surface deposits.

Note:
Because of the nature of the definitions, the only Gold Mine categories of any relevance in 1988 are categories B and E.