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South African mining tax in the 1990s*

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SYNOPSIS

This paper reviews the current mining taxes in South Africa, discussing the recommendations of the Marais Technical Committee, the measures already implemented, and the future outlook. It is concluded that the tax burden imposed on individuals and on the corporate sector should be reduced, and that the taxation of all economic sectors should be neutral. The reforms implemented in 1989 and 1990 are expected to continue, and it is thought that, if the State commits itself to tax neutrality and reduces the ordinary rate of company tax to 40 per cent, the rate of mining taxes will also be lower. Ring-fencing is expected to be reduced further and the rules for capital safe-havens to be refined.

SAMEVATTING

Hierdie referaat gee 'n oorsig oor die huidige mynbelastings in Suid-Afrika en bespreek die aanbevelings van die Marais Tegniese Komitee, die stappe wat reeds geïmplementeer is en die vooruitsigte vir die toekoms. Daar word tot die gevolgtrekking gekom dat die belastinglas op individue en op die korporatiewe sektor verlig behoort te word en dat die belasting van al die sektore van die ekonomie neutraal behoort te wees. Daar word verwag dat die hervormings wat in 1989 en 1990 geïmplementeer is, sal voortgaan en daar word gereken dat as die Staat hom tot belastingneutraliteit verbind en die gewone koers van maatskappybelasting tot 40 persent verlaag, die koers van mynbelasting ook sal daal. Belastingomheining sal na verwagting verder verminder word terwyl die reëls wat betref veilige hawens vir kapitaal verfyn sal word.

Introduction

The 1980s saw two negative tax developments affecting the mining industry, namely a very substantial increase in the effective tax rates imposed on mining companies, and the introduction of stringent ring-fencing measures. Although by no means the only important factors, these measures contributed to the stifling of growth in the mining sector, especially with regard to gold mining.

The 1988 Marais Technical Committee on Mining Tax recognized this negative effect and recommended various counteracting steps. This paper discusses these recommendations, the measures already implemented, and prospects for the future.

This article was written before the publication of the 1990 Income Tax Act. This Act confirmed the planned amendments announced in the 1990 budget, as discussed below, while also introducing a few minor subtleties not discussed in this article.

The Three Pillars of Tax Reform

Attention to three pillars of tax reform will enable the mining sector to react to the challenges of the decades to come. These pillars are

- neutrality of the tax burden
- relaxation of ring-fencing
- mobilization of capital.

Neutrality of the Tax Burden

The mining sector is overtaxed. This statement may be greeted with scepticism by those reeling under the impact of individual tax fiscal drag, but it is true nonetheless. The average tax rates actually borne by the mining sector have for decades exceeded those borne by other economic sectors.

In the past, such an imbalance could exist without too much negative impact since profit margins were high and the tax burden differential was not too onerous. However, over the past decade four factors combined to deal the mining industry a telling blow.

(a) The growth in State expenditure led to higher taxes for all, and to high inflation.
(b) Commodity prices tended to soften.
(c) In the gold sector, grades declined while costs increased.
(d) Special tax surcharges on the mining sector grew rapidly.

The following effective tax rates, including surcharges, are given as an indication of the last point:

Mining sector	*1979* %	*1989* %
Gold—marginal rate	63,00	75,00
Diamonds—flat rate	47,25	56,25
Other—flat rate	42,00	57,50.

The situation is further exacerbated by the fact that, in the case of precious metals and precious stones, one must pay a royalty to the State for the right to mine, even when the State does not own the relevant mineral rights. Such royalties could easily push the effective tax rate in 1989 for gold and diamonds above 80 per cent and 60 per cent respectively.

To achieve sustained economic growth, the tax burden on individuals and on the corporate sector must be reduced. This factor has been recognized worldwide, even in ostensibly socialist economies. Furthermore, the tax

* This paper is based on a paper delivered by the author at the Sixth Annual Mining Conference, which was held at Mintek in October 1989, and on an article by the author entitled 'Mining Tax Reform', which appeared in the March 1990 issue of Juta's *Foreign Tax Review*.

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burden imposed on economic sectors should be neutral.

The Marais Technical Committee recognized this second point, and recommended that, given the current corporate tax rate of 50 per cent, the same rate should be effectively imposed on the mining sector. This was to be achieved by a phasing-down towards a formula of $y = 61 - (61 \times 5/x)$ in the gold sector, and towards a 50 per cent flat rate for other mining.

The first two steps in the phasing-down of the formula have been implemented (Table I). It is of utmost importance that the phasing-down process should continue. It is also important that the ordinary rates of company tax should be reduced to a level of 40 per cent as soon as possible, and that the mining phasing-down schedule is aimed at this new target.

TABLE I
RATES OF GOLD-MINING TAX

Tax formula	($y = a - ab/x$)	a	b	ab
Tax years ending 31st March				
Confirmed				
1989	1966 and pre-1966 mines	75	6,000	450
	Post-1966 mines	75	8,000	600
1990	1966 and pre-1966 mines	73	5,863	428
	Post-1966 mines	73	7,644	558
1991	1966 and pre-1966 mines	71	5,761	409
	Post-1966 mines	71	7,268	516
Projected, in terms of Marais Committee recommendations				
1992	1966 and pre-1966 mines	69	5,623	388
	Post-1966 mines	69	6,870	474
1993	1966 and pre-1966 mines	67	5,478	367
	Post-1966 mines	67	6,448	432
1994	1966 and pre-1966 mines	65	5,338	347
	Post-1966 mines	65	6,000	390
1995	1966 and pre-1966 mines	63	5,175	326
	Post-1966 mines	63	5,524	348
1996	1966 and pre-1966 mines	61	5,000	305
	Post-1966 mines	61	5,000	305

Note: If the ordinary rate of company tax drops to 40 per cent in the five-year period to 1995, the projections above could change accordingly.

Relaxation of Ring-fencing

There are a number of forms of ring-fencing that constrain the mining sector. Of these, the most significant is the provision, introduced as recently as 1985, that capital expenditure on a particular mine may be offset only against income from that mine.

Thus, capital expenditure by Mine A may not be offset against mining income from Mine B, even where they are both divisions of a single company. Even worse, capital expenditure by Mine A on an expansion into an adjacent area is not deductible against Mine A's mining income if the expansion is itself deemed to be a new mine.

This latter effect dramatically decreases the rates of return on new mining projects and, unless relaxed, will simply rule out a number of the proposed new mining developments that brokers are so fond of speculating about.

In theory, there is a way out in that the authorities have the power to totally overrule this ring-fencing restriction. However, given that the motivation for this restriction was a fear that the ever-increasing capital costs of new mining projects would deplete the mining-tax base, it is understandable that overruling decisions have been as scarce as hen's teeth.

Blanket ring-fencing of this nature is not applied to other economic sectors in South Africa. It makes little sense to apply it to what is arguably the most important sector.

The Marais Technical Committee recognized this problem and suggested a compromise. Instead of the current 'all or nothing' approach (i.e. 100 per cent ring-fencing of no ring-fencing), it recommended a more flexible approach. Although this approach was provisionally rejected in the 1989 Budget Review, the issue is of such significance that it was reconsidered in 1990 as discussed below.

Mobilization of Capital

It is an undisputed fact that turnover on the Johannesburg Stock Exchange is decidedly stodgy. For example, the Exchange averages approximately 5 per cent of issued capital, compared with 62 per cent in Tokyo, 57 per cent in New York, and 35 per cent in London.

One contributor to this relative inertia is the South African system of income tax. Many companies, including mining houses, have substantial share investment resulting from past 'greenfields' investments. The gains that could be realized from disposing of these now stable investments (held in many cases for decades) may be taxable in full if they are held to be of a revenue nature.

Small wonder that these companies think twice about realizing these (massive) gains to raise funds for further 'greenfields' operations.

The end result is

- a lack of capital mobility
- a lack of 'greenfields' funds
- economic stagnation.

The solution lies in a favourable tax regime that does not penalize the disposal of long-standing investments.

But does this amount to a request for a tax handout? The answer is no! If the current uncertain position continues, there will simply be continued inertia and minimal tax collections.

Mining Tax Reform in 1989 and 1990

Tax Rates on Mining

Before discussing mining tax rates, a few words of explanation. Non-gold mines are taxed at flat rates, but gold mines are taxed in accordance with the following formula:

$$y = a - ab/x,$$

where y is the tax rate to be determined, a and b are factors fixed by statute, and x is the only variable, being the ratio of taxable income from gold mining to the total income from gold mining, expressed as a percentage.

Thus, for example, a post-1966 gold mine with a tax year ending in March 1991 will be subject to a formula of $y = 71 - 516/x$. If the ratio of taxable income to income is, say, 30 per cent, the formula results in the

following tax rate:

$y = 71 - 516/30$,

i.e. $y = 53,8\%$.

The Marais Technical Committee (on which the author served as an advisor) recommended in 1988 that the tax rates on mining should be reduced over a period to equal those applicable to ordinary companies, currently 50 per cent. If this is fully implemented, the changes indicated in Table I (gold mining) and Table II (other mining) will follow. The first phase of these changes was implemented in 1989, and this year (1990) the second phase has been implemented. As a consequence, the following rates will apply to mining companies with tax years *ending* in the period to 31st March, 1991:

1966 and pre-1966 gold mines	$y = 71 - 409/x$
Post 1966 gold mines	$y = 71 - 516/x$
Non-gold mines	54,5 per cent.

TABLE II

RATES OF OTHER (NON-GOLD) MINING TAX

Tax years ending 31st March		
Confirmed		
1989	Diamonds: 56,25%	Other: 57,5%
1990	Diamonds *and* other:	56%
1991		54,5%
1992		53%
1993		51,5%
1994		50%

Note: If the ordinary rate of company tax drops to 40 per cent in the five-year period to 1995, the projections above could change accordingly.

The proposed changes detailed in Tables I and II were based on the assumption that the rate of company tax remained at 50 per cent. It was stated in the report of the Marais Technical Committee that the objective was to equate the rates of mining tax to those of non-mining tax, whatever the latter might be. Thus, if the Minister of Finance's comments about reducing the ordinary company-tax rate to 40 per cent over the next five years are, in fact, followed through, and if the Government accepts this aspect of the Committee's recommendation, the phasing-down tables for the next five years should be adjusted to reflect an ultimate target of 40 per cent in the case of non-gold mines and a formula of about $y = 49 - 245/x$ for gold mines.

The 1990 Budget Review paper (para 8.2.2.1) clearly indicates that the State cannot be committed to a fixed time schedule, and that further adjustments would have to be considered annually in the light of financial conditions and budgetary considerations.

Ring-fencing

It has now been provided that ring-fencing may be automatically breached to the extent of 25 per cent of an existing mine's taxable income. As a consequence, capital expenditure by a particular company on the development of a new mine may be offset against up to 25 per cent of the taxable income of any mines operated by that company. This has the following effects.

- The capital expenditure on the new mine must be carried forward until the mine starts production. In the case of gold mines, this unredeemed capital expenditure qualifies for the increased capital allowance discussed below.
- Once the mine starts production, the capital expenditure may automatically be written off against 25 per cent of the mining taxable income generated by the company from mines other than the new mine. Unredeemed capital expenditure will continue to qualify for the new capital allowance.

The Budget Review paper qualifies this concession in using the phrase 'as long as the new mine remains the property of the same taxpayer' (para 8.2.2.1(b)). The Income Tax Act has *never*, for obvious reasons, allowed expenditure incurred by one company to be deducted by another company, and the phrase is intended to convey nothing more than this; in other words, for ring-fencing to be breached, the mining company with tax base must itself own the new mine. If the new mine is, instead, owned by a subsidiary or a fellow subsidiary or an associated company, etc., ring-fencing simply cannot be breached. This does not mean that there cannot be outside interests of one sort or another in the new mine; for example, an outside party could have an interest by way of a royalty or a shareholding.

The phrase above also does not preclude a number of mines from operating the new mine in partnership as long as the new mine is not placed in a separate company. For example, if companies A and B have mining taxable income of R100 million each and they open a new mine in a 50:50 partnership, ring-fencing may be breached to the extent of 25 per cent of the combined mining taxable income of R200 million. This occurs even if the two companies are operating different types of mines, for example gold and coal.

If the ring-fencing amendment is enacted as expected, the 25 per cent relaxation will be automatic, and a mine will still be in a position to ask for a *total* relaxation of ring fencing if the circumstances warrant this, subject to the permission of the Minister of Finance and the Minister of Mineral and Energy Affairs. One can thus summarize the 1990 change as being a change from an 'all or nothing' approach to an 'all or 25 per cent' approach.

At the risk of stating the obvious, ring-fencing (and its relaxation) applies only to new mines—it does *not* apply (and never has applied) to extensions that are not regarded as new mines. The latter will continue to be treated as before; namely, the expenditure is not ring-fenced at all, and is for the most part fully deductible on incurral without the necessity to wait until production commences.

For the purposes of this ring-fencing relaxation, and in relation to the discussion of the new capital allowance discussed below, a *new mine* means a mine in respect of which *mining commenced* after 14th March, 1990.

The Capital Allowance

The capital allowance on unredeemed mining-capital

expenditure has been increased from 10 to 12 per cent in respect of new mines as defined above, provided that these new mines are gold mines. For existing gold mines and natural-oil mines that currently qualify for the capital allowance, that allowance remains unchanged. The rates are therefore as follows:

	%
New gold mines	12
Existing gold mines	10
Natural-oil mines	6.

Mines other than gold and natural-oil mines do not qualify (and never have qualified) for the capital allowance.

In the gold sector, the increased capital allowance will provide some compensation for the modified continuation of ring-fencing, provided the mine is successful, in that the capital allowance will boost the overall rate of return. This follows because the allowance is computed (on a compound-interest basis) on the unredeemed capital expenditure carried forward. As a consequence, if the cost of capital is equal to the allowance percentage, the delay in obtaining the capex tax deduction is compensated for. However, if the mine is unsuccessful, the allowance provides for no compensation. In this connection, it is interesting that, when ring-fencing was introduced in 1984, the Minister of Finance gave an assurance in Parliament that consideration would be given to the relaxation of ring-fencing in the event of failure of a mine. Although there are no specific legislative provisions to allow for this, it is assumed that he would stick to his word, and there is as a consequence a strong case for ensuring that high-risk projects are undertaken within existing profitable companies; if they are undertaken in separate companies, the Minister will have no basis to relax ring-fencing in the event of failure of the project.

Broader Application of Section 24A

A few months ago, the tax authorities indicated a willingness to accept a broader application of section 24A in the event that a taxpayer wishes to dispose of existing investments to generate funds to re-invest in a new mine. This section provides for companies to exchange existing shares that are held as trading stock for other shares, without tax consequence. The effect of this change in departmental practice should enable mining houses to more freely dispose of existing mature investments to generate funds for reinvestment into new projects.

Capital Safe-havens

South Africa does *not* tax capital gains, but it is frequently extremely difficult to distinguish between these gains and those of a revenue (i.e. taxable) nature. It has been argued that this is an important reason for the relatively low share turnover on the Johannesburg Stock Exchange, and that this relative immobility of capital restricts the availability of capital for new investments. As an interim measure to alleviate this problem, taxpayers may now elect to be treated in terms of safe-haven rules in respect of JSE-listed shares held for a period of more than ten years. Where these rules apply, the gains made will *not* be taxable, although related expenditures that had been deducted in the past will have to be clawed back. Gains realized within the ten-year period will still be subject to the normal requirements of distinguishing between capital and non-capital gains.

These measures are not intended to provide the final solution to the problem, and they are likely to be refined and expended in the near future.

Mining Leases

Although not specifically dealt with in the Budget Speech, the mining-lease system will fall away following the enactment of the new Minerals Bill. It is expected that this Bill will be enacted in the current session of Parliament. If this occurs, it is not certain what the effective date of the Act will be, a date that is important seing that the legislation provides for the lease system to fall away precisely two years after the effective date.

Predictions for the 1990s

The probability of the continued reform of mining-tax rates in accordance with Tables I and II must be very high, given that the State has implemented the first phases in this process. Furthermore, if the State commits itself to tax neutrality, and if the ordinary rate of company tax is reduced to 40 per cent, it is probable that the rate of non-gold-mining tax will ultimately be phased down towards this target, while the rate of gold-mining tax may be phased down towards a formula of approximately $y = 49 - 245/x$.

Regarding ring-fencing, it is quite clear that the 25 per cent relaxation will provide little encouragement for large new projects, unless the rand gold price increases substantially. As a consequence, given that the capital ring-fencing measure is an artificial restriction, it is possible that this 25 per cent may be increased in the near future, and it is not impossible that ring-fencing may be abolished completely within a year or two.

As acknowledged in the Budget Review paper, the rules for capital safe-havens are at this stage somewhat primitive, and it is likely that they will be refined substantially in the next year or two. This measure should go some way towards bringing up sterile capital for new investment, some of which will flow into the mining sector.