BIZCOMMUNITY

Contract mining clarification muddies the water

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Proposed amendments to the Income Tax Act limiting capex deductions to mining right holders are likely to have negative consequences, particularly for the junior mining sector

Image source: Getty/Gallo

The finding of the Supreme Court of Appeal in the Benhaus Mining case has triggered proposed amendments to sections 15 and 35 of the Income Tax Act. The aim of the proposed amendments is to clarify the policy position, which is that only entities with mining rights are entitled to claim capital expenditure (capex) deductions.

In the Benhaus Mining case, the court ruled that a company conducting contract mining operations is entitled to benefit from the capex deduction contained in section 36 read with section 15. These sections allow companies that carry on mining operations to deduct capex against income of a revenue nature from mining operations. This capex is offset against normal tax assessed losses or normal tax over time and any excess deduction is carried forward to subsequent years. The main purpose is to shield taxpayers carrying on mining operations from cash tax during the initial phases of mining, when no or very little income is generated, but large amounts of capital must be spent to operationalise the mine.

The problem with narrowing the access to the capex deduction to taxpayers holding a mineral right is that it loses sight of the commercial reality in which mining taxpayers operate, for the following reasons:

- many junior mining companies cannot raise the funding for the significant capital outlay required for mining operations, especially at the outset. These mining companies depend on more experienced contract miners who have the equipment, skills and capital to facilitate operational mining, specifically at the early stages when the capital requirements to set up the mine are at their highest; and
- taxpayers might choose to have a separate titleholder entity and an operational arrangement for commercial reasons unrelated to tax, such as operational efficiency, shareholder participation or the inability to transfer the mining right efficiently.

This amendment may affect legitimate commercial arrangements that do not constitute contract mining, such as:

- joint venture or similar arrangements, specifically where one party contributes the title and another undertakes mining operations;

- mining activities that do not require mining rights where taxpayers mine for their own purposes (i.e. do not use contract mining arrangements); and
- prospecting activities.

The inclusion of a limitation to "mining right", as defined in section 1 of the Mineral and Petroleum Resources Development Act, 2002, excludes "prospecting rights". Consequently, section 15(b) becomes inoperative, since some taxpayers might conduct prospecting activities without holding or ever obtaining a mining right.

Amendment

The amendment will reduce the tax efficiency associated with contract mining, increasing the cost to the mining right holders who use contract mining arrangements. This may unintentionally raise the barrier to entry into operational mining for junior mining houses, who already have limited access to capital. There is also increasing risk in capital markets for the mining industry, which, combined with their increased cost of doing business, limits companies' ability to access capital easily, potentially hampering growth. This appears contrary to policies aimed at stimulating entry to the mining sector by these types of entities and increasing the competitiveness of mining in South Africa.

The timing of this introduction is similarly questionable. The recent state of disaster and the consequent economic impact on many taxpayers has been severe. The introduction of this limitation without considering transitional arrangements will result in additional hardship for such taxpayers. Taxpayers, contract miners and otherwise, who have to date lawfully been entitled to the capex deductions, may face the dilemma of having no capital deductions available while they continue to incur large capital outlays.

The fiscal risk crystalises where two taxpayers, the mining right titleholder and the contract miner, claim a deduction for the same cost, so reducing the overall ability to collect taxes in the mining industry. This risk is remote, since section 36 sets out the costs that can be deducted, especially when taken with the inability to "indirectly" incur these expenses. The existing auditing capabilities of SARS should be able to detect capex deductions by taxpayers not conducting mining operations. The additional risk that taxpayers who are not entitled to the benefit of the capex deduction may benefit from it is not base erosive and does not constitute tax avoidance.

A change in the policy position should be clearly communicated and phased in over time, since the fiscal risk is low and the current situation does not constitute tax avoidance or harmful tax practices.

Given the remoteness of the risk to the fiscus and the significant impact that this amendment will have on smaller mining companies and valid commercial arrangements, it seems that the amendment is overly simplistic in light of the complex commercial reality in which mining companies operate.

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