Proposal to amend debt reduction rules applicable to mining companies

By Candice Gibson

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Section 36 of the Income Tax Act, No 58 of 1962 (Act) contains unique provisions which are only applicable to mining operations, and which set out the manner in which redemption allowances and unredeemed capital expenditure are calculated. The definition of “capital expenditure”, as provided for in s36, contains a list of expenditure regarded as capital expenditure for purposes of mining operations, such as expenditure relating to shaft sinking, mine equipment, development and management, amongst others.

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Reduced or waived debts

When a debt is reduced or waived, i.e. a debt arising in respect of a loan used to obtain a capital asset, paragraph 12A of the Eighth Schedule to the Act (Eighth Schedule) contains the tax implications applicable to the amount of debt that is reduced or waived (debt reduction amount). In the event that debt was used to acquire a capital asset which qualifies for specific capital allowances in terms of the Act, paragraph 12A makes provision for the debt amount so reduced to be used to reduce the base cost of such capital asset, resulting in an increased capital gain when the capital asset is ultimately disposed of.

On the other hand, where debt funding is utilised for the purpose of financing operating expenses, and is therefore not of a capital nature, but constitutes tax deductible expenditure, s19 of the Act makes provision for a recoupment of the expenditure which has been previously deducted by including these amounts in the taxpayer’s income. The difficulty noted with the current legislative framework, is that both paragraph 12A of the Eighth Schedule and s19 of the Act are not applicable to mining operations which are governed under unique provisions in the Act and which fail to deal with the tax treatment of debts reduced or waived in relation to mining operations.

It is evident, following the publication on 19 July 2017 of the draft Taxation Laws Amendment Bill, 2017 (2017 draft TLAB), read together with the Explanatory Memorandum in respect of the TLAB (Memorandum), as well as the Draft Response Document published by National Treasury (Treasury) on 14 September 2017 (Draft Response), that proposals have been made by Treasury and the South African Revenue Service (SARS), to amend s36. This is in order to include specific provisions applicable to mining operations in respect of the tax treatment regarding the reduction or waiver of debts used to fund capital expenditure.

As indicated in the Memorandum, an important reason for the proposed amendment of s36 is due to the fact that mining operations account for their capital expenditure in respect of capital assets and allowance assets differently from companies in other sectors, and these differences result in anomalies when applying the current capital gains tax rules found in paragraph 12A. When debt raised in respect of non-mining operations is used to finance capital expenditure, the debt reduction amount is required to first reduce the base cost of the capital asset or allowance asset if the asset is still held by the taxpayer, thus resulting in a higher capital gain when the asset is ultimately disposed of. Should a situation arise where the debt is not traceable to the financing of any capital expenditure, or the base cost of the capital asset or allowance asset that was acquired using this debt has been fully reduced to zero, the debt reduction amount will be used to reduce any assessed capital losses the taxpayer may have. Subsequent to this, to the extent that the taxpayer’s base cost of its capital asset or allowance asset and assessed losses are fully reduced in accordance with the above, no capital gain will arise.

The same treatment is, however, not applicable in respect of mining operations. For example, as a result of taxpayers conducting mining operations being granted a 100 per cent upfront deduction of capital expenditure claimed against income solely derived from the mining operations, any reduction or waiver of a debt in respect of mining operations cannot be used to first reduce the base cost, as mining companies will be taxed on the recoupment thereof. In other words, the mining company will be taxed on the recoupment of the 100 per cent upfront deduction previously granted in respect of the mining asset and included in the taxable income of the mining company and subject to normal tax. Paragraph 12A, however, fails to take into account whether or not an upfront allowance may have been granted as in the case with mining operations.

Proposed amendment

Section 36(7EA) was included in the 2017 draft TLAB for comment and contains the draft provisions regarding the reduction or waiver of debts in respect of mining operations. The intention of s36(7EA) is to provide a solution regarding the tax treatment when debt which is used to fund capital expenditure, has been reduced or waived. In these circumstances, s36(7EA) provides that the debt reduction amount is required to be applied in order to reduce any amount of capital expenditure incurred in the year of assessment in which the debt reduction amount arose.

Section 36(7EA) contains a proviso that to the extent that the debt reduction amount exceeds the capital expenditure incurred, the debt reduction amount must be treated as an amount which has been received by or accrued to the mining company and included in its gross income.

Following the publication of s36(7EA) in the 2017 draft TLAB, submissions were made by interested stakeholders, including the public. These submissions were subsequently addressed by Treasury and SARS and are set out in the Draft Response. In this regard, the following interesting considerations were raised in respect of the proposed s36(7EA):

Paragraph 12A contains various exceptions in terms of which the reduction of debt provisions do not find application in certain circumstances, however no exceptions have been included in the draft provision.

In response to this, Treasury and SARS indicated that the current exceptions included under paragraph 12A will be extended to apply to mining companies;
In respect of the proviso where a debt reduction amount exceeds the capital expenditure amount, the debt reduction amount must be included in the gross income of a “mining company”, as defined. The term “mining company” must be amended in order to align it with paragraph (j) of the definition of gross income, and reference should be made to a taxpayer carrying on mining operations instead. Treasury and SARS accepted this comment and indicated that the 2017 draft TLAB will be amended to refer to a taxpayer carrying on mining operations;
The draft provisions do not take into account how the reduction of capital expenditure is to be taken into account in respect of ring-fenced mining operations (s36(7F)). Clarity is required in respect of whether the taxpayer must only reduce the capital expenditure of the mine in respect of which the debt was reduced or waived, or whether the capital expenditure of any other mines which the taxpayer operates will also be affected. The response from Treasury and SARS is that only the capital expenditure of the mine which was funded with the debt which was subsequently reduced or waived, should be reduced by the debt reduction amount. Any other mines operated by the taxpayer will not be affected. Changes will therefore be made to the 2017 draft TLAB to clarify this issue.

ABOUT THE AUTHOR

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