



An evaluation of South Africa's debt reduction rules within the context of the mining tax regime

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ABSTRACT

The 2018 year of assessment was the first year the Income Tax Act (58 of 1962) (hereafter referred to as the Act) contained a provision detailing the workings of debt-funded mining capital expenditure being reduced. Subsection (7EA) was introduced to align, in taxation terms, the mining debt reduction provisions to the general debt reduction provisions.

The literature review aimed to answer a twofold research question, that is, a critical consideration of whether the mining debt reduction provision is aligned to the general debt reduction provisions. The second issue relates to whether the mining debt reduction provision should be aligned to the general debt reduction provisions with consideration towards a tax incentive provision.

It was found that the mining debt reduction provisions' workings were significantly aligned to the general debt reduction provisions with the exception of the group relief provisions. The first exception noted relates to the winding-up, liquidation, deregistration or final termination of a group company. The second exception noted relates to the workings of debt being converted to equity. Further, the research highlighted the characteristics of an ideal mining tax regime. The characteristics broadly focused on key principles a mining tax regime should comprise to advance the investment attractiveness of the sector. The study found that the mining debt reduction provision agrees to the basic principles of a mining tax regime.

The issue of whether the mining debt reduction provision should be based on the principles of the general debt reduction provisions found that the provision should rather be unique to the mining environment. The research suggests that provisions designed to attract foreign investment outweighs the tax principles of neutrality and simplicity.

KEYWORDS

Debt reduction, fiscal stabilisation tax incentive, unredeemed capital expenditure, recoupment, debt capitalisation

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CHAPTER 1: INTRODUCTION

1.1. Background

Many would argue that mining activities create, develop and maintain communities, cities and countries. South Africa enjoys abundant mineral resources and according to Economic Tax Analysis (2013), it accounted for 30 percent of the global production of platinum group metals, ferrochromium and aluminosilicates. To further emphasise the importance of mining operations in a developing country such as South Africa, one needs to consider the following facts as indicated by the Chamber of Mines of South Africa (hereafter referred to as CMSA) (2017):

- a) The direct contribution of mining to the Gross Domestic Product (hereafter referred to as the 'GDP') in 2017 is R 312 billion;
- b) The direct contribution of mining operations to fixed investments is R93.4 billion;
- c) Taxes paid as a result of mining operations is R16 billion; and
- d) Royalties paid as a result of mining activities is R5.8 billion.

The most important factor to be attributed to the mining industry is the fact that it provided employment for about 464 667 people in 2017 and indirectly created jobs for about 1.4 million people (CMSA, 2017) while keeping in mind South Africa had an unemployment rate of 27.7% in 2017 (Statistics South Africa, 2017).

To understand the mining industry of South Africa one needs to be aware of the South African mining industry body which represents about 90 percent of the country's mineral production. This South African body describes itself as 'a mining employer's organisation that supports and promotes the mining industry of South Africa' (CMSA, 2017). It was established in 1887 after an Australian gold-digger discovered gold on Langlaagte farm (CMSA, 2017). Furthermore, South Africa's mining sector is governed and regulated by the Mining Charter which was developed in 2002. The Mining Charter provide directives on how to transform the industry and to comply with the Codes of Good Practice (Nortjé, 2015).

The mining industry of South Africa came under fire in recent years and some of the challenges, as set out by Beech (2014), include: the impact of the global financial crisis on the global demand for commodities, regulatory and legislative uncertainty, logistical challenges such as infrastructure, ports, rails, water and electricity, health and safety, environmental compliance requirements and illegal mining activities. Beech (2014) further states that 'the cumulative impact

of these challenges, cannot be underestimated.’ Additional challenges for mining firms include trading in uncertain environments concerning international commodity prices in addition to exchange rate and domestic control pressures.

In 2017, the Chamber of Mines emphasised that the mining sector of South Africa had entered a crisis and used the following facts to substantiate the statement: the real ‘GDP’ of the mining sector was smaller in 2016 when compared to 1994. Secondly, over the previous five years, mining contributions to the GDP had declined by 0.2% while the rest of the economy grew by 1.6% per annum. Thirdly, investment at gross and net level had declined materially over the preceding two years. Lastly, in 2015, the sector made a R31 billion loss while over 70 000 jobs were lost in the period 2012–2016 and the mining sector continued to shed about 1 500 jobs per month (CMSA, 2017).

Companies need to accept and accommodate certain risks involved in operating in certain geographical locations. According to Beech (2014), regulatory and legislative uncertainty have the most significant impact on and the potential to deter investment. Chapter 2 of the study illustrates the impact of tax policies on investment decisions and explain the risks relating to uncertainty. In 2017, the Mining Charter of South Africa was reviewed and amended by the Department of Mineral Resources (hereafter referred to as ‘DMR’). The economic impact of this amendment was shattering, as listed mining companies lost as much as fifty-one billion rands of their aggregate market capitalisation on 15 June 2017 when the amended Mining Charter was announced (CMSA, 2017). This loss in the valuation of shares was a direct result of the regulatory uncertainty around the mining industry in South Africa.

These facts and events emphasise the indubitable importance of the mining industry for a developing country such as South Africa. Debt and the associated costs are inevitable considering that mining companies operating in South Africa are trading in one of the most difficult environments in the world. The *Oxford Dictionary* (OUD, n.d.) defines ‘debt’ as a ‘buy now pay later’ principle and explains it as ‘A sum of money that is owed or due’. Debt, when used in a productive and on a value-added basis, would enhance a company’s financial performance and is therefore also known as ‘good’ debt. Once a debt is used to pay back debt or when it is used to fund non-productive products companies could find themselves in financial distress if the new debt is not subject to more relaxed terms and conditions, as Gontikas (2011) has demonstrated. He further comments that debt makes the world go round while our global economy is based on it. This illustrates the importance of productive debt in a developing country and also irradiates

the importance of measures and policies that should be in place to assist companies in financial distress.

The underlying cause of the 2008 global financial crisis can be contributed to debt and the escalating effect it had on global markets. According to the Economist (2013), reckless lending by and from the financier in the years leading up to 2008 was just the tip of the iceberg when one examines the causes of the global financial crisis. Just like debt almost brought the world to its knees, a mining company's Achilles heel would be debt, especially if it operated and traded in an unforgiving mining environment. Eyraud and Weber (2013) aver that debt reduction is perceived as a pressing objective towards restoring market confidence and fiscal sustainability and that debt reduction has become a key target of fiscal policy in a number of advanced economies.

Debt occurs on various levels. Intercompany loans are globally common as the consideration for these loans remains outstanding to fund the debtor company's operations or just to keep said company liquid. Retief (2015) states that loans are waived or written off to facilitate group restructuring, sale agreements, acquisitions or mergers and therefore the need arises for debt reduction to consolidate intercompany loans.

South Africa's Income Tax Act (58 of 1962) (South Africa, 1962) provides specific consequences should a debt be waived or restructured. Since the Taxation Laws Amendment Act (22 of 2012) (South Africa, 2012b) replaced and amended sections 8(4)(m) and 20(1)(a)(ii) of the Act as well as paragraph 12(5) of the Eighth Schedule to the Act, which regulated the then debt reduction regime, the debt forgiveness rules have changed numerous times over the past few years. The intention for introducing the new debt reduction rules, which came into effect on 1 January 2013, was to alleviate the consequences of the global financial crisis which resulted in numerous companies entering a stage of financial distress (South Africa, 2012a).

Debt reduction provisions were significantly amended during the 2017 legislative cycle which resulted in potential uncertainty and some onerous provisions. The 2018 legislative cycle allowed for the retrospective application of some of the provisions to prevent the taxing of an unrealised event. The 2017 provisions were applicable in circumstances where a debt was waived or reduced whereas the new provisions would apply in any concession or compromise that resulted in a debt benefit (Chong & Grimm, 2018). This resulted in a broader scope for the provisions and could cover all forms of debt restructuring (Chong & Grimm, 2018).

These continuous changes indicate that the debt reduction regime in South Africa is actual and that sound and suitable provisions are not in place as yet. One needs to consider the purpose or

intention of the funding to determine the tax consequences applicable in terms of the debt reduction provisions. The intention concerning the funding and its tax effects are discussed in chapter 3 of the study.

Section 48 of the Taxation Laws Amendment Act 17 of 2017 (hereafter referred to as 'TLAA') (South Africa, 2017b) amended section 36 of the Act with the insertion of subsection (7EA). Subsection (7EA) has been in effect since the 1st of January 2018 and would apply to years commencing on or after that date (South Africa, 2017b). According to Gibson (2017), with regard to the Explanatory Memorandum in respect of the Taxation Law Amendment Bill (hereafter referred to as 'TLAB') (SARS, 2017), one of the reasons for the inclusion of the subsection in the Act is the fact that mining companies account for capital expenditure differently from companies in other industries. Applying section 19 of the Act and paragraph 12A of the Eighth Schedule of the Act to the reduction of mining debt could result in anomalies.

There are two perceptions regarding the different tax regimes for companies with different operations. Chapter 2 outlines these two perceptions including an analysis of the benefits and disadvantages associated with each. The question of whether the debt reduction provisions for a mining company should be consistent with the provisions applicable to other companies are the underlying question of this research project, as captured below by the research question.

This study further evaluates South Africa's debt reduction provisions by critically analysing the amended provisions while comparing the utilisation of debt reduction for mining companies in terms of section 36 (7EA) of the Act to companies in other sectors that utilise section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act.

1.2. Motivation

One could argue that the main reason for the inclusion of the debt reduction rules was to create a mechanism to facilitate debt reduction, with the anticipation that it would benefit a company without creating additional tax consequences for a distressed company.

The outcome of assisting companies in financial distress, as described in the TLAB (South Africa, 2017a), was not accomplished and caused more distress with a view to financial implications and legislative uncertainty. Furthermore, Van Reenen (2015) states that legislation does not adequately provide for companies that continue mining operations. The TLAB (South Africa, 2017a) for the first time tried to align the tax implications for mining companies and companies in other industries in terms of receiving financial assistance in the form of debt forgiveness. The

uncertainty regarding the debt reduction provisions given its purpose and the rationale in respect of which it is applied reinforces the need for this study.

The 2017 amendments broadened the scope of the debt reduction provisions to such an extent that the 2018 amendments resulted in the retrospective application of certain amendments. The most recent amendments resulted in a tax trigger only when a realisation event occurred. This means that the phrase 'concession or compromise' is less comprehensive and the mere change in terms and conditions would not trigger the envisaged effect of the debt reduction provisions.

One of the instances where the end does not justify the means, in terms of debt reduction, is the fact that Chapter 6 of the Companies Act of South Africa (71 of 2008) (South Africa, 2008) provides a debtor company in business rescue to compromise with a creditor to enhance the possibility of full repayment of debt obligations to the creditor company (Louw, 2014). The compromising of the debt obligations could result in various tax consequences. Thus, it does not discharge the liability of the debtor and defeats the purpose of Business Rescue as it does not assist companies financially while this could moreover impact economic growth negatively (Louw, 2014).

1.3. Problem statement and research question

The problem statement that this study aims to address therefore emerges from a context where the aim of the inclusion of subsection (7EA) to section 36 has been to align the debt reduction rules for mining companies and companies in other industries. In particular, the problem arises as to whether the wording of the subsection is sufficient to address the inconsistency of debt reduction by mining companies as well as companies in other industries. This problem represents the main focus of the study.

The research question that this study is aimed at answering, in other words, reads whether the inclusion of subsection (7EA) to section 36 of the Act adequately addresses the disparity between the debt reduction regimes when the mining debt reduction provision is compared to the debt reduction provisions applicable to companies in other industries. Further, the question of whether the mining debt reduction provision should be aligned with general debt reduction provisions are considered an important question to be answered in the process of addressing the research question.

1.4. Objectives

1.4.1. Primary objective

The primary objective of this study was to establish whether the inclusion of subsection (7EA) to section 36 of the Act adequately addressed the disparity of the debt reduction rules when comparing mining companies to those in other sectors. By examining the question of disparity, this study further determined whether the mining industry's debt reduction provisions should be aligned with general debt reduction provisions.

1.4.2. Secondary objectives

To support the primary objective, the following secondary objectives needed to be addressed:

- a) Critical analysis of a tax regime's dimensions to consider its investment decision impact with special reference to mining tax regimes. Further, to interpret different perspectives around the issue of whether the mining debt reduction provision should be aligned with the general debt reduction provisions. (Chapter 2 discusses this objective);
- b) Analysis of the progression of general debt reduction provisions, that is, section 19 and paragraph 12A, to obtain an understanding of the amendments by examining the rationale that drove them. (Chapter 3 focuses on this objective);
- c) Critical examination and comparison of the triggers, impact and consequences of the capital expenditure mining debt reduction provision and the general debt reduction provisions. Apply the characteristics of a mining tax regime (discussed in chapter 2) to subsection (7EA) to determine the appropriateness of the subsection. (Chapter 4 examines this objective);
- d) Reaching a conclusion, by taking the above considerations into account, on whether the mining debt reduction provision is aligned to the general debt reduction provisions. Further, to conclude on the issue of whether the mining debt reduction provision should be based on the general debt reduction provisions. (This objective is discussed in chapter 5 of the study).

1.5. RESEARCH METHODOLOGY

1.5.1. Literature study

The Western Sydney University (2017) published a paper that states the purpose of a literature review as follows: 'to gain an understanding of the existing research and debates relevant to a

particular topic or area of study, and to present the knowledge in the form of a written report'. The study was in great part conducted as a literature study which entails critical evaluation of available literature materials whether in hard copy or electronic format. This literature study focused on, but not be limited to, relevant tax legislation including interpretation notes, binding private ruling and relevant academic articles by analysing, interpreting or explaining the relevant legislation to reach a conclusion.

A systematic process was followed to analyse and assess the National Treasury's rationale for the amendment to the current debt reduction regime and the inclusion of subsection (7EA) to section 36 of the Act. The research further explores the possible difficulties and shortcomings of the debt reduction provisions that resulted from the amendments to the provisions.

1.5.2. Paradigmatic assumptions

According to McKerchar (2008), two core research philosophical paradigms exist which describe the design and conduct of research. These paradigms that guide a researcher are referred to as positivist and interpretivist. She (McKerchar, 2008) states that 'paradigm choice is by large a reflection of the researcher's perspective of the world (ontology) and believes that knowledge is created (epistemology).' In other words, a researcher's beliefs, experience and disciplinary focus will influence his/her approach to the research (McKerchar, 2008).

This author further describes a positivist approach as research that seeks objectivity in its explanation of social reality while the researcher remains detached from the study and the explanations derived are based on empirical evidence and tested theories (McKerchar, 2008). In contrast, the interpretivist paradigm is positivist as the researcher is not detached from the study and his or her approach provides an understanding of social reality that is based on the subjective interpretation of the researcher.

1.5.3. Research method

To reach the objectives of analysing and comparing subsection (7EA) to the general debt reduction provisions, a non-empirical research methodology was followed. This includes a literature review of academic sources such as interpretation of the relevant legislation, dissertations and articles. Consulting the various academic resources resulted in an understanding of the principles applicable to a tax regime. Further, this includes an analysis of the impact the various principles have on the investment attractiveness of a tax regime.

The manner in which the research was performed is a study ‘about the law’, rather than ‘in the law’. This means the reason for the inclusion of the provision’s existence rather than the interpretation thereof was considered (Pearce *et al.*, cited by McKerchar, 2008:19). This resulted in an analysis of the rationale for the inclusion of subsection (7EA) by comparing this provision to the general debt reduction provisions.

This study further leans towards an interpretive approach which Kara (2018) explains as the study to obtain an understanding of the meaning behind actions. In addition to obtaining an understanding of the meaning, the researcher is required to interpret elements of the study. This includes interpreting the shortcomings and inconsistencies of subsection (7EA) when this subsection is compared to the general debt reduction provisions. These interpretations are due to the fact that no direct prior research on this topic was conducted prior to the commencement of this study.

1.6. CHAPTER OUTLINE

This study comprises of the following chapters:

Chapter 1: Introduction

The introductory chapter is included to illustrate the background and motivation for the study. This chapter summarises some core aspects of the mining environment and also comprise of the problem statement, research questions, objectives and the research methodology employed in conducting the literature study.

Chapter 2: Mining tax regime and investment decision making

This chapter explores the correlation between tax policies and their impact on investment decisions. A further argument discussed in this chapter is the design of a tax regime that can create a balance between benefit for the public sector and encouraging investment in the sector. This chapter demonstrates how the study’s arguments for tax policies are ultimately based on the four maxims described by Adam Smith.

This chapter discussed the tax policies to be considered towards designing an ideal mining tax regime. Factors such as tax levels and transparency, mix of taxation instruments and distribution of tax revenues are considered.

Chapter 2 also analyses the Davis, Margo and Marais Tax Committee recommendations to address the underlying objective of this study being whether the debt reduction rules should be aligned.

Chapter 3: Progression of the general debt reduction regime

This chapter examines the progression of the general debt reduction provisions including the initial debt reduction provisions and the rationale for making amendments to these. The discussion involves an analysis of the phrases ‘reduction amount’ and ‘amount applied’—these phrases emanated from the 2017 amendments.

Current debt reduction provisions resulting from the 2018 amendments significantly increased the effectiveness of the debt reduction provisions. The phrases ‘debt benefit’ and a ‘concession or compromised’ transaction are discussed in this regard.

Chapter 4: South Africa’s mining debt reduction provision

This chapter examines the proposed mining debt reduction provision and investigates public comments made around this. Inconsistencies that resulted from this proposed provision and practical impracticalities are also explained. Comments on and responses to this subsection, as set out in the draft TLAB of 2017, are considered in this regard.

This chapter describes the amendments brought on in the 2017 TLAA as based on public comments made in response to the 2017 draft TLAB.

This chapter evaluates the capital expenditure mining debt reduction provision in terms of comments made in response to the proposed provision as reflected in the final provision. This chapter comprehensively focuses on the group exclusions and its implications. Further, the rationale for the inclusion of subsection (7EA) to section 36 of the Act is described and examined.

This chapter concludes with a comparison between debt reduction provision for mining companies and general debt reduction provisions with special reference to the scope and implications of these provisions. This chapter measures the mining debt reduction provision to the characteristics of a sound mining tax regime (as explained in chapter 2).

Chapter 5: Summary and conclusion

The study concludes on the individual chapters by summarising the conclusions reached throughout the study as described in the previous chapters. The summaries include findings reached on the various objectives and problem statement described in chapter 1.

This chapter summarises the study and provides a conclusion for the shortcomings and inconsistencies identified with regard to the mining debt reduction provision. In addition to this, the underlying question of whether the mining debt reduction provision should be based on the general debt reduction provisions are set out in this chapter.

CHAPTER 2:

THE MINING TAX REGIME AND INVESTMENT DECISION MAKING

2.1. A mining tax regime and its implications for investment decisions

This part of the study analysis the characteristics of a tax regime and the principals involved in designing a tax regime. Further, the investment considerations applicable to said principles are explained in order to measure the mining debt reduction provision, chapter 4, to the taxation principles and considerations.

This part of the study also addresses the underlying issue of the study being whether the debt reduction provisions should be aligned. This examination is be based on the interpretation of various case law and from the opinions of the Davis, Margo and Marais Tax Committees. The principles of a tax incentive are used to measure the mining debt reduction provision in chapter 4.

2.1.1. Characteristics of a mining tax regime

The Organization for Economic Cooperation and Development (hereafter referred to as 'OECD') set out to promote economic welfare and provide aid to developing countries (OECD, 1996). It defines taxation as 'compulsory unrequited payments to general government' (OECD, 1996). Whilst the definition appears to simplify the meaning of taxation, the basis of a tax regime bears down to four principles discussed below.

The philosopher Adam Smith is regarded as the godfather of classical economics (Drenkard, 2015) and the four maxims of taxation that he laid out are the foundation of many tax regimes across the globe. Essentially, these maxims are equality, certainty, the convenience of payment and economy of collection.

Equality refers to a taxpayer's contribution towards the state which needs to be a fair reflection of the said taxpayer's ability in proportion to the revenue recognised in that state. According to Farrell (2009) certainty refers to the financial liability as well as time and manner of payment. The maxim around the convenience of payment relates directly to the maxim of certainty and refers to the method of payment to be levied at a certain time and in a manner that will be convenient for a taxpayer. The final maxim refers to the efficiency of collecting the taxes in relation to which Farrell (2009) explains that the tax:

'ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.'

The efficiency maxim as described above refers to the manner in which taxes are collected. The process of collecting taxes should not result in additional liability for the taxpayers in addition to the actual tax liability. An example of inefficiency would be taxpayers giving up valuable time for an administrative function to be performed.

The factors discussed in chapter 1 outline the need for a sound and advancing mining environment in a developing country. To enable recommendations, considerations and comments around the section 36 (7EA) debt reduction provision, one needs to obtain an understanding of mining tax principles. Subsequently, this chapter sets out to provide the basic principles of a tax regime. The impact of the taxation principles on an investment decision are part of the aspects considered in the discussion. The chapter further provides the fundamentals of a mining tax regime by analysing a tax regime according to certain dimensions.

Mining companies are taxed differently from other companies although governed and administered by the same act. For example, mining companies can get a 100% accelerated capital expenditure allowance (Myburg, 2013) while this is not the case for all other industries. The provision has a positive impact on cash outflow as the wear-and-tear allowance is not apportioned over the years.

Over recent years there has been a number of amendments to South Africa's mining tax system due to rates and/or policy changes. Mining is a cyclical industry and all regions of the world are affected by this cyclicity, as Mitchell (2009) has indicated. He (Mitchell, 2009) further states that the ultimate goal of any government's mining tax system is to ensure a balance between the greatest possible benefit for the public and the greatest possible encouragement of investment in the sector. To ensure a balance for mining operations could be difficult considering the sensitive factors affecting the industry. These factors include, but are not limited to, the type and grade of the ore, political and socio-economic environment, geographical and infrastructural challenges as well as foreign currency limitations. Achieving a balance between benefit for the public and investment in the sector requires the sharing of risks and benefits between investors and governments (Varma, 2009).

The International Council in Minerals and Metals (hereafter referred to as 'ICMM') (2009) is of opinion that a mineral tax system should be less complex in lower-income mining countries since this results in tax liability to be calculated more accurately and with more ease. In addition to this,

the administrative burden is lifted and a less complex system could result in more recoveries at less cost. Bird and Zolt (2006) agree with the statement made by the ICMM by stating that even in developed countries with long-established tax systems, the subject of taxation on growth and equity remain complex. Also, reliance would shift from indirect taxes to direct or profit-based taxes. The ICMM (2009) continues that mining companies should be subject to the general taxation system including some mining-specific features that address special characteristics. This is in line with Adam Smith's four maxims as it translates to the maxims around equality and uncertainty.

The timing of taxes will affect the investment decisions of mining companies and the government. As explained in chapter 1, debt is a norm in the mining industry where start-up costs are significant. Karlsson (2018) calls an investment in mining extractive energy within a capital-intensive industry. Taxing companies, and not providing relaxed tax provisions in the early stages of mining, can lead to cash flow problems during these early stages. Raising taxes will increase government revenue in the short term whereas significant increases will discourage exploration and development thus reducing revenue in the long term (Mitchell, 2009).

2.1.2. Principles for designing a mining tax regime

Designing a tax regime therefore requires the government to trade-off various objects. These government objects include attracting investment, maximising revenues and enhancing the developmental impact of mining (ICMM, 2009). When evaluating a tax system, the following questions need to be answered in the affirmative (Mitchell, 2009):

- a) Are payments to society adequate?
- b) Are investors receiving a fair return?
- c) Is the system competitive when compared to tax systems in other countries?

A discussion around the questions and substance of an effective and credible tax system, in the form of a lifespan of a mine, follows below. The focus and constraints of mining taxation principles form part of the discussion and can be considered the core focus of what a mining tax regime should comprise. General taxation principles around the possibility of governments accommodating for the difficulties in each stage can be expressed in the following phases of a mine:

- a) Exploration;
- b) Mine development;
- c) Production; and

d) Post-mining.

Designing a tax system for the mineral industry can be challenging as certain factors and policies, as mentioned, need to be balanced. Exploration forms part of the activities taken prior to the commencement of mining activities. Haldar (2018) explains that exploration is an activity that requires high investment, cash flow and time while it involves high risk, all of which will be considered in the decision of investing or not.

During the exploration stage, substantial expenditure results in losses for the operation as the mining profit-making activities have not commenced as yet. Governments accommodate this phase by allowing losses to be carried forward to be set-off against future profits (Mitchell, 2009). The provisions allowing for the losses to be carried forward also allow for companies to progress to the production phase despite unutilised losses.

The development phase results in capital outflow towards infrastructure and mining methods as well as systems and designs of mineral processing roots (Haldar & Tišljär, 2014). Mitchell (2009) confirms that the development phase is a high-cost phase requiring substantial capital inputs.

Governments usually accommodate the substantial costs by allowing an accelerated recovery of capital costs in the form of wear-and-tear and low import duties (Mitchell, 2009). Considering the fact that mining equipment is specialised, most of the infrastructure needs to be imported, hence the lower import duties constraint.

Allen and Overy LLP (2013) defines the production stage as 'the commercial exploitation of minerals found in an authorised contract.' This phase ought to be the longest and most profitable. Mitchell (2009) explains that revenue to government commences in this phase and that the minerals are sold into competitive markets where price fluctuations occur. Fluctuation involves currency, as well as commodity-dominated currency, and governments usually provide relief in the form of limited to no export duties or relief from other substantive taxes (Mitchell, 2009).

In the post-mining phase, governments employ a conflict between moral and compulsory tax regimes. In most cases, site rehabilitation is compulsory and forms part of the license to mine while some argue that restoring the site is part of the social responsibility code. In this phase, significant rehabilitation costs are incurred to restore the site. Governments usually respond to this phase by allowing tax deductions for contributions towards a rehabilitation fund built up during the production phase (Mitchell, 2009).

2.1.3. Mining taxation principles and investment considerations

The final aspect to be considered is mining royalty tax. Halder (2018) states that mining royalties are payable to the state to compensate it for the depletion of its minerals. Governments can accommodate for these royalties by considering the scale of mining and commodity value. Subsidising the royalties by investing in infrastructure and other public goods are also applicable to some tax systems (Mitchell, 2009).

Farming-, mining- and passive income-related activities are common. They are usually marked by the term 'ring-fence' activities. South Africa's ring-fence provision was introduced in 1984 and effectively restricts capital expenditure to mining income on a mine-to-mine basis. This accelerated capital deduction regime was introduced with the main goal of attracting investment in new mining operations and reducing the cost of extraction (Murphy, 2018). It is clear that the ring-fence provision prevents companies to off-set revenue from profitable- to unprofitable projects. But mining companies can consider this to be a tax disincentive. The ICMM (2009) validates this recognition and expressly states that tax disincentives are deterrents for positive investment decisions and may even outweigh possible tax incentives.

The ICMM (2009) describes three additional factors to consider when assessing the objectives of a tax regime:

- a) Taxing of resource rents and maximising government revenue by means of adopting a neutral fiscal regime;
- b) Taxation as a policy instrument to attract foreign direct investment; and
- c) Taxation as a factor in contributing to or undermining state-building and better governance.

Resource rent exists because natural resources exist already, therefore efficient output levels create a producer surplus (ICMM, 2009). As mentioned, the fact that the state owns the natural resources means it should be compensated for the consumption as extracted rather than in the future. Rent can be taxed by means of the following kinds of rent: short term-, volatility- and pure rent. Short term rent and rent based on volatility such as high commodity prices have a positive short term and most often a politically motivated benefit but governments suffer harm in the long term.

Possible implications or consequences of resource rent is the fact that marginal projects would not be undertaken and that major projects would be stopped prematurely due to profit requirements not being fulfilled. Also, resource rent involves a presumed and inherent perception

risk and therefore needs to be stable and predictable to allow the rent to be included in the risk-premium incorporated in the required return on capital. The ICMM (2009) argues that lowering the cost element of an investment could cause an increase in resource rent. It concludes that fair sharing between companies and the government is a key aspect in a successful mineral industry, adding that the viability of the long-term investments required within this industry can only result from leaving a sufficient share of the pure rent to companies, thereby ensuring continued development (ICMM, 2009).

These factors need to be carefully balanced to advance the investment-attractiveness of the mining industry. There is also a counter-argument to this: that the tax regime should be uniform across all industries thereby allowing more economical efficiency. This reasoning entails that investment-attractiveness is not distorted by government incentives and administration while the determinations around tax liability are simultaneously less complex (Mitchell, 2009). The ICMM (2009) argues that mining companies should be taxed differently from other companies. It argues that the only advantage of the uniform taxation of companies occurs when public administration is weak and when there is a need to limit the scope and incentives for sector-specific rent-seeking and lobbying activities (ICMM, 2009).

It is clear that governments need to understand the impact of the tax regime on the investment system. Mitchell (2009) endorses Adam Smith's idea, in line with the four maxims mentioned in the preceding parts of this chapter, that it is essential for a tax system to demonstrate fairness and reasonableness while key stakeholders must consider these characteristics to be present.

2.2. Three dimensions of a mining-specific tax regime

2.2.1. Introduction

Section 2.1 above provided insights into tax regime policies and principles. The overall conclusion there is that an effective and equal tax regime depends on a balance between powers. Below, section 2.2 supplements the principles set out in section 2.1 by analysing a mineral-specific tax regime.

2.2.2. Three dimensions of a mining tax system

On examining the different mining tax regimes across the world, one can conclude that the mining industry faces challenges that are unlike those faced by any other industry. Therefore, an ideal tax system for this sector can be described and implemented only with difficulty. The following principles set out by the ICMM (2009) outline the core of a mining tax regime. These aspects in

combination with those considered in section 2.1 could describe an ideal theoretical mining tax system:

- a) Tax levels and transparency;
- b) A mix of taxation instruments;
- c) Distribution of tax revenues.

Tax levels and transparency are key considerations for governments who wish to maximise revenue over the long term by instituting neutral and progressive tax systems. Governments should design tax regimes that are neutral and progressive and should also incentivize sustainable development (ICMM, 2009). This will ensure innovation and the attraction of profit-seeking investors which, in turn, will lead to a technologically advanced industry. According to Mitchell (2009) the only way of ensuring this is to be less reliant on regressive tax systems and focus should shift to establish bodies that will consciously review key assumptions for predictable policy changes and consensual decision-making. The ICMM (2009) deems transparency to be an important investment consideration due to the increase in awareness of the monetary advantages of mining operations not only to the country's economy but to the citizens as well.

Moran (2009) further confirms the ideas given in section 2.1 that a mix of taxes is crucial to attracting investment and that sharing the risks and benefits appropriately will lead to more attractive investment opportunities. A mix of taxes refers to the fact that the mining industry is subject to different taxes levied on different levels of government. Differences in tax treatment do not adhere to uniform tax policies as discussed above but have additional advantages. Mitchell (2009) suggests that limited reliance be placed on indirect taxes while a centralised tax system based on profit or income should be applied.

Taxes can be classified as direct or indirect and can influence investment behaviour. Taxes based on units of production irrespective of profitability may create economic inefficiencies (Mitchell, 2009) by shortening the useful life of a mine since lower grade ore will not be mined due to profitability concerns. Contrary to this, taxes based on profits can lead to inherent risks in mining operations but are more efficient (Mitchell, 2009). The constraints around profit-based taxing involve its complexity and the difficulty of administration in some developing countries (Mitchell, 2009).

Profit-based and production-based taxes are usually the two categories of instruments used when taxing companies. The first instrument refers to a revenue net of qualifying costs that are subject to a tax charge whereas the latter refers to charges assessed against deposits of production

inputs and services (ICMM, 2009). Profit-based instruments are most commonly found across mining regimes and consist of income tax, royalties based on profit or income and profit taxes or withholding taxes on dividends. Production-based taxes include, but are not limited to, sales and excise taxes, unit-based- and ad valorem royalties as well as import duties (ICMM, 2009).

Finding the perfect balance between these instruments is easier said than done as profit-based taxes are preferred by mining companies given their exposure to cash flow risk if taxes are imposed on production. Contrary to this, governments prefer production-based taxes due to the relative ease of its collection and administration while these further ensure minimum revenue-flow to the government even in loss-making years. However, the ICMM (2009) suggests more reliance on profit-based taxes to achieve optimal investment attractiveness. Overall, and ideally, a tax system should be neutral with respect to production decisions and a tax base should be taxed progressively.

2.2.3. Distribution of mining tax revenues

'*Canon Minero*' is the term used by the Peruvian government to describe the distribution of mining royalties from national- to regional government (PwC, 2012). The term translates to the monetary transfer of revenues which regional and local governments receive as a percentage of the total taxes paid by mining companies (Orihuela and Echenique, s.a.). The allocation of mining revenues can be seen as an important moral and social responsibility where non-tax contributions are allocated to the local community. The corporate social responsibility enforced by law is part of what companies consider in their investment decision. Mitchell (2009) describes the importance of this factor as cultivating constructive relationships and encouraging collaboration among all relevant parties. According to the ICMM (2009), the absence of explicit conditions regarding revenue-sharing or -distribution may lead to uncertainty and inconsistency when potential investors consider attractiveness.

From a mining company's perspective, the rate and bases of taxes are not considered to be the main investment constraints when assessing a tax regime. Instead, stability, predictability and non-complex tax policies and regimes are factors that influence an investment decision the most (ICMM, 2009). But these factors result in an increase in administration costs and disputes with governments due to different interpretations and make the operation more susceptible to political capture. The ICMM (2009) lists factors such as the efficiency of tax administration and the functioning of the country's legal system with regard to disputes as having a significant impact on the overall investment attractiveness of the country in addition to efficiency regarding refunds.

As part of the distribution of tax revenues, one needs to consider the fiscal regimes available to levy the extraction of minerals. Royalty- and contractual-based systems are methods of distributing tax revenues and are most frequently used. The discussion around the royalty regimes forms part of the discussion around the mix of taxes. The difference between these two regimes lies in the control and rights of the output of the extraction process of the mining operations. Royalty tax provides companies with the privilege of ownership of the production process. Contrary to this, contractual-based systems allows the government to retain the right to the output (ICMM, 2009). In the latter regime, companies are compensated or reimbursed for the production or extraction of the minerals. The ICMM (2009) states that the type of tax system does not matter when considering the financial objective at hand and that governance is the strongest when royalty tax is set out unilaterally.

Royalty regimes could have a significant impact on investment decisions. This includes factors such as the return of a project, risk-sharing between governments and mining companies and could impact the life-cycle of the mine as the extraction of the lower grade deposits would in some instances not be economically viable (ICMM, 2009).

Three common royalty regimes exist and can impact investment decisions. First, profit-based royalties is a system based on recourse rent and is in effect subject to the profitability of operations. Second, unit-based royalties is a system where the weight or volume of the minerals is the royalty-determining factor. Last, value-based royalties relate to a system where the royalties payable are determined in terms of the value of minerals or commodities at a certain stage of the production process. The ICMM (2009) states that the value-based royalty system is most common. While value-based tax systems may be the common regime, certain challenges exist around its nature including different interpretations of the valuation at different stages of the extraction and production process.

2.2.4. Mining specific tax principles

The main aim of the special treatment will probably be to attract investment in this lucrative industry as the commodities allow for foreign currency to enter the country's economic structure. In addition to this, the mere fact that the extraction process allows for resource rent to be paid to the government exceeds the normal taxation relating to the cost and profit of an operation. The ICMM (2009) lists the following special characteristics applicable to a mining environment, which necessitate special tax provisions and also enhance the reason for a different and value-added debt reduction provision:

- a) Significant start-up costs in the exploration phase with no prospects of profit together with substantial cost after mining operations to cease mining activities;
- b) Investment in a mine results in immobile assets and often requires specialised imported technology;
- c) The impact of change due to a long life-cycle resulting from political changes to changes in currency; and
- d) The increase in cost resulting from increases in the extraction of less accessible minerals whilst adhering to the required rate of return mostly from foreign investors.

Arguments against special taxation regimes include the fact that the tax regime would be less complex and as a result would be less expensive to collect. The ICMM (2009) adds that further arguments against special treatment include avoiding additional procedures and legislation and as a result the ability to exercise more control over the collection of taxes. Further, fiscal leakage as a result of weak tax administration and lack of coordination between government entities could undermine efficient and effective public expenditure management (ICMM, 2009).

Part of a special tax regime is the appetite for allowing relief for expenditure and capital allowances during the early phases of the operations. Considering this and the fact that losses could be carried forward should make the main aim of special regimes possible, namely to allow companies to recover costs more quickly. Not unlike many other countries, South Africa provides for an accelerated wear-and-tear allowance on mining equipment. Countries are even allowing deductions for costs of unsuccessful exploration efforts to enhance continued development (ICMM, 2009) which comprise a special tax regime.

2.3. Mining debt reduction in the context of incentive

2.3.1. Introduction

Chapter 1 outlined the main objective of this study as an analysis of the mining tax debt reduction regime when compared to general debt reduction provisions. The underlying objective of this study is to examine the question of whether a tax regime skewed in favour of mining operations should be aligned in terms of debt reduction regimes. This part of the chapter examined case law and the opinions and recommendations of the Davis, Margo and Marais Tax Committee to form a conclusion in response to the underlying objective.

2.3.2. Tax Committee standpoint on mining tax

The Davis Tax Committee (hereafter referred to as the DTC) published a report on Hard Rock Mining in 2016 with a focus on mining in its traditional sense. This report also structures the phases of mining as listed and discussed, in the sections above, of the study and confirms statements made regarding major costs and risks unique to mining operations (DTC, 2016). The focal points of this report are recommendations made regarding a proposed alignment of the mining corporate income tax regime and other sectors (DTC, 2016). One of the proposed recommendations, resulting from the alignment of the DTC report, is the recall of accelerated capital expenditure provision and aligning the wear-and-tear regime with those in the manufacturing sector.

The DTC report is important concerning the question of whether mining debt reduction provision should be aligned with general provisions. This report indeed refers to the Margo and Marais Commissions. The importance of references made to the Margo and Marais Commission are that both these commissions made recommendations towards the future of South Africa's mining tax environment. Again, the discussion regarding different commissions relate to the underlying question of whether mining provisions should be aligned with provisions applicable to other sectors as these commissions made recommendations regarding the mining tax regime of South Africa.

The Margo Commission believed that the mining capital allowance should be aligned to the then manufacturing sector which deducted the mining capital allowance over a period of three years. The reasoning was to minimise distortion of the tax system and the risk of misallocation of resources (DTC, 2016). This view was based on the principle of tax neutrality which reinforces the basis of recommendations made by the DTC, as explained below.

The overriding principle in the case of the Marais Commission is the principle of simplicity which ties in well with the tax principle of efficiency and certainty, as explained in the sections above. The Marais Commission thought that the difference between the allowances attributed to the then manufacturing sectors and the accelerated capital expenditure were insignificant and it subsequently opted for the accelerated provision. Also, it highlighted the fact that the nature of mining operations made it difficult to distinguish between capital- and operational expenditure once the mine was in the production phase (DTC, 2016). This reasoning is directly related to the inconsistencies and impracticalities around mining tax debt reduction provisions mentioned and discussed in chapter 3.

In this respect, the DTC report is in agreement with the Margo Commission and focuses on the principle of neutrality. The DTC report is based on the following principles (DTC, 2016), which agrees, to some extent, with the maxims of Adam Smith listed in the sections above:

- a) Stability which entails consistency and certainty in policy development;
- b) Predictability;
- c) Fairness;
- d) Flexibility;
- e) Simplicity;
- f) Efficiency;
- g) Neutrality;
- h) Tax equity which consists of horizontal and vertical equity; and
- i) Transparency.

2.3.3. The mining debt reduction provision in the context of incentive

When presented with the argument of whether mining tax debt reduction provision should be aligned with the provision applicable to other sectors, one needs to consider the arguments in favour of and against mining tax incentives. Considering the argument that mining debt reduction provision should not be benchmarked against general debt reduction provisions, one tends to lean towards the principles of tax incentives.

The Intergovernmental Forum on mining, minerals, metals and sustainable development (Readhead, 2018) compiled a report for governments to analyse tax incentives concerning the mining fiscal regime designs. This report defines a mining tax incentive as ‘any special tax provision granted to mining investors that provide favourable deviation from the general tax treatment that applies to all corporate entities’ (Readhead, 2018).

The DTC report further dovetails well with statements made in chapter 1 and in the above sections of this chapter about the recognition that mining is a cyclical industry since investments follow their cycles at different stages (DTC, 2016). Special tax allowances have been introduced in an effort to accommodate the risks posed during each specific cycle or phase of a mine. These phases and the accompanying risks and investment considerations have been discussed in Chapter 2 of the study and are included in the Act to address the following issues (DTC, 2016):

- a) Accommodating large upfront investments needed for mining;
- b) Decommissioning of the costs of mines; and

- c) Additional allowances for the cost of financing gold mining operations and mining marginal gold ore bodies.

These elements make provision for the uniqueness of South Africa's mining tax regime and -tax incentive policies. The basic principles of a tax incentive form part of the discussion below followed by an examination of the typical mining incentives.

A tax incentive of this nature, that is, one aimed at assisting financially distressed mining firms in the form of non-taxable debt reduction provisions, is not an actively pursued tax incentive and not directly measurable in monetary terms. Rather, it is a long-term indirect tax incentive with the objective of stabilising the mining fiscal regime. Readhead (2018) therefore rightly describes fiscal stabilisation as an incentive in and of itself and lists potential impacts of stabilising tax incentives to include:

- a) A combination of tax incentives with the use of stability provisions that could magnify the impact of adverse tax incentives; and
- b) Limiting the government's ability to correct mistakes and prevent unexpectedly large revenue losses.

The inclusion of this type of incentive should be limited to time and the scope of the provisions. Readhead (2018) avers that a time-limited provision concerning capital recoveries need to be applied and an 'insurance premium' charge could furthermore be applied in cases of investors who take advantage of the stabilising incentive. Further, Readhead (2018) notes the following aspects for consideration before implementing an incentive (such as the stabilising incentive discussed above):

- a) A cost estimate with regard to revenue forgone and an impact assessment of investment decisions;
- b) Incentives should not create a parallel fiscal regime;
- c) Base erosion and profit shifting possibilities should be carefully considered before implementing an incentive; and
- d) The incentive should not be open-ended and should be open for review.

Section 2.1. and 2.2. of this chapter highlighted the balance of powers between the principles of a tax regime on the one hand and their impact on an investment decision on the other hand. The use of incentives for fiscal stabilisation also includes a balance to be struck between a competitive mining tax regime and forgone revenues for public spending.

Taxpayers deriving income from mining operations are taxed in the same manner as taxpayers in other industries, subject to areas of departure which can be examined as tax incentives to some extent:

- a) Operational expenditure;
- b) Write-off allowance;
- c) Prospecting;
- d) Additional capital allowances;
- e) Recoupments on sale of assets; and
- f) Rehabilitation provisions.

The deductibility of operational expenditure is consistent across all sectors while a departure in respect of mining operations is the fact that during the construction phase and phases of non-production, certain operating expenditures are capitalised for tax purposes.

The DTC (2016) states that special allowances are granted for manufacturing operations, commercial property and hotel owners. Once the operations of a taxpayer satisfy the definition of mining operations one is compelled to claim a 100% capital allowance. The capital allowance applicable to mining operations provides a taxpayer with unredeemed capital expenditure in respect of said allowances. The DTC (2016) summarises the mining allowance provision by stating that mining companies are allowed to deduct 100% of qualified capital expenditure in any given year while the deduction is limited to available income.

One of the main arguments of section 2.1. and 2.2. was the impact that tax provisions have on investment decisions. A tax regime that is set on promoting investment should provide for the deduction of prospecting-related expenditure. South African taxpayers can claim prospecting expenditure, within the republic, in full (DTC, 2016). The Act does not prescribe a definition for 'prospecting expenditure' and therefore the meaning of the phrase can be widely interpreted. In addition to these factors, the mine-specific ring-fence limitation does not apply to prospecting expenditure (DTC, 2016).

A mining provision completely departed from other industries is special recoupment in respect of the sale of mining assets. The DTC (2016) states that the sale of mining and capital equipment results in a recoupment with a prescribed value irrespective of actual proceeds. The recoupment value is determined by the Department of Mineral Resources based on the effective value such as the insurance replacement value. Liability in respect of the disposal would then be based on the excess of the prescribed recoupment value over the unredeemed capital expenditure brought

forward. On the other hand, the purchaser of the assets, provided that these have been used for mining operations, is allowed to claim this effective calculated value as opening capital expenditure (DTC, 2016).

The final departure of mining tax provisions, directly relevant to this study, are incentive provisions relating to rehabilitation provisions. Tax legislation is aligned with the legislation governing mining operations with regard to the provision for expenditure on the closure of the mine. From a taxation perspective, an entity or trust set up to accumulate funds to rehabilitate the mine site is, in basic terms, exempt from tax and contributions made by the contributing entity may be subject to a section 11(a) deduction (DTC, 2016).

2.3.4. The interpretation of case law regarding South Africa's mining tax regime

South Africa's mining tax regime has a history that dates far back and has evolved over many years, by case law, in response to the unique characteristics of operating a South African mine (DTC, 2016). The following cases illustrate the progression of the mining tax regime.

The Supreme Court of Appeal in *CIR v D & N Promotions (Pty) Ltd* (South Africa, 1995) reached the following verdict regarding the deductibility of capital expenditure:

Also in the court a quo Levinsohn J stated that – 'the legislature intended farmers to be placed in a privileged position as far as their entitlement to deduct capital expenditure from farming income and hence the concept of income derived from farming operations ought to be strictly construed'.

In the case of *Western Platinum Ltd v CSARS* (South Africa, 2004) the ruling of *CIR v D & N Promotions (Pty) Ltd* (South Africa, 1995) was quoted and the ruling was extended to include mining operations. This case underscores statements made in chapter 1 and in the sections above with regard to the fact that the Income Tax Act is skewed in favour of mining and farming operations. This ruling reads as follows (South Africa, 2004):

The fiscus favours miners and farmers. Miners are permitted to deduct certain categories of capital expenditure from income derived from mining operations. Farmers are permitted to deduct certain defined items of capital expenditure from income derived from farming operations. These are class privileges. In determining their extent, one adopts a strict construction of the empowering legislation.

The case of *Benhaus Mining v CSARS* (South Africa, 2019) case referred to the *Western Platinum Ltd v CSARS* (South Africa, 2014) case in reaching the following judgement (partly quoted):

For many decades the income tax dispensation for miners (as well as for farmers) has been different from that governing other businesses. Miners are given privileged treatment, in order, we are told, to encourage the growth of the mining industry.

These rulings illustrate the progression of the mining tax regime and also emphasise the fact that the mining tax regime is not aligned with that of other companies. The Davis Tax Committee's recommendations, therefore, differ from case law regarding mining tax because it recommended that the mining tax regime should be transformed to be aligned with other regimes to promote the principles of neutrality, transparency and equity, the latter of which has been explained in the sections above.

Current legislation is usually compared with other jurisdictions to motivate and advance changes. The DTC (2016) makes it clear that South Africa's mining legislation is unique and any comparison would result in a skewed representation. As the mining legislation cannot be compared to other jurisdictions, this study focused on a report by Sungley and Baunsgraad (2001) who consider the issue of whether a mining sector requires a specific tax regime and answer in the affirmative. Their affirmation occurs regarding the fact that governments own the underground resources and must attract capital on terms that ensure the greatest possible value. Further, their view is based on the fact that tax levies and incentives apply to mining companies and not to other sectors which include the following three levies (Sungley & Baunsgraad, 2001):

- a) A royalty to secure a minimum payment;
- b) Regular income tax that is applicable to all companies; and
- c) A resource rent tax to capture a larger share of the most profitable projects.

These scholars further emphasise that a fundamental conflict exists between mining companies and governments regarding the risks and rewards of mineral deployment. Both parties in this case inevitably want to maximise revenue and pass much of the risk to the other party. Given these considerations, the right choice of a fiscal regime should be beneficial for both parties so that a small sacrifice on one side should result in a gain for the other side (Sungley & Baunsgraad, 2001). The levies listed above are in agreement with the factors discussed in the above sections of this chapter as this part concluded on the matters of royalty payments and resource rent as factors contributing to stability.

The paramount importance of growth and investment in the mining environment has been a key focus point of the study. The DTC (2016) reinforces the statements and conclusion made in the above sections of this chapter where it was indicated that a tax system should be designed to promote growth and investment. However, this finds itself in some contrast with the tax principle

of neutrality which holds that tax provisions should not alter investment decisions through incentivizing or dis-incentivizing. This study is in favour of disregarding the tax principle of neutrality to some extent so that mining tax provisions and incentives can act as a way to create an identity for the mining tax regime of a country.

2.4. Chapter conclusion

In this chapter, section 2.1. discussed the overall foundations of a tax regime and determined that a balance should be struck between the interests of taxpayers and governments. The only way to achieve such a balance is through sharing the risks and benefits. These findings find an effect when the mining debt reduction provision is measured against the general debt reduction provisions. The section further discussed the fact that an equal, fair and effective tax system depends on adequate payments to society and fair returns for investors. The analysis was performed about the life-cycle of mining and included suggestions for governments to accommodate the challenges faced in each phase by means of a fiscal policies.

Section 2.2. analysed the notion of a mineral regime by means of explaining the implications of certain tax levels for a tax regime as well as different taxes applicable to mining regimes, indicating the importance of distributing tax revenues to communities as part of mining companies' social responsibility and to the different levels of governments. The section moreover clearly illustrated that a balance of power between mining investors and governments is necessary for a successful mineral tax regime to occur. The ICMM (2009) indeed argues that mining companies should be subject to the country's general tax system as this would put taxpayers on equal playing fields and provide for greater certainty and stability.

It, therefore, appears that taxation policies should be structured in such a way as to enhance cash flow for mining companies. Further considerations include the fact that corporate social responsibility is a key principle for stability whereas the rate of taxes is not the main investment consideration.

One can, therefore, conclude with a view to this chapter that a tax regime has an enormous impact on financial investment decisions and that setting an ideal tax regime may be easier said than done. One could also summarise the chapter by concluding that the following factors are to be considered as factual considerations for mining companies:

- a) Stability and political risks;
- b) Simplicity and consistency of an overall tax regime;
- c) Effective tax administration;

- d) Transparency in tax dealings and distributions; and
- e) The ability to allocate and distribute tax revenues effectively.

The reason why the obvious factor of rates-and-tax bases has not been included in this list is that its presumed impact level has been over-valued in the past. One would think that companies only considered the tax rate when analysing a tax regime for an investment decision whereas the contrary is true: the aggregate consideration resulting from the factors listed above clearly outweighs the tax rate aspect. Tax regimes and their stability are therefore important risks to consider and therefore play an important role in mining investment decision making (Mitchell, 2009).

Section 2.3. considered the underlying issue of whether the mining debt reduction provision should be based on the general debt reduction provisions or whether the provision should be unique. This discussion dovetailed around the principle of a tax incentive and according to the ICMM (2009), governments' concession towards a provision of a generous tax incentive, to attract mining investments, often results in political pressure after commencing with operations to change the fiscal regime to collect more mining revenues. Also, a common trend in countries where revenue collection has to be negotiated, that is, when a tax collection policy is not contained in a statute, is that it often results in great uncertainty among potential investors.

Special tax incentives that include benefits but do not apply to other taxpayers could in other words constitute a disregard for the meaning of the neutrality principle. The golden rule regarding class privilege, which in the case of mining relates to the accelerated capital deduction, was laid down in the case of *Ernst v CIR* (South Africa, 1954). The rules in favour of mining operations have followed this ruling and to date remains skewed in favour of mining operations.

The mining debt reduction provision contained in subsection (7EA) to section 36 of the Act was based, to a considerable degree, on general debt reduction provisions in the 2017 draft TLAB and was to some extent amended to apply to mining operations in the 2017 TLAA. The true identity of South Africa's mining environment is however not reflected in this provision.

It is beneficial to mining companies and governments when mining tax provisions and incentives are designed to encourage a stable fiscal regime. The balance of powers that has been a focal point of this project is important when designing mining tax provisions. It entails an attractive and generous mining tax regime while remaining conservative around promoting and ensuring the development of non-renewable resources at a later stage. This study ultimately recommends that mining debt reduction provision be designed and implemented without reference to general debt

reduction provisions as it has been proven to be impractical. It should rather be designed with the effect of tax incentives in mind.

However, this recommendation carries caveats as indicated by Readhead (2018). When designing a tax incentive consideration should be given to when tax incentives are necessary towards attracting investment and the cost of implementing said incentive (Readhead, 2018). Since minerals are finite phenomena owned by the government, incentives should be applied to the benefit of citizens. A combination of tax incentives, base erosion and profit shifting could, in other words, result in significant revenue losses for the government. Base erosion and profit shifting refer to tax avoidance strategies that take advantage of gaps and mismatches in tax provisions resulting in the artificial movement of profit to low or no-tax jurisdictions (O'Connell, 2017).

CHAPTER 3:

PROGRESSION OF THE GENERAL DEBT REDUCTION REGIME

3.1. Background and basic principles of South Africa's debt reduction regime

3.1.1. Introduction

As indicated, chapter 2 of the study is set out to provide principles applicable to a tax regime and their effect of certain principles on investment decisions. It further explained tax regime principles specific to mining and also describes the mining debt reduction provision as a possible tax incentive. These factors form part of the discussion in the following chapter, after the comparison between the debt reduction provisions, around the issue of whether mining debt reduction provisions are aligned with section 19 and paragraph 12A of the Income Tax Act (58 of 1962) (South Africa, 1962).

This chapter aims to explain the development of the general tax debt reduction regime, which entails a discussion of the background to it as well as basic principles around it including explanation of 2017 amendments to the general debt reduction provisions and, finally, an illustration of South Africa's current debt reduction regime as related to these matters.

Chapter 1 explained the reason and rationale for the inclusion of debt reduction provisions, in 2013, in the Income Tax Act (58 of 1962) (South Africa, 1962) while the section to follow provides further background about the initial debt reduction regime and amendments that were brought on to it later.

3.1.2. Background to the general debt reduction rules

To comprehend the progression of debt reduction provisions one needs to examine the provisions prior to the 2012 amendment. The debt reduction provisions were governed by three provisions namely proviso (ii) to section 20(1)(a), section 8(4)(m) and paragraph 12(5) (Van Reenen, 2015).

Section 20(2)(1)(a)(ii) of the Act detailed debt written off whilst the debtor was in an assessed loss position. The debt, in this case, had to have occurred in the ordinary course of the debtor's trade and expenditure in terms of section 11 of the Act had to have been claimed.

From the wording of section 8(4)(m) it was noted that it was subject to section 20 which meant that this section related to situations where debt was reduced and the taxpayer whose debt got reduced did not have an assessed loss. This section was introduced due to the technical

limitations of the recoupment provision of section 8(4)(a) of the Act. It eliminated uncertainty pertaining to recoupments of amounts not actually paid by a debtor but allowed as a deduction (Ross, 2016). The fund and subsequent reduction of debt relating to capital expenditure were not covered in section 8(4)(m) and were specifically dealt with in terms of paragraph 12(5) of the Eighth Schedule to the Act.

In the event where debt was used to fund capital expenditure and where it was subsequently reduced or waived, paragraph 12(5) of the Eighth Schedule to the Act would have deemed a disposal to have occurred in the hands of the person receiving the benefit of the reduction, provided that the debt had been discharged for considerably less than the face value of the debt. The purpose of this paragraph was, therefore, to ensure a capital gain when a debtor was discharged from its obligation to pay (Camay, 2011). The paragraph was subject to the fact that the debt reduction amount had not already been taken into account in terms of section 8(4)(m) or section 20(1)(a)(ii) of the Act. This provision was introduced in 2001 when capital gains tax became effective in South Africa: only section 8(4)(m) and section 20 governed debt prior to this introduction (Ross, 2016).

However, these provisions were scrapped when the Taxation Laws Amendment Act of 2012 came into effect. The change can be attributed to the 2008 global financial crisis. Graven (2012) argues that the National Treasury realised the difficult economic climate in South Africa and needed a platform to allow taxpayers to restructure their debt. Camay (2011) confirms this when she states that a mechanism to allow debt reduction without creating an impeded future tax obligation was needed for the number of companies in financial distress.

3.1.3. Amendments to general debt reduction regime

Section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act replaced the previous debt reduction rules with the intention to reverse tax benefits claimed when a debt was applied in a business to the extent that the debt had been reduced or waived. These provisions came into effect on 1 January 2013 and have since then been amended by the Taxation Laws Amendment Act (31 of 2013) as well as the Taxation Laws Amendment Act (43 of 2014) before being signed into law in terms of the Taxation Laws Amendment Act (17 of 2017) (South Africa, 2017b).

These amendments resulted in the utilisation of section 19 of the Act in instances where a debt was used to fund deductible expenditure, acquired allowance assets or trading stock while paragraph 12A of the Eighth Schedule to the Act was employed in instances where the debt was used to acquire a capital asset (Retief, 2015). The latest amendment was signed into law in terms

of the Taxation Laws Amendment Act (23 of 2018). This part of the chapter considers the 2017 amendments to provide a background to the current debt reduction regime as some of the 2018 amendments are still applied retrospectively.

One of the basic principles underpinning the debt relief provisions is the manner in which the expenditure was incurred, that is, funding an allowance or capital asset. The phrase 'allowance asset' is defined in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act which, in both cases, define the phrase as a capital asset for which a deduction or allowance is allowable under the Income Tax Act for the purpose other than the determination of a capital gain or capital loss.

The Act also refers to a depreciable asset which should be distinguished from an allowance asset as defined above. The Act defines a depreciable asset as

'an asset as defined in paragraph 1 to the Eighth Schedule to the Act (other than trading stock and a debt), for which a deduction or allowance determined wholly or partly with reference to its cost or value is deductible under this Act for purposes other than the determination of a capital gain or loss.'

The phrase 'other than the determination of a capital gain or loss' in general terms means 'to be deductible under this Act for the purposes for the determination of a taxpayer's taxable income'. In its turn, this means that the cost of the asset is deductible for normal tax purposes. An allowance asset differs from a depreciable asset as the allowance asset only excludes trading stock whereas a depreciable asset excludes not only trading stock but also a debt.

Before the 2017 amendments, section 19(2) and paragraph 12A of the Act respectively stated in respect of these definitions, the following:

- (2) Subject to subsection (8), this section applies where a debt that is owed by a person is reduced by any amount and
 - (a) the amount of that debt was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted in terms of this Act; and
 - (b) the amount of that reduction exceeds any **amount applied** by that person as consideration for the reduction.

- (2) Subject to subparagraph (6), this paragraph applies where a debt that is owed by a person is reduced by any amount and
 - (a) the amount of that debt was used, directly or indirectly, to fund any expenditure
 - (i) other than expenditure in respect of which a deduction or allowance was granted in terms of this Act; or

- (ii) incurred in respect of an allowance asset; and
- (b) the amount of that reduction exceeds any **amount applied** by that person as consideration for that reduction (emphasis added).

In other words, section 19 applied to debt incurred towards funding expenditure on a revenue account whereas paragraph 12A applied to debt incurred for the purpose of funding expenditure on a capital account (PWC, 2017). The phrase 'amount applied,' as highlighted in the citations above, was deemed relevant to the debt reduction regime as this would have had a significant impact on the reduction amount.

The Act describes the phrase 'reduction amount' as '*any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.*' Brink (2017) explains that the debt reduction provisions prior to the 2017 amendments, as cited above, were only triggered to the extent that the reduction of debt exceeded any amount applied.

One could argue that the 2017 amendments to the debt reduction regime were the most significant when considering the impact of the amended provisions. Gers and Marais (2018) confirm this when they say that the 2017 TLAA brought major changes to debt reduction provisions. The Taxation Laws Amendment Bill (2017) *inter alia* proposed the following amendments which were subsequently signed into law in terms of the Taxation Laws Amendment Act (17 of 2017) on 14 December 2017 (South Africa, 2017a):

- a) The trigger for the application of the debt relief provisions be amended by considering the added phrase 'concession or compromise';
- b) The reduction amount amended by replacing the phrase with 'debt benefit';
- c) Debt forgone provisions are amended specifically to mining companies; and
- d) Paragraph 12A's group exemption was proposed to be amended to be aligned with that of section 19.

According to Gers and Marais (2018), the basic mechanics of section 19 and paragraph 12A remain the same while the 2017 amendments broadened the scope of the provisions. Although the amendments listed above had a significant impact on debt reduction provisions, only the inclusion of the definition 'concession or compromise' and the replacement of the phrase 'debt benefit' fall within the scope of this chapter. The 2017 TLAA amendments replaced section 19 and paragraph 12A in its entirety (Gers & Marais, 2018). The 2017 TLAA applies to the year of assessment commencing on or after 1 January 2018 and the following extracts from section 19

and paragraph 12A regarding the phrase 'debt benefit' each illustrates the significance of the amendments:

(3) Where

- (a) a **debt benefit** arises in respect of a debt owed by a person as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (b) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time the debt benefit arises,

the **debt benefit** in respect of that debt must, to the extent that an amount is taken into account by that person in respect of that trading stock in terms of section 11 (a) or 22 (1) or (2) for the year of assessment in which the debt benefit arises, be applied to reduce the amount so taken into account in respect of that trading stock (emphasis added).

(3) Where

- (a) a **debt benefit** arises in respect of a debt owed by a person as contemplated in subparagraph (2); and
- (b) the amount of that debt was used as contemplated in item (b) of that subparagraph to fund expenditure incurred in respect of an asset that is held by that person at the time the debt benefit arises,

the amount of expenditure so incurred in respect of that asset must, for the purposes of paragraph 20, be reduced by the **debt benefit** in respect of that debt (emphasis added).

One could argue that the tax trigger for the debt reduction tax implications was changed as a result of the 2017 amendments. The scope of the trigger was changed through replacing 'reduction amount', as explained above, with the phrase 'debt benefit' that arises from a 'concession or compromise' (Brink, 2017). Furthermore, the trigger for debt reduction provisions changed and among others included the following actions: 'change or waiver of the terms and conditions of a debt, a novation of the obligation in terms of which a debt is owed' (Gers & Marais, 2018). The inclusion of the phrase 'concession or compromise' is unpacked below (TLAB, 2017):

'concession or compromise' means any arrangement in terms of which—

- (a) any—
 - (i) term or condition applying in respect of a debt is changed or waived; or
 - (ii) obligation is substituted, whether by means of novation or otherwise, for the obligation in terms of which that debt is owed; or
- (b) a debt owed by a company is settled, directly or indirectly, by—
 - (i) being converted to or exchanged for shares in that company; or
 - (ii) applying the proceeds from shares issued by that company.

According to Van der Zwan (2017), a concession or compromise transaction consists of two categories. The first is the change to or waivers of any terms or conditions that apply to a debt and the second relates to debt capitalisation transactions. Further, the Act describes the phrase 'debt benefit' as follows:

'in respect of a debt owed by a person to another person, means any amount by which the face value of the claim held by that other person in respect of that debt, prior to the entering into of any arrangement in respect of that debt, exceeds—

(a) in the case of an arrangement—

- (i) described in paragraph (a) of the definition of 'concession or compromise', the market value of the claim in respect of that debt; or
- (ii) described in paragraph (b) of the definition of 'concession or compromise', where the person who subscribed for or acquired shares in a company in terms of that arrangement did not hold shares in that company prior to the entering into of that arrangement, the market value of the shares, held or acquired by reason or as a result of the implementation of that arrangement; or

(b) in the case of an arrangement described in paragraph (b) of the definition of 'concession or compromise', where the person who subscribed for or acquired shares in a company in terms of that arrangement held shares in that company prior to the entering into of that arrangement, the amount by which the market value of the shares held by that person in that company after the implementation of that arrangement exceeds the market value of the shares held by that person in that company prior to the entering into of that arrangement;

reduced, in the case of a debt owed by a company to a person who holds shares in another company that forms part of the same group of companies as that company, by so much of any increase in the market value of the shares so held by that person as is attributable solely to the implementation of that arrangement.

The reason and rationale for these amendments are described in the Draft Response Document on the Bill issued on 14 September 2017 by Treasury which states (South Africa, 2017):

'The current definition of a **reduction amount has technical limitations** in respect of covering all instances of debt concessions [...] The benefits arising from any concession or compromise or debt restructuring arrangement should, from a policy point of view, be subject to the same rules [...] (emphasis added).

As mentioned in chapter 1, the purpose of the introduction of debt reduction provisions were to assist companies in financial distress. The amendments appeared to have caused more distress due to the uncertainty they created and the added questions concerning the implementation of

the provisions. Chong and Grimm (2018) are in agreement with the statement made around the added uncertainty. A tax implication on an actual amount was replaced with a tax implication on a notional value, that is, the debt benefit which results from a concession or compromise transaction. The result of the 2017 amendments were, therefore, a likely tax trigger for unrealised events.

3.1.4. Interpretation of the 2017 amendment of a ‘concession or compromised’ transaction

The impact of the concession or compromise transaction, as per 2017 amended provisions, forms part of the explanation below, followed by an explanation and impact assessment of the introduction of the debt benefit provision.

Chong and Grimm (2018) state that the provisions embodied in section 19 and paragraph 12A were expanded significantly by replacing an actual waiver or reduction of debt through a ‘concession or compromise’ which created a ‘debt benefit.’ According to Brink (2017), at that time the new trigger brought about a fundamental shift and encompassed a much wider set of circumstances. Any change in the terms of a loan which include a change in interest rate, repayment terms or period of the loan could have resulted in debt reduction provisions being triggered (Brink, 2017).

Chong and Grimm (2018) further explain the impact of the amended provisions as the fact that any restructuring or refinancing strategy of the debt could have resulted in an immediate tax effect for the debtor. Van Rensburg and Van den Burg (2018) endorse Chong and Grimm by stating that the changes to the terms and conditions of a debt need not have resulted in a new debt as the definition of ‘concession or compromise’ centres on the conjunction ‘or.’ The reference to ‘or’ in the definition of ‘concession or compromise’ means that any change in the market value of the debt would have resulted in a debt benefit (Van Rensburg & Van den Burg, 2018). Resulting changes to the structuring of debt according to Chong and Grimm (2018) include:

- a) Changes or waivers of terms and conditions;
- b) Exchange of an obligation for the debt related obligation; and
- c) Direct or indirect settlements of debt with shares in the debtor.

A debt benefit which could result from the concession or compromise transaction can, therefore, be described, in simplified terms, as the excess amount of the face value of the debt before and after the concession or compromise transaction (Chong & Viljoen, 2017). It is only once the debt benefit is quantified that the tax impact can be determined which is also subject to the purpose of

the debt which, in its turn, does not differ from the pre-amended debt reduction provisions. Due to the amended debt reduction provision, debtors might have found it difficult to restructure their obligations in a manner that did not result in a tax burden, which was still a possibility prior to the 2017 amendments (Van der Zwan, 2017). As stated above, the 2017 amendments resulted in more sensitive tax triggers and could have resulted in an immediate tax effect for any benefit accrued to a debtor as a result of common debt restructuring or refinancing strategies (Chong & Viljoen, 2017). As a consequence, a debtor had to consider whether a 'debt benefit' accrued to the debtor taxpayer in case of a change, amendment, restructuring, refinancing of any debt arrangement.

3.2. Current debt reduction provision

3.2.1. Introduction

Section 3.2 of this chapter provided a background and basic principles of the tax debt reduction regime of South Africa. The 2017 amendments were discussed and clearly indicates the reason for the 2018 amendments. This part of the chapter set out to explain the changes made to debt reduction provisions as a result of the fact that some of the 2017 amendments were onerous. The practical implications and limitations are explained below, followed by a summary of the 2018 changes made to section 19 and paragraph 12A. The changes made to these sections, which fall within the ambit of this study, forms part of the discussion to follow by considering the newly amended definitions.

3.2.2. Background to 2018 debt reduction amendments

Brink (2018) explains that the introduction of anti-avoidance provisions often leads to concerns being raised for the unintended consequences of the amended provisions. The 2018 TLAB was released for public comment on 16 July 2018 and contained important amendments to the debt reduction regime (PWC, 2018). These proposed amendments attempted to address the concerns raised as a consequence of the 2017 legislative cycle (Brink, 2018). The legislature accepted most of the public comments regarding the 2017 amendments and introduced the Taxation Laws Amendment Bill (23 of 2018) on 24 October 2018 with some additional amendments based on public input.

Significant changes were made to the debt reduction rules in the 2017 legislative cycle (Brink, 2018). The introduction of definitive rules were a significant part of the changes and effected the relevant rules applied in instances where a debt was settled with inadequate consideration (Brink, 2018). The Explanatory Memorandum to the 2018 TLAB (SARS, 2018a) confirms the argument

made in section 3.2 of this chapter where it states that the reason that moved the National Treasury and SARS to propose the 2018 amendments were the concerns raised regarding the practical implications of the 2017 amendments to section 19 and paragraph 12A. These examples illuminate such practical limitations:

- a) Changes to the terms and conditions;
- b) Substitution of a debt; and
- c) Quantification of a debt benefit.

A simple change in the terms and conditions could result in the debt reduction provisions being triggered which amounts to a taxable event. The reason that these amendments needed to change was, furthermore, as mentioned, due to the fact that a taxable event could be triggered on an unrealised basis (PWC, 2018). The Explanatory Memorandum to the 2018 TLAB (SARS, 2018a) explains the unrealised basis as a subordination of a debt which results in no real significant change in the financial position nor the cash flow of a taxpayer despite resulting in a taxable event (PWC, 2018). Brink (2018) argues the fact that a simple change in the terms and conditions is within the scope of a concession or compromised arrangement is a 'blunt instrument' targeting a narrow group of taxpayers.

The Explanatory Memorandum to the 2018 TLAB (SARS, 2018a) further states that substitution of a debt does not result in a loss for the National Treasury and should, therefore, be removed. Replacing a bridge loan, that is, a temporary with a permanent one would result in a substitution of debt with no loss to the National Treasury. Brink (2018) confirms that a change in an arrangement which does no effect on the National Treasury should be removed and not trigger a taxable event. The quantifying of a 'debt benefit' is also of concern as a valuation needs to be done in order to compare the face value of the debt prior to a 'concession or compromise' arrangement to the market value afterwards. These impracticalities, then, have been discussed in sections 3.2 and 3.3 of this chapter by analysing public comments and academic articles. They have also been acknowledged by the National Treasury in the Explanatory Memorandum to the 2018 TLAB (SARS, 2018a). Price Waterhouse Coopers (PWC, 2018) therefore rightfully states that the proposed amendments seek to address concerns relating to the provisions introduced in the 2017 legislative cycle.

3.2.3. The 2018 TLAA debt reduction amendments

One could summarise the 2018 changes made to section 19 and paragraph 12A in terms of the 2018 TLAA as follows:

- a) Definition of a ‘concession or compromise;’
- b) Definition of an ‘interest-bearing debt;’
- c) Definition of a ‘debt benefit;’
- d) Reductions to a ‘debt benefit’ determined in respect of debt converted into equity; and
- e) Introduction of a definition of ‘market value.’

The Taxation Laws Amendment Act (23 of 2018) amendments to the definition of a concession or compromise and debt benefit fall within the study’s ambit. Based on public input received after introducing it, the 2018 TLAA contains further amendments in response to the 2018 draft TLAB. The following are the amendments made to the concession or compromised definition in terms of section 36 of the 2018 TLAA (South Africa, 2018):

‘concession or compromise’ means any arrangement in terms of which –

- (a) a debt is—
 - (i) cancelled or waived; or
 - (ii) extinguished by—
 - (aa) redemption of the claim in respect of that debt by the person owing that debt or by any person that is a connected person in relation to that person; or
 - (bb) merger by reason of the acquisition by the person owing that debt of the claim in respect of that debt, otherwise than as the result or by reason of the implementation of an arrangement described in paragraph (b);
- (b) a debt owed by a company is settled, directly or indirectly—
 - (i) by being converted to or exchanged for shares in that company; or
 - (ii) by applying the proceeds from shares issued by that company.

These amendments resulted in a more comprehensive definition that effectively limits the scope of debt reduction provisions (PWC, 2018). The amendments would, therefore, result in the triggering of tax events only when the debt is actually ‘realised,’ in contrast to the earlier amendments. These new amendments had the effect that a simple subordination of a debt no longer triggered a taxable event unless the subordination resulted in a realisation of the debt (PWC, 2018). In contrast to these amendments, the 2017 amendments to the definition of a concession or compromised arrangement were broadly defined while the amendments as stated above addressed that issue (Daya & Marais, 2018). These amendments to the concession or compromise definition, section 19 and paragraph 12A, shall apply in the following scenarios (Brink, 2018):

- a) In the event of a cancellation or waiver of a debt;
- b) In the event of debtor (or a connected person to the debtor) redeems the claim in respect of the debt, or in the event of a merger by acquiring the claim in respect of the debt and in so doing extinguishes the debt;
- c) In the event of a debt to equity conversions which include:
 - i) Converting debt claims into shares;
 - ii) Exchanging debt for shares; and
 - iii) When the proceeds from shares issued to settle the debt are applied.

The intention with the introduction of the new rules was to limit the application to realisation events (Brink, 2018). Realisation events are considered *inter alia* to entail a cancellation, waiver, redemption, acquisition or conversion of debt to equity, according to Brink (2018). He furthermore confirms the inference that an important change to debt reduction provisions is the fact that a taxable event will not be triggered unless the changes result in an actual realisation event (Brink, 2018).

Paragraph (b) of the definition of a concession or compromised transaction is triggered in the event of a debt capitalisation or debt to equity conversion arrangement. Janse van Rensburg and Nel (2018) explain the term 'debt capitalisation' as the process whereby the discharge of an existing debt accounts for the consideration of shares issued. Janse van Rensburg and Nel (2018) list three methods for reaching the effective outcome, as indicated below:

- a) Direct settlement by issuing shares in settlement of the debt;
- b) Setting-off the subscription loan against the debt and issuing shares; and
- c) Conversion of debt to shares and realising the conversion rights attached to the debt.

The revised definition of a 'concession or compromised' transaction in the case of debt capitalisation transactions exclude equity loans and generally refer to interest-bearing debt. The explanatory memorandum to the 2018 TLAB describes the reason this as to prevent legitimate transactions being subjected to unintended tax consequences (SARS, 2018a).

Duvenage (2019) states that a concession or compromised arrangement goes hand in hand with the phrase 'debt benefit' so that the two terms need to be considered in combination. The debt benefit regime has the objective of enhancing tax symmetry by attempting to tax debtors on the gain that equals losses which are then allowed as a deduction for the creditors (Groenewald & Van Rooyen, 2019). The amended definition of a debt benefit in terms of section 36 of the 2018 TLAA has an impact on debt reduction provisions as demonstrated in the below extract of the Act:

- 'debt benefit'**, in respect of a debt owed by a person to another person, means—
- (a) in the case of an arrangement described in paragraph (a)(i) of the definition of 'concession or compromise', the amount cancelled or waived;
 - (b) in the case of the extinction of that debt by means of an arrangement described in paragraph (a)(ii) of the definition of 'concession or compromise', the amount by which the face value of the claim in respect of that debt held by the person to whom the debt is owed **prior to the entering into of that arrangement** exceeds the expenditure incurred in respect of—
 - (i) the redemption of that debt; or
 - (ii) the acquisition of the claim in respect of that debt;
 - (c) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise', where the person who acquired shares in a company in terms of that arrangement did not hold an effective interest in the shares of that company **prior to the entering into of that arrangement**, the amount by which the face value of the claim held in respect of that debt **prior to the entering into of that arrangement** exceeds the market value of the shares acquired by reason or as a result of the implementation of that arrangement; or
 - (d) in the case of the settling of that debt by means of an arrangement described in paragraph (b) of the definition of 'concession or compromise,' where the person who acquired shares in a company in terms of that arrangement held an effective interest in the shares of that company **prior to the entering into of that arrangement**, the amount by which the face value of the claim held in respect of that debt prior to the entering into of that arrangement exceeds the amount by which the market value of any effective interest held by that person in the shares of that company immediately after the implementation of that arrangement exceeds, solely as a result of the implementation of that arrangement, the market value of the effective interest held by that person in the shares of that company immediately **prior to the entering into of that arrangement** (emphasis added).

The change in the debt benefit provisions centres on an attempt to prevent tax abuse (Groenewald & Van Rooyen, 2019). The tax abuse relates to taxpayers disposing of the assets before entering into arrangements, which could result in tax consequences. As a result of the disposal, taxpayers could have avoided paying tax had the taxpayer not had an assessed loss. This would have become apparent as the base cost of the asset is non-existent and the recoupment of previous allowances claimed had already been included in the taxpayer's taxable income on the disposal of the asset. The explanatory memorandum to the 2018 TLAA dated 19 January 2019 explicitly states that changes made to the debt relief provisions are intended at closing the loopholes of the previous regime (SARS, 2018b).

The current debt reduction regime effectively implemented since 1 January 2019 entails a change around distinguishing between assets still on hand and assets disposed of in the year prior to the concession or compromise transaction. The tax implication for capital assets still on hand has remained unchanged, see section 3.2 of this chapter. In instances where capital and allowance assets had been disposed of in the year prior to the assessment in which the debt benefit arose, paragraph 12A(4) of the Eighth Schedule to the Act would apply. This means that taxpayers need to determine the gain or loss that would have been applicable had the debt benefit been taken into account for the disposal. The capital gain in the year of assessment in which the debt benefit arose would be an absolute difference between the deemed gain or loss had the debt benefit been taking into account at disposal and the actual gain or loss on disposal (Groenewald & Van Rooyen, 2019).

Further, section 19(6A) provides for an additional recoupment in terms of section 8(4)(a) should the actual recoupment on disposal, without taking the debt benefit into account, be less than the recoupment determined had the debt benefit been included in the calculation (Groenewald & Van Rooyen, 2019).

Paragraph (c) and (d) of the term 'debt benefit' describe the tax implications in the event of a debt capitalisation arrangement triggering the debt reduction provisions, as set out in the concession or compromised transaction definition. Musviba (2018) interprets the amendments in this case as the difference between the face value of the debt prior to the concession or compromise transaction and the market value of the claim in respect of the debt or shares acquired as the amount of the debt benefit.

Sections 3.2 and 3.3 of this chapter have demonstrated that a clear transition and progression with regard to debt reduction provisions are visible. Daya and Marais (2018) welcome the 2018 amendments and state that the mere change of the terms and conditions would not result in section 19 and paragraph 12A being triggered. The explanatory memorandum to the 2018 TLAA (SARS, 2018b) provides background for the reasons that led to the 2018 amendments which have been implemented from 1 January 2019 and state that the amendments are meant to prevent tax abuse due to the structure of the debt relief rules in the Act. The latter refers to ordering rules that mean that debt relief rules are subject to other provisions in the Act and can, therefore, create anomalies.

3.3. Conclusion

This chapter analysed the progression of the initial debt reduction regime when compared to the previous regime and concluded with the latest amendments of current debt reduction provisions. It explained the reason for the amendments of the initial debt reduction provisions as a result of the 2008 global financial crisis.

The basic mechanics of the provisions as set out in section 20, section 8(4)(m) and paragraph 12A remained the same with a view to recoupment and cost reduction. The introduction of section 19 and paragraph 12A, however, did change the order that would be applied to the reduction of debt. The main principle of the amended provisions is the purpose for which the debt was used. This chapter also explained that the intention with section 19 and paragraph 12A amendments was to reverse tax benefits claimed when the debt was applied in the taxpayer's business.

The phrase 'amount applied' was replaced with the phrase 'debt benefit' which resulted in a change around the trigger for debt reduction provisions. This phrase moreover incorporates specific principles such as the reduction of debt by means of shares issued. Also, the amendments have the intention of preventing tax abuse by taxpayers who might dispose of assets before a debt waiver occurs.

Chapter 3 further examined the significant impact that the 2017 amendments had on the debt reduction regime. In addition to this, it illustrated that, retrospectively, 2018, changes resolved uncertainties caused by the 2017 amendments. One of the 2018 changes that addressed an uncertainty caused is the narrowing of the scope of the phrase 'concession or compromised' in relation to a given transaction.

Chapter 4 of the study considers the background around the introduction of the mining debt reduction provision by examining the 2017 TLAB and public comments in response to it. As indicated in this chapter, it forms part of the conclusion reached by means of comparing the mining debt reduction provision to the general debt reduction provisions.

CHAPTER 4:

SOUTH AFRICA'S MINING DEBT REDUCTION PROVISION

4.1. Proposed mining debt reduction provision and inconsistencies around it

4.1.1. Introduction

Chapter 3 of the study illustrated the changes to the general debt reduction provisions through a timeline. This allowed for context as the amendments formed a specific debt reduction regime which in turn form the basis of the analysis of the mining debt reduction provision, in this chapter. Chapter 2 and 3 measures the mining-specific debt reduction provision on the hand of whether the provisions allows for parity between the different sectors.

This part of the study examines the proposed debt reduction provision applicable to a company performing mining operations in South Africa. The analysis is presented in the form of a timeline by stating the initial proposed provision and analysing the said provision based on public comments. The chapter concludes by focusing on inconsistencies and impracticalities of implementing the final amended mining debt reduction provision. Its inconsistencies as well as shortcomings are addressed by reference to the principles discussed in chapter 2. These principles include a discussion around a neutral tax system, the trade-off between the benefit for the public and attracting investment, non-complex rules, the timing of taxes and the mining debt reduction as a tax incentive.

4.1.2. Mining debt reduction before section 36 (7EA)

The reason for the inclusion of subsection (7EA) can be argued in twofold. The National Treasury identified the need to achieve parity between the different sectors. Secondly, section 19 and paragraph 12A of the Act do not apply to the capital expenditure provisions of mining companies. PWC (2017) and Van Reenen (2015) agree with these statements by, respectively, stating that debt reduction provisions in section 19 and paragraph 12A 'did not adequately cater for mining companies and that legislation does not adequately provide for debt reduction in favour of mining companies'. This is evident from the fact that before the inclusion of subsection (7EA) in section 36, section 8(4)(a) recoupment provision was triggered in the event of a waiver of debt. This recoupment provision explicitly excluded amounts allowed to be deducted or set off under section 15(a) (Van Rensburg & Van Den Berg; 2018). This resulted in a non-recoupment of section 15(a) deductible and unredeemed capital expenditure (Van Rensburg & Van Den Berg; 2018). The inclusion of subsection (7EA) addressed this issue which results in the excess of the 'reduction

amount' and the unredeemed capital expenditure to be included in a taxpayer's taxable income in terms of paragraph (j) of the definition of 'gross income', as explained in part 4.1.4. below.

Mining operations are subject to a special tax regime with some academic opinions and case law, set out in chapter 2, expressly state that the Income Tax Act is skewed in favour of mining companies. This special regime can, to some extent, be illustrated by comparing the mining tax provisions to the provisions applicable to manufacturing companies. Myburgh (2013) outlines differences between mining- and manufacturing operations and notes the following:

- a) A mining operation qualifies for a 100% accelerated deduction of capital expenditure whereas a manufacturing company qualifies for an allowance of wear-and-tear over a prescribed period;
- b) Mining operations' capital expenditure are governed by section 15 and 36 of the Act and do not form part of the general deduction provision as set out in section 11(a) of the Act; and
- c) Mining operations are subject to mining royalty tax and mine-specific ring-fencing is applicable.

4.1.3. Mining debt reduction provision proposed and not implemented

Myburgh (2013) emphasises the complexity of the mining tax laws by maintaining that the differences in the interpretation of the complex tax laws between the taxpayers and SARS, lead to uncertainty concerning the tax implications around mining activities. Before the 2017 amendments, there were no specific debt reduction provisions that catered for the capital expenditure of mining companies (PWC, 2017) as the general debt reduction provisions applied to expenditure not governed by section 36 i.e. all operating expenditure. Van Reenen (2015) confirms this when she states that legislation did not adequately provide for debtors carrying on mining operations. Section 48 of the 2017 TLAB, in fact, embodied the first attempt to align the mining industry with other industries in terms of South Africa's tax debt reduction regime, and proposed the following (South Africa, 2017a):

(7EA) Where a **debt** that is owed by a person is **reduced** by any amount and that debt was used to fund any amount of **capital expenditure** incurred, the **reduction amount** in respect of that debt must be applied to reduce any amount of capital expenditure incurred in the year of assessment that the reduction amount arises: Provided that any amount of the reduction amount that exceeds the capital expenditure incurred in the year of assessment that the reduction amount arises, must be treated as an amount received by or accrued by the **mining company**

during that year of assessment in respect of a disposal of assets the cost of which has been included in capital expenditure incurred (emphasis added).

As indicated, an outcry from the public calling for certain amendments to be made in order to align the provision with section 19 and paragraph 12A debt reduction provisions followed. The problems that resulted from the amendments are listed below while acknowledging that a revised provision was included in the 2018 TLAA, as discussed in section 4.2. below.

It is therefore clear that any amount of debt waived or reduced that was used to fund capital expenditure would first be utilised against unredeemed capital expenditure that has been carried forward (Da Silva, 2017). Any excess amount would be included in the gross income of a company. This is similar to the recoupment provisions in terms of section 19 and paragraph 12A.

The proposed mining debt reduction provision gives the impression of a simplistic provision incorporating, the already established, general debt reduction provisions. The characteristics of a mining tax regime, discussed in chapter 2, provides for a less complex tax system in lower-income countries. In addition to this, the principle of neutrality is evident from the basic characteristics of a tax system and is also evident from the recommendations made in the Davis Tax Committee report. The proposed provision is based on the principles of the general debt reduction rules and therefore the design is indicative of progression towards a neutral and less-complex mining tax system.

4.1.4. Unredeemed capital expenditure and the carried-forward principle

The phrase 'capital expenditure incurred' occurs in the subsection mentioned above. Section 15(a) grants a deduction for an amount ascertained from section 36 against the income of the taxpayer derived from mining operations (De Koker *et al.*, 2000). The Act defines capital expenditure incurred as follows:

'for the purpose of determining the amount of capital expenditure incurred during any period in respect of any mine, means the amount (if any) by which the expenditure that is incurred during such period in respect of such mine and is capital expenditure, exceeds the sum of the amounts received or accrued during the said period from disposals of assets the cost of which has in whole or in part been included in capital expenditure taken into account (whether under this Act or any previous Income Tax Act) for the purposes of any deduction in respect of such mine under section 15 (a) of this Act or the corresponding provisions of any previous Income Tax Act'.

This means that an excess of the capital expenditure above the total amounts received or accrued from a disposal of assets will constitute unredeemed capital expenditure incurred. According to De Koker *et al.* (2000), the deduction as described above is granted in the case of:

- a) Wear-and-tear allowance;
- b) Lease premium allowance;
- c) Allowance on the cost of patent and similar rights; and
- d) Allowance on alienation, loss or destruction of an asset.

In simplified terms, capital expenditure means expenditure on shaft sinking and mine equipment excluding interest, finance charges and employees' capital expenditure (De Koker *et al.*, 2000). Mine equipment has a broad meaning and includes all apparatuses necessary for carrying on mining operations but excludes incorporeal benefits or advantages only tangible assets are therefore included (De Koker *et al.*, 2000).

Mining tax principles are also referred to as the deduction regime. This entails certain provisions capping the deduction concerning mining expenditure. Section 36(7E), (7F), (7G) respectively limits a taxpayer's capital expenditure deduction to the taxable income received from mining and by further capping the expenditure to a specific mine. The debt reduction mining provision appears to follow section 36(7E) which means that this subsection must first be considered. Subsection (7E) governs subsection (7C) which limits the deduction under the latter subsection when it comes to any mine or mines to the so-called 'gross mining taxable income' which is derived from mining operations (De Koker *et al.*, 2000). Subsection (7E) reads as follows:

(7E) The aggregate of the amounts of capital expenditure determined under subsection (7C) in respect of any year of assessment in relation to any mine or mines shall not exceed the taxable income [...] derived by the taxpayer from mining, and any amount by which the said aggregate would [...] have exceeded such taxable income as so determined, shall **be carried forward** and be deemed to be an amount of capital expenditure incurred during the **next succeeding year of assessment** in respect of the mine or mines to which such capital expenditure relates (emphasis added).

This subsection clearly outlines the carry-forward principle which functions around unredeemed capital expenditure. The excess expenditure is not tax-deductible which means the capital expenditure cannot create a loss for the entity and will thus be carried forward and again be deemed as capital expenditure incurred in the subsequent year (Van Reenen, 2015). Subsection (7E) therefore sets a general cap on the capital expenditure deductions for mining companies (De Koker *et al.*, 2000).

The carry-forward principle, as described above, agrees with the characteristics of a mining tax regime, as discussed in chapter 2. This is evident in the exploration stage as high costs cannot be offset against revenue as the mining activities have not commenced as of yet. Mitchell (2009) believes that governments accommodate for the high costs in the explorations stage by encouraging the carried-forward principle of losses.

In the event where the debt waiver or debt benefit exceeds the unredeemed capital expenditure, the excess amount would be included in the mining entity's gross income in terms of section 1 paragraph (j) of the definition of 'gross income' of the Act, which paragraph states:

(j) so much of the sum of any amounts received or accrued during any year of assessment in respect of disposals of assets the cost of which has in whole or in part been included in capital expenditure taken into account [...] for the purposes of any deduction in respect of any mine under section 15 (a) of this Act or the corresponding provisions [...] as **exceeds the sum of so much of any capital expenditure** as in the case of such mine is **unredeemed** at the commencement of the said year of assessment and the capital expenditure that is incurred during that year in respect of such mine, as determined before applying the definition of 'capital expenditure incurred' in section 36 (11) (emphasis added).

Subsection (7EA) means that excess of the 'reduction amount' and unredeemed capital expenditure were to be included in the gross income of a mining company in terms of paragraph (j) of the 'gross income' definition (Da Silva, 2017). In principle, the same effect would have resulted in the event of a debt that was used to fund an allowance asset in terms of the general debt reduction provisions, being reduced. The base cost would have been reduced in terms of paragraph 12A(3) and the excess would have been included in the taxpayer's income. It should be noted that the 2017 draft TLAB resulted in the deletion of the phrase 'reduction amount' in section 19 and paragraph 12A of the Act whilst the inclusion of the proposed subsection (7EA) still referred to the phrase.

As can be seen here, a comparison of the debt reduction regimes boils down to the wording, interpretation and practicality around applying the relevant provision to mining entities in contrast to provisions applicable to other entities. The comparison includes an examination of section 19 and paragraph 12A with reference as to why these provisions are not suitable in the case of mining companies. The inherent limitations of the 2017 draft TLAB inclusion of subsection (7EA) form part of the discussion below with reference to public comments on the proposed 2017 tax year amendment bill.

4.1.5. Proposed mining debt reduction and connected person exclusions

The draft mining debt reduction provision was not included in the scope of paragraph 56 of the Eighth Schedule to the Act (Nysschens, 2017). This paragraph sets out the tax implications when debt relating to a connected person is cancelled or waived. This could be the result of the fact that the proposed provision was not excluded in cases where inter-group debt had been reduced. Section 1 of the Act defines a connected person to a company as follows:

- (i) any other company that would be part of the same group of companies as that company if the expression 'at least 70 percent of the equity shares in' in paragraphs (a) and (b) of the definition of 'group of companies' in this section was replaced by the expression 'more than 50 percent of the equity shares or voting rights in';
- (iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 percent of
 - (aa) the equity shares in the company; or
 - (bb) the voting rights in the company;
- (v) any other company if at least 20 percent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company.

Paragraph 11(1)(b) of the Eighth Schedule to the Act regulates the release or waiver of a right to receive a payment. A right to receive a payment forms part of the definition of an asset in the Eighth Schedule to the Act and the waiver or release thereof constitutes a disposal in terms of this Schedule thus resulting in capital gains tax (Viviers, 2014). This leads to a situation where capital losses arising from the debt reduction or waiving between a mining company and a connected person cannot be disregarded, should the debt be waived or cancelled (Nysschens, 2017).

The exclusion from the scope of the mining debt reduction provision entails that debt waiving exclusions will not apply when a person who owes a debt is a company that forms part of the same group of companies and that debt is reduced. An exception to this occurs when the debtor assumed that the debt incurred by the debtor company had been settled, taken over or refinanced by another company that did not form part of the group of companies on the date which the debt was incurred or had been reduced or settled by means of a share issue (ENSAfrica, 2013).

The Act provides for exclusions of certain provisions due to the principle of a 'group of companies,' defined in section 1 of the Act as follows:

two or more companies in which one company (hereinafter referred to as the 'controlling group company') directly or indirectly holds shares in at least one other company (hereinafter referred to as the 'controlled group company'), to the extent that

- (a) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.

In terms of the Act, there are numerous reasons for companies to belong to or be part of a group of companies. According to ENSAfrica (2013), tangible benefits emerge from being part of a group if the group structure is set out correctly. Section 19(8)(e) and paragraph 12A(6)(d) of the general debt reduction provisions make provision for group exemption and this exclusion is not evident in the mining debt reduction provision above.

Chong and Grimm (2018) explain in simple terms when a group exclusion is allowed. The group exclusion is only applicable between resident debtors and creditors in the same group where the debtor did not trade in the current year of assessment that is, a dormant entity, and in the case where shares were used to settle the debt. The meaning of this is that no adjustment has to be made to the base cost of the asset as a result of the reduction of waiving of debt (Van der Zwan, 2017).

The proposed subsection (7EA) was significantly changed before being signed into law. The following part of this chapter considers the final mining debt reduction provision and determine whether these inconsistencies continue to prevail.

4.2. The final mining debt reduction provision

4.2.1. Introduction

Many of the inconsistencies resulting from the proposed mining debt reduction regime were noted and accepted by the legislature as reflected by the Final Response Document on the 2017 TLAB. The comments that were noted and accepted are listed below and would, therefore, be contained in the final amended subsection (7EA) (South Africa, 2017):

- a) Debt reduction rules for mining companies will apply to debt both direct and indirectly funded capital expenditure;

- b) The exclusion listed in paragraph 12A will be extended to the mining debt reduction provision;
- c) Notional amounts of capital expenditure will not be subject to mining debt relief provisions;
- d) The wording of a 'mining company' will change to the phrase 'mining operations' to allow for the inclusion of the excess of the reduction amount compared to the reduction of the mining capital expenditure in terms of paragraph (j) of the gross income definition;
- e) Only capital expenditure of the mine that was funded with debt and subsequently subject to the debt reduction provision will be deducted from the reduction amount; and
- f) The group exclusion applicable to paragraph 12A will be extended to include mining debt reduction provision.

4.2.2. The current mining debt reduction provision

In relation to these changes noted and accepted by the legislature, set out above, the following provision was signed into law in terms of the Taxation Laws Amendment Act (17 of 2017) (South Africa, 2017b):

(7EA) **Subject to paragraph 12A(6)(a) to (d) and (f)** of the Eighth Schedule, where a debt benefit, as defined in section 19, arises in respect of a debt that is owed by a person and that debt was used **directly or indirectly** to fund any amount of **capital expenditure incurred**, the **debt benefit** in respect of that debt must be applied to reduce any amount of capital expenditure incurred in the year of assessment that the debt benefit arises: Provided that any amount of the debt benefit that exceeds the capital expenditure incurred in the year of assessment that the debt benefit arises, must be treated as an amount received by or accrued to that person carrying on **mining operations** during that year of assessment in respect of a disposal of assets the cost of which has been included in capital expenditure incurred **in respect of the mine** to which that capital expenditure relates (emphasis added).

The first amended version of section 36 in the 2017 draft TLAB did not make provision for group exclusion which led to submissions made to the National Treasury to ensure that the provision signed into law would contain the group exclusion. Gibson (2017) states that no exceptions had been included in the draft provision and that Treasury and SARS indicated that the exception would apply to mining companies. In response to the submissions made, intra-group exclusions were subsequently made available to mining companies (Van Rensburg & Van Den Burg, 2018). The version of subsection (7EA) that was signed into law expressly stated that the sub-paragraph is '*subject to paragraph 12 (6) (a) to (d) and (f) of the Eighth schedule*' which is evident with a view to the extract listed above.

Section 19 employs the term 'expenditure' whereas section 36 (7EA) uses the phrase 'capital expenditure' even though section 36 (7EA) refers to section 19 concerning the meaning of a debt benefit. The fact that the mining provision only deals with capital expenditure illustrates that it does not embrace all types of expenditure, not least since a mining company's non-mining assets would be subject to section 19. Consider in this respect that the mining debt reduction provision signed into law allows for directly and indirectly funded capital expenditure to be subject to the provision, therefore it could be said that the inconsistency was addressed.

The introduction of the word 'indirectly' broadens the scope of section 19 and paragraph 12A (Van Reenen, 2015). The case of *C: SARS v Labat Africa Ltd* (South Africa, 2011) gave meaning to the word 'expenditure' as intended in the Act. This case indicated that expenditure refers to 'the action of spending funds; disbursement or consumption; and hence the amount of money spent.' Therefore, the term 'indirectly' ensures that capital expenditure acquired by means other than that of a direct finance agreement is also subject to debt reduction provisions. The addition of the term also ensures alignment between mining- and general debt reduction provisions.

This mining debt reduction provision, as discussed above, provides for a debt benefit component to be present which is furthermore similar to general debt reduction provisions. Also, the phrase 'mining operations' is worth examining in relation to subsection (7EA). Mining operations and mining are defined in section 1 of the Act as follows: every method or '*process by which any mineral is won from the soil or from any substance or constituent thereof*'.

Brink (2018) states that legislation governing debt reduction forms part of a complex web of technical rules. This web of technical rules was adopted on a more straightforward basis in 2013 but only to the extent of including industries affected by section 19 and paragraph 12A while these did not include the mining industry's capital expenditure regime. The first mention of an amendment to the special mining provisions was made in the 2017 draft TLAB which proposed the inclusion of subsection (7EA) to section 36 and was subsequently adopted, with the amendments made as given above. The mining provision was subject to scrutiny when public comments came around as has been explained above. The National Treasury realised the need to align the industries in terms of the tax treatment of debt waiver provisions which resulted in the introduction of subsection (7EA) to section 36 (Van Rensburg & Van den Burg, 2018).

4.2.3. The amended mining debt reduction provision and the group exclusion provisions

The 2018 TLAB did not refer to any changes in debt reduction provision for mining companies. The following factors are still applicable when comparing subsection (7EA) to the current section

19 and paragraph 12A debt reduction regime, as discussed in section 4.1 of this chapter. One of the inconsistencies named was the fact that the draft 2017 TLAB did not make provision for so-called group exclusions in the proposed section 36. Some of the group exclusions were subsequently extended to section 19 and to mining companies in terms of section 36 in the 2017 TLAA and therefore signed into law in terms of subsection (7EA).

The phrasing of subsection (7EA) to section 36 refers to paragraph 12A and to a debt benefit as defined in section 19 Paragraph 12A carries two additional exclusions with the first stating that in the case of winding-up of a debtor, any debt benefit that arises in terms of a connected person is excluded with a view to the implications of paragraph 12A (Chong & Viljoen, 2017). Thus paragraph 12A results in the exclusion of subsection 6(e) which deals with reduction of debt in anticipation or in the course of liquidation, winding-up, deregistration or final termination of the existence of a company.

Paragraph 12A(6)(e) therefore allows for the disregard of debt reduced between connected persons in the event of a liquidation, winding up, deregistration or final termination. The exemption applies only to the extent that the debt benefit does not exceed the base cost of the creditor's expenditure. Since it makes economic sense to disregard debt relief in this instance, one would have expected that the liquidation exception would be applied to the mining debt relief provisions as the intention with the introduction of these provisions were to provide relief to companies in financial distress by reducing the possibility of an immediate tax liability.

Section 4.1. above unpacked the inconsistencies that resulted from the proposed mining debt reduction provision. The transformation of the proposed provision to the provision signed into law has been clearly illustrated here: it resulted in the provision to be significantly aligned to the working of the general debt reduction provisions. These changes made to the proposed provision were a result of comparisons made to general debt reduction provisions and by the public participants in the public participation process.

Paragraph 12A(6)(g) and the similar provision contained in section 19(8)(g) are another group exclusion not available to mining companies. These provisions provide that the general debt reduction provisions not being trigger in the event of a debt owed by a person being settled by means of a debt capitalisation arrangement as described in paragraph (b) of the definition of a 'concession or compromise'. The debt should also not comprise of interest incurred by a taxpayer during any year of assessment. In simple terms this translates to the exclusion of debt being converted to equity, to the extent that the debt does not comprise of interest incurred.

A debt benefit will result in the case of debt owed being converted to equity in terms of paragraph (c) of the definition of a 'concession or compromise'. The impact of subsection (7EA) not being subject to paragraph 12A(6)(g) means the debt benefit will be set-off against the unredeemed capital expenditure and has the potential of being included in a taxpayer's taxable income in terms of paragraph (j) of the definition of 'gross income'.

4.2.4. The application of the characteristics of a mining tax system to the amended mining debt reduction provision

The principles of an ideal mining tax regime, as discussed in chapter 2, can be applied to mining debt reduction provision. The workings of subsection (7EA) are based on the principles of the general debt reduction provisions and the National Treasury stated that the introduction of mining debt reduction provision was aimed at aligning the sectors. These developments confirm a progression towards a neutral mining tax regime by subjecting taxpayers, irrespective of the sectors they operate in, to the same taxation provisions. The principles of neutrality and transparency entail a uniform set of tax principles to be applied across all industries.

A tax regime based on the principles of neutrality and which is progressive could result in long term sustainable investments (ICMM, 2009). The mere fact that the mining debt reduction provision is not within the scope of the group exclusion whilst the general debt reduction provisions are included in the scope of the said exclusion, result in a disparity in the debt reduction regimes. From an investor's perspective, this can be seen as a tax deterrent and is therefore not in line with the principles of chapter 2.

The capital intensive characteristics applicable to mining operations require relaxed tax provisions in the early stages of the mining operations. The final mining debt reduction provision allows for the unredeemed capital expenditure to be utilised against the 'debt benefit'. This reduces the effect of a cash outflow resulting from the reduction of a debt and is in line with the principle of the timing of taxes as an immediate tax liability is avoided.

Subsection (7EA) includes the phrase 'in respect of the mine' to which that capital expenditure relates'. This phrase refers to the ring-fence provisions applicable to mining operations. This provision disallows the offset of profitable from unprofitable operations. Chapter 2 clearly states that the ring-fence provisions can be regarded as a tax disincentive from an investor's perspective. In this case, the excess of the debt benefit over the unredeemed capital expenditure would result in the inclusion of the amount in the taxable income of a taxpayer whilst other mining operations might have an unredeemed capital expenditure tax buffer.

One of the factors listed in chapter 2 was the fact that a tax regime should ensure a balance between benefit for the public on the one hand and encouraging investment into the sector on the other. The rationale with the introduction of the debt reduction provisions was to assist companies in financial distress. Ross (2016) compared South Africa's general debt reduction provisions to those of Chapter 6 of the Companies Act of South Africa (71 of 2008) which governs the process of business rescue and rehabilitation. This study found that there was a significant disparity between general debt reduction provisions and the aim of the process of business rescue of financially distressed but still viable companies (Ross, 2016).

As the mining debt reduction provision is based, to some extent, on the general debt reduction provisions, the findings of the study conducted by Ross (2016) are deemed to apply to the mining debt reduction provision as well. It can thus be concluded that subsection (7EA), in isolation, does not encourage investment and is not aimed at benefitting the public if the basis of the business rescue process is not considered in the scope and consequences of the provision. The mere fact that it does not encourage investment and is not beneficial to the public is in contrast to the principles of a mining tax regime, as discussed in chapter 2.

The fact that investment attractiveness is assessed based on stability, predictability and non-complex tax rules, while it is not necessarily based on the rate of the tax regime, has been explored in the examination of tax regime principles within chapter 2 of the study. Subsection (7EA) resembles the characteristics listed above as this provision, in simple terms, ensures a reversal of prior benefits. The rationale for the inclusion of mining debt reduction provision was to align the sectors while the aim of debt reductions itself was to assist companies in financial distress.

4.3. Chapter conclusion

This chapter illustrated the progression of the mining tax debt reduction provisions. The tax implications before 2013, which were determined to not adequately represent the workings of the mining provisions, were discussed with reference to the National Treasury's rationale for the inclusion of the amended provision. The recoupment provision, section 8(4)(a), was triggered in the event of a debt waiver and this section specifically excluded amounts deducted under section 15(a). Section 15(a) governs the scope of the deductions allowed for mining operations.

The movement towards a neutral and uniform tax system for all sectors is a clear indication for the mining debt reduction provision being included in its current wording. This is in line with the

recommendations made in the Davis Tax Committee report on Hard-Rock Mining, in the broader sense of the mining tax system.

Section 48 of the 2017 TLAB introduced the proposed mining debt reduction provision which was flawed in terms of the practical implementation thereof. This is evident from the public comments in response to the said provision and the difference in the final provision signed into law in terms of the 2017 TLAA. The proposed provision referred to the phrase 'reduction amount' whilst the proposed amendment to the general debt reduction provisions included the phrase 'debt benefit'.

The principles of unredeemed capital expenditure carried-forward and the inclusion of the excess of the 'reduction amount' to the unredeemed capital expenditure were analysed to explain the workings of the proposed and final amended provision. The unredeemed capital expenditure carried-forward principle is not comparable to the general debt reduction provisions. The general debt reduction provisions are subject to the workings of the tax allowance provisions which are not ring-fenced to specific operations as in the case of the mining tax system.

The proposed mining debt reduction provision was compared to the general debt reduction provisions and the exclusion of the group relief, in terms of paragraph 12A(6)(e) and (g), were identified as a shortcoming which continued to prevail, to some extent, in the final amended section 36 (7EA).

Paragraph 12A(6)(e) of the Eighth Schedule to the Act is not included in the scope of the mining debt reduction provision whilst being included in the scope of the general debt reduction provisions. This provision allows for relief in the event of the winding-up, liquidation and deregistration of a connected person.

In addition to the paragraph 12A(6)(e) exclusion not being available to mining companies, paragraph 12A(6)(g) was identified as a significant provision not being available to mining companies. The relief not being available to mining companies relate to debt capitalisation arrangements in terms of paragraph (c) of the definition of a 'concession or compromise'. The failure to include these group relief provisions for mining companies are not in line with the rationale for the inclusion of the mining debt reduction provision and also result in a tax disincentive as explained in chapter 2.

From the proposed subsection (7EA) it was clear that significant changes needed to be made to the provision in order to be comparable to the general debt reduction provisions. The changes, listed 4.2.1. (a) to (f), to the proposed provision resulted in a final mining debt reduction provision which is significantly aligned to the workings of the general debt reduction provisions with the

exclusion of the group relief provision dealing with the winding-up, liquidation and deregistration of group companies and with the settling of debt with equity shares. The alignment refers to the basic mechanics of the general debt reduction provisions being similar to the working of the mining debt reduction provision.

Section 19 and paragraph 12A, *inter alia*, deal with debt used to fund an allowance asset. In the event of the said asset still being on hand when the debt reduction provisions are triggered, the remaining base cost of the allowance asset will be reduced. The excess of the debt benefit and the allowance asset will be included as a recoupment in the taxpayer's taxable income. The workings of subsection (7EA) are in effect the same as the previously mentioned scenario. In the case of subsection (7EA), the unredeemed capital expenditure will be reduced in the event of the debt reduction provision being triggered. The excess of the debt benefit and the unredeemed capital expenditure will also be included in the taxpayer's taxable income.

CHAPTER 5: SUMMARY AND CONCLUSION

5.1. Introduction

Chapter 1 emphasised the importance of the mining sector for South Africa as a key player in providing employment and contributing to South Africa's GDP. The characteristics of a mining tax regime, chapter 2, described the capital intensive industry and described the design of the tax provisions to accommodate the risks in the mining industry. Debt in this capital intensive industry was inferred and therefore mining debt relief provision as a subject of this study was deemed relevant. The introduction of the mining debt relief provision was highlighted by the rationale to align the sectors and to address the disparity between the debt reduction regimes.

This study aimed to discuss whether the mining debt reduction provision is aligned to the general debt reduction provision by measuring them against each other. In furtherance of the question of whether the debt reduction regimes are aligned, this study aimed to address whether the mining debt reduction provision should be aligned to the general debt reduction regime. This entailed a discussion regarding the characteristics of a mining tax regime as well as the measurement of the mining provision against the principles of a tax incentive.

This chapter summarises the findings and conclusions reached in the individual chapters and concludes on the study by taking the findings into account. The extent to which the objectives of this study, as discussed in chapter 1, were achieved forms part of the discussion in the following part of this chapter.

5.2. Achievement of objectives and summary of findings

The objectives of this study, as set out in chapter 1.4., were addressed through a literature study that entailed an examination and comparison of different debt reduction provisions as found in section 19 and paragraph 12A and subsection (7EA) to section 36, involving mining debt reduction provision. Further, literature regarding tax regime dynamics and their impact on investment decisions were considered. The findings of the literature study addressed the problem statement as set out in section 1.2 of the study with special reference to the research objectives, as follows:

- i) Critical analysis of a tax regime's dimensions to consider its investment decision impact with special reference to mining tax regimes. Further, to interpret different perspectives*

around the issue of whether the mining debt reduction provision should be aligned with the general debt reduction provisions.

The study of the principles of a tax regime and the impact of these principles on an investment decision were conducted to establish what a tax provision's basis should constitute if it were to have a positive effect on investment attractiveness.

The analysis in part 2.1.1. of the study revealed that the basis of a tax regime should be measured against four principles. These principles comprise of equality, certainty, convenience relating to the payment of a tax liability and efficiency in the methods of collecting taxes. The overall suggestion regarding the mechanics of a tax regime is that a tax regime should progress towards a less complex and less incentive driven regime for lower-income countries. The ICMM (2009) report, in this regard, concludes that a country's economic reality should be reflected in its tax regime principles.

The study of a sound tax regime further suggested, in 2.1.2. of the study, that a successful and effective tax regime should allow for adequate payments to society, ensure an adequate return for investors and should be competitive with other regimes. Pondering the objectives of such a regime revealed that it should be neutral regarding maximising government revenue through resource rent taxing while it should be perceived as a policy instrument towards attracting foreign direct investment; further, taxation should aid governance and state-building.

The discussion regarding taxation policies and specific investment considerations in part 2.1.3. of the study considered royalty payments, ring-fence provisions and resource rent as part of the impact assessment of taxation policies on an investment decision. This analysis revealed alternative measures as to the fiscal payment of royalties. Investing in infrastructure can be a measure to subsidise royalty payments.

The ring-fence factors considered as part of an investment decision revealed that it would lean towards a tax disincentive as it prevents companies to off-set profitable and non-profitable operations. The analysis of resource rent as an investment consideration revealed that marginal projects would not be undertaken and resource rent can also result in premature closing of operations due to the fact that the required return on investment cannot realise.

This objective was also addressed by considering mining tax regime principles. The subsequent examination, in part 2.2.2. of the study, revealed that governments could

maximise revenue in the long term by designing neutral, progressive and long-term sustainability-based principles; based, that is, on the principles of tax levels and transparency.

The analysis, in part 2.2.3. of the study, regarding the distribution of tax revenues revealed that investors consider this practice to cultivate relationships and encourage collaboration among the relevant parties. The moral and social responsibility of distributing tax revenues are considered an investment attraction as this ensures stability.

The analysis around the issue of whether the mining debt reduction provision should be based on the general debt reduction provisions was conducted in an extension of the focus on the issue of whether the mining debt reduction provision is aligned to the general debt reduction provisions that have underpinned the study. The analysis revealed that the most recent report submitted to the Minister of Finance on mining, that is, the Davis Tax Committee report, recommended that the mining industry be aligned to other sectors, this was discussed in part 2.3.2. of the study.

Closer scrutiny of the Marais Commission report revealed that it promoted the principle of simplicity in furtherance of the overall principle of an effective tax regime. This report, read together with work done by Sungley, Baunsgraad and Readhead again showed the recognition that mining is a unique sector that can therefore not be subject to the same boilerplate provisions as found in other sectors. This study further revealed that South African case law has repeated itself by allowing for the progression of the fact that the Income Tax Act is skewed in favour of mining operations.

Part 2.3.3. of the study considered the mining debt reduction provision as a fiscal stabilisation tax incentive. This type of tax incentive is aimed at assisting financially distressed mining companies. Assistance, from governments, can be provided by means of not adding an additional liability when the debt reduction provisions are triggered.

The overall conclusion around a mining tax regime was that special tax provisions are common ways of attracting investment and, with a mix of taxes, government and mining companies should share the risks and rewards. Further, this examination revealed that the rates and bases of taxes are considered inferior to risks, sustainability and predictability factors.

Finally, an analysis of the fundamental factors underpinning a tax incentive revealed, in part 2.3.3. of the study, that mining debt reduction provision should be incentive-based rather

than merely coming down to a passive reversal of recoveries of previously deducted expenditure.

- ii) *Analysis of the progression of the general debt reduction provisions, that is, section 19 and paragraph 12A, to obtain an understanding of the amendments by examining the rationale that drove them.*

The study of the progression of general debt reduction provisions was conducted to illustrate and determine the impact of the amendments and to provide a base for comparing mining debt reduction provision to the said provisions.

This analysis, in part 3.1.2. to 3.3.3 of the study, revealed that the triggers and consequences of general debt reduction provisions were strategically amended over the previous years. The change from the phrase 'reduction amount' to 'debt benefit' resulted in changes in the extent and trigger for debt reduction provision.

The most recent amendment, to the phrase 'concession or compromise,' cleared-up some of the uncertainty that the 2017 amendments introduced. The result, which is evident from part 3.3.2. of the study, was that the mere change to the repayment terms and conditions of debt would no longer trigger debt reduction provisions. A realisation event would have to be triggered before the general debt reduction provisions could be implemented.

- iii) *Critical examination and comparison of the triggers, impact and consequences of the capital expenditure mining debt reduction provision and the general debt reduction provisions. Apply the characteristics of a mining tax regime (discussed in chapter 2) to subsection (7EA) to determine the appropriateness of the subsection.*

Examining the mining debt reduction provision is the core of this study. Focusing on the consequences of mining debt reduction provision allowed for a comparison between the provision and general debt reduction provisions. Further, it led to the unmasking of inconsistencies around applying this provision.

The analysis set out in 4.2.2. and 4.2.3. of the study revealed major inconsistencies with regard to the group exclusions. These inconsistencies and shortcomings relate to the winding-up, liquidation, deregistration and final termination of group companies (paragraph 12A(6)(e)) and the debt reduction through equity share conversion transactions between a group of companies (paragraph 12A(6)(g)). These were not built into mining debt reduction provisions and resulted in a significant deficiency in the mining debt reduction regime.

The analysis set out in 4.2.2. and 4.2.3. of the study revealed major inconsistencies with regard to the group exclusions. These inconsistencies and shortcomings relate to the winding-up, liquidation, deregistration and final termination of group companies (paragraph 12A(6)(e)) and to the debt reduction by means of equity share conversion transactions between a group of companies (paragraph 12A(6)(g)). These were not built into mining debt reduction provisions and resulted in a significant deficiency in the mining debt reduction regime.

The result of the omission of group exclusion relating to paragraph 12A(6)(e) was that due any debt that had been reduced in anticipation or in course of a liquidation, winding-up, deregistration or final termination of a company, which are normally excluded in terms of the corporate roll-over rules, would be subject to the debt reduction provisions.

The result of the omission of the group exclusion relating to paragraph 12A(6)(g) can have severe consequences for mining companies. The debt benefit in terms of the general debt reduction provisions is limited to the interest accrued whereas this limitation is not extended to the mining debt reduction provision. This means a debt benefit in a share capitalisation, or similar, transaction has to be off-set against the unredeemed capital expenditure and therefore the excess can even result in an income being created.

The discussion around the characteristics of the mining debt reduction provision throughout chapter 4, and specifically in part 4.2.4., revealed the progression towards a neutral tax regime as the workings of the mining debt reduction provision are significantly based on the workings of the general debt reduction provisions. The analysis further revealed that the deviation from this principle, with regards to the group exclusion mentioned above, can be regarded as a tax disincentive and therefore discourage investment into the mining sector.

5.3. Limitations of the study

This study focused on the mining debt reduction provision with reference to the workings of the general debt reduction provisions. Some limitations have been encountered during the study as the focus was placed on determining the inconsistencies of the mining debt reduction provision when compared to the general debt reduction provisions, rather than assessing the mining debt reduction provision as a stand-alone provision.

Furthermore, this research followed a literature approach and did not aim to gather large volumes of data regarding the mining debt reduction provision as a tax incentive. This means the impact on the economy was not considered in this regard.

Further inherent limitations around the general debt reductions provisions include the fact that companies as a legal entity were mentioned throughout this study despite the fact that individuals, trusts and other entities are also subject to these provisions.

5.4. Recommendations for further study

The aim of this study, as set out in part 1.4. of the study, resulted in a comparison between the mining debt reduction provision and the general debt reduction provisions. The study of the issue of whether these provisions are aligned identified certain areas subject to further research.

The comparison of the general debt reduction provisions and the mining debt reduction provision revealed two major inconsistencies relating to the principles set out in paragraphs 12A(6)(e) and (g). Further studies could aim to determine the impact of the omission of these two provisions.

Further studies could also aim to gather information from other tax jurisdictions with regard to mining debt reduction rules to investigate whether the mining debt reduction provisions should be customised to reflect the mining tax regime's characteristics.

In furtherance of the aim set out above, this study aimed to address the issue of whether the mining debt reduction provision should be aligned to the general debt reduction provisions. This entailed an analysis of the characteristics of a tax incentive which is open for interpretation as further studies could provide examples of the mining debt reduction provision as a tax incentive to actively assist companies in financial distress.

5.5. Conclusion

The main objective of this study was to assess whether the mining debt reduction provision is aligned with debt reduction provisions set out in section 19 and paragraph 12A. To address the main objective with sufficient evidence from a tax- and a mining tax regime perspective, the trade-off between tax principles and the impact thereof on an investment decision were examined in section 2.1. Section 2.2 provided further perspectives around mining debt reduction provision by analysing mining tax regime in terms of three dimensions namely tax levels and transparency, a mix of tax instruments and distribution of tax revenues.

The development of the general debt reduction provisions contained in section 19 and paragraph 12A from the time of the amendment of the initial provisions in 2013 up to the amendment of the provisions in 2018 were discussed in chapter 3, sections 3.1 to 3.3. This explanation provided the basis of the comparison made between the general debt reduction provisions and the mining debt reduction provision (set out in chapter 4) which in turn addressed the main objective of this study. The main objective of this study is the question of whether the mining debt reduction provision is aligned to the general debt reduction provisions. The comparison between the two debt reduction regimes, therefore, yielded shortcomings and inconsistencies between the two regimes and in turn addressed the main objective of the study. The discussion included an analysis of the previous 'reduction amount' to the current 'debt benefit' requirement which was argued to be the key aspect of debt reduction provisions. Further, the trigger for debt reduction provisions, that is, the fulfilment of a 'concession or compromised' transaction and the impact of the amendments thereof were deliberated.

The detailed discussions in chapters 2 and 3 explored the main objective of this study in terms of a non-taxation basis and assisted the examination of mining debt reduction provision in chapter 4 as this provided a basis and benchmark for the mining debt reduction provisions to be measured against. The main objective was ultimately addressed in chapter 4 by comparing the components of the detailed analysis of the final amended mining debt reduction provision to the statements made in chapter 3, sections 3.2 and 3.3. This comparison concluded that the mining debt reduction provision is to some extent aligned with general debt reduction provisions in terms of the consequences of triggering these debt reduction provisions. The fact that group exclusions are not included in mining debt reduction provision is a major departure when compared to the general debt reduction provisions. This chapter further pointed out inconsistencies that continue to prevail due to the nature of the mining environment in South Africa.

Pursuing the main objective of this study raised questions around the need to address the underlying secondary objective to the main objective. The secondary objective of this study was to discuss whether mining debt reduction provision should be aligned and be in agreement with general debt reduction provisions, given the fact that the mining tax regime of South Africa is unique. Chapter 2, section 2.3., discussed the matter in detail and included case law to illustrate the progression and originating causes of South Africa's unique mining tax legislation. Further, arguments in favour of the alignment of the sectors were examined with a view to the Davis Tax Committee's recommendations which were found to make a strong argument for the alignment of the taxes of the different sectors based on the principle of neutrality. This chapter concluded, with arguments against the alignment, that the uniqueness of South Africa's mining tax provisions

allows for the debt reduction provision to comprise of tax incentive characteristics and that it should not be based on general debt reduction provisions.

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