Fiscal Regimes for Extractive Industries in South Africa

ITIC AFRICA TAX DIALOGUE: Striking the Tax Balance:
Domestic Revenue Mobilization and Investment Climate
Cape Town, South Africa
November 15-17, 2016

Alpa Shah
Fiscal Affairs Department
International Monetary Fund

IMF Review of SA EI Regimes

- IMF review conducted in 2015 by Philip Daniel, Martin Grote, Peter Harris, and Alpa Shah.

- Designed to assist in DTC's overall review of the tax system.

- IMF (2015) review considered the current fiscal regime against the following objectives:
  - Attractive climate for new investment to develop the tax base
  - Fiscal regime that secures a reasonable contribution to government revenues, with a higher share from more profitable operations.

SOUTH AFRICA: MINING SECTOR

Mining fiscal regime

- Overall regime has a long history, is well understood, and few complaints that it deters investment or production
- Taxation is far from top of the list in current challenges facing the development of EI in South Africa… however,
- …mining revenue yield since the late 1980s has been poor

Mining fiscal regime

- … a range of additional impositions have raised costs and there is uncertainty in the regulatory and fiscal environment
- …accretion of royalty and income tax amendments over time, and now of sector legislation, have created difficult legal framework

Challenge is to have in place a fiscal regime perceived both to be stable and credible by all parties

Mining fiscal regime

- Fiscal regime not confined to tax – has three main elements
  - Variable Rate Royalty
  - Income Tax
  - Indirect taxes, levies or refunds on inputs
- BEE participation

Mining: IMF Fiscal reform options

1. A comprehensive reform of flat rate royalty, CIT, and use of some form of cash flow tax that affects only highly profitable operations

2. Maintain current structure but with partial reforms

3. Do very little.

Mineral Royalty

- Royalty act of 2008 (effective 2010): maximum “unrefined”, 7%, “refined” 5%; uses scale of EBIT to determine rate on gross value:
  - Scheme is fairly complicated and duplicates income tax in attempt to vary with profit.
  - Distinction between refined and unrefined minerals creates administrative difficulties.
  - Construction minerals subject to royalty provision
- Adoption of a single flat royalty of 1.5% on gross revenue would have raised a total royalty stream of R21.3 billion versus the actual collected total of R20.6 billion.

Recommended Royalty Reforms

Full Reform Option:

- Set royalty at flat rate on gross sales at around 2 percent.

Partial Reform Option :

- Move to Net Smelter Return (NSR) base removes need to distinguish refined/unrefined products

- Adjust rates and scale

- In both cases, consideration should be given to impose a specific charge (R/ton of material removed) for high volume but low value commodity.

Corporate Income tax

- Standard CIT rate of 28%
- Capital expenditure qualifies for 100 percent deduction capital allowance
- 3 types of ring-fence
- CIT Rate for gold is determined by formula currently: $y = 34 – (170/x)$, with an additional capital redemption allowance

Corporate Income Tax

- Current system is complex – gold formula, capital allowances and multiple ring-fences

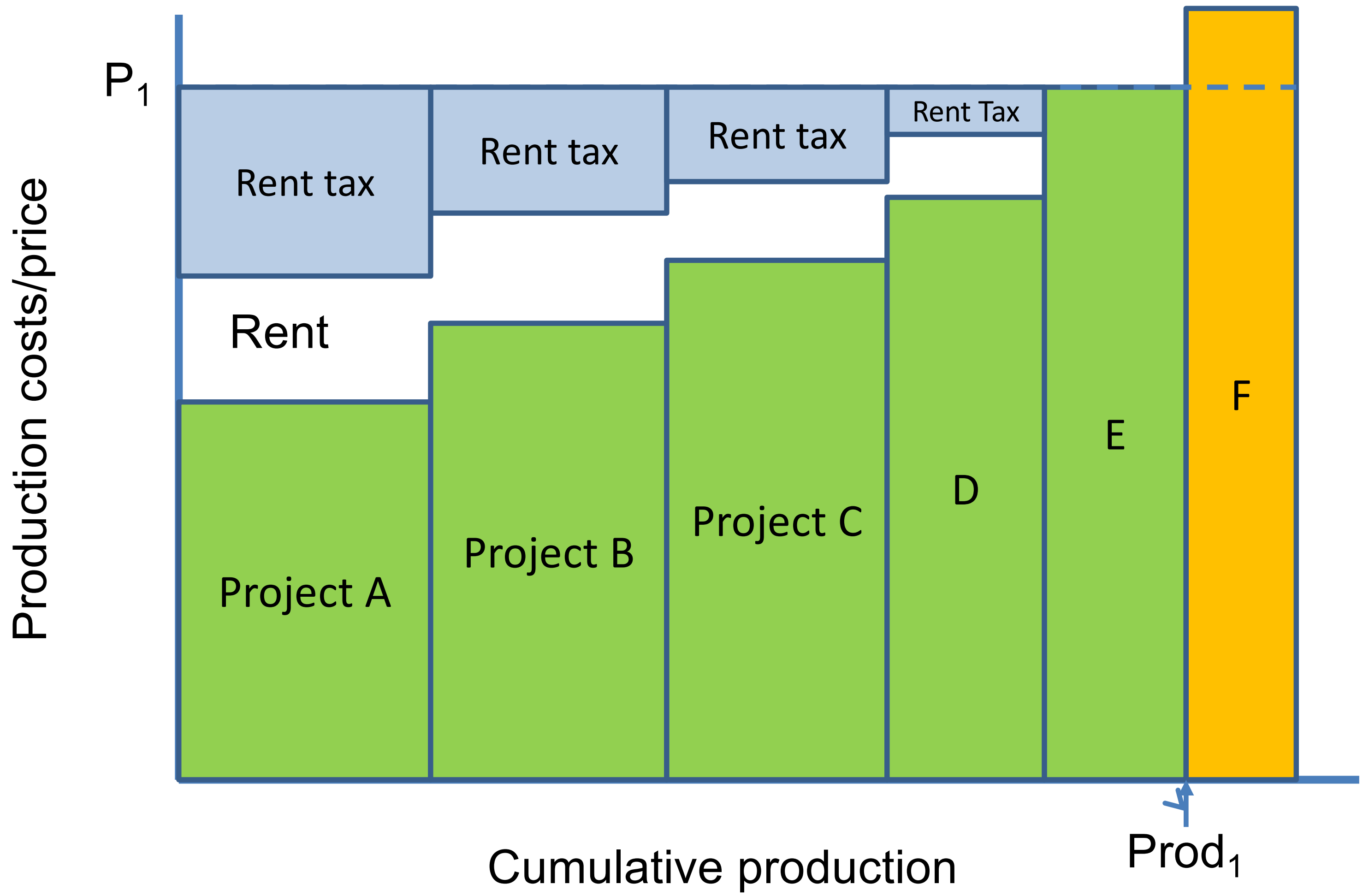
- Recommendations:
  – adoption of single corporate rate (28 percent) for all economic sectors
  – move away from immediate deduction of capital.

Recommended CIT reforms

- Maintain **ring-fence for CIT** licence by licence; except for unsuccessful exploration expenditure elsewhere by the taxpayer
- Write off of **exploration and development capital expenditure** over five years
- Introduce an **allowance for corporate capital (ACC)** on unredeemed capital expenditure balances at annual rate
- Eliminate **deduction of interest** – ACC stands in lieu
- Remove gold formula tax and additional capital redemption allowance (uplift) for new gold mines.

An additional resource rent tax?

- Should not distort investment decisions
- Allows state to share in "upside" of projects



An additional resource rent tax?

- South Africa introduced its variable royalty system as a proxy for taxation of mineral rent.

- **Our preference**…a flat rate royalty with a cash flow tax as the variable charge on resource use (rent tax) – both deductible for CIT

BEE, SLP, and indirect taxes

- BEE requirements for 26% + HDSA equity in mining companies
  - Lowers prospective returns on new investment
- Social and labor plans (SLP), together with obligatory and voluntary infrastructure expenditures.
  - Tax treatment requires clarification.
- Multiplicity of levies, environmental charges, trade taxes, payroll taxes and mining charter obligations
  - Rising cost structure reducing competitiveness

SOUTH AFRICA: PETROLEUM SECTOR

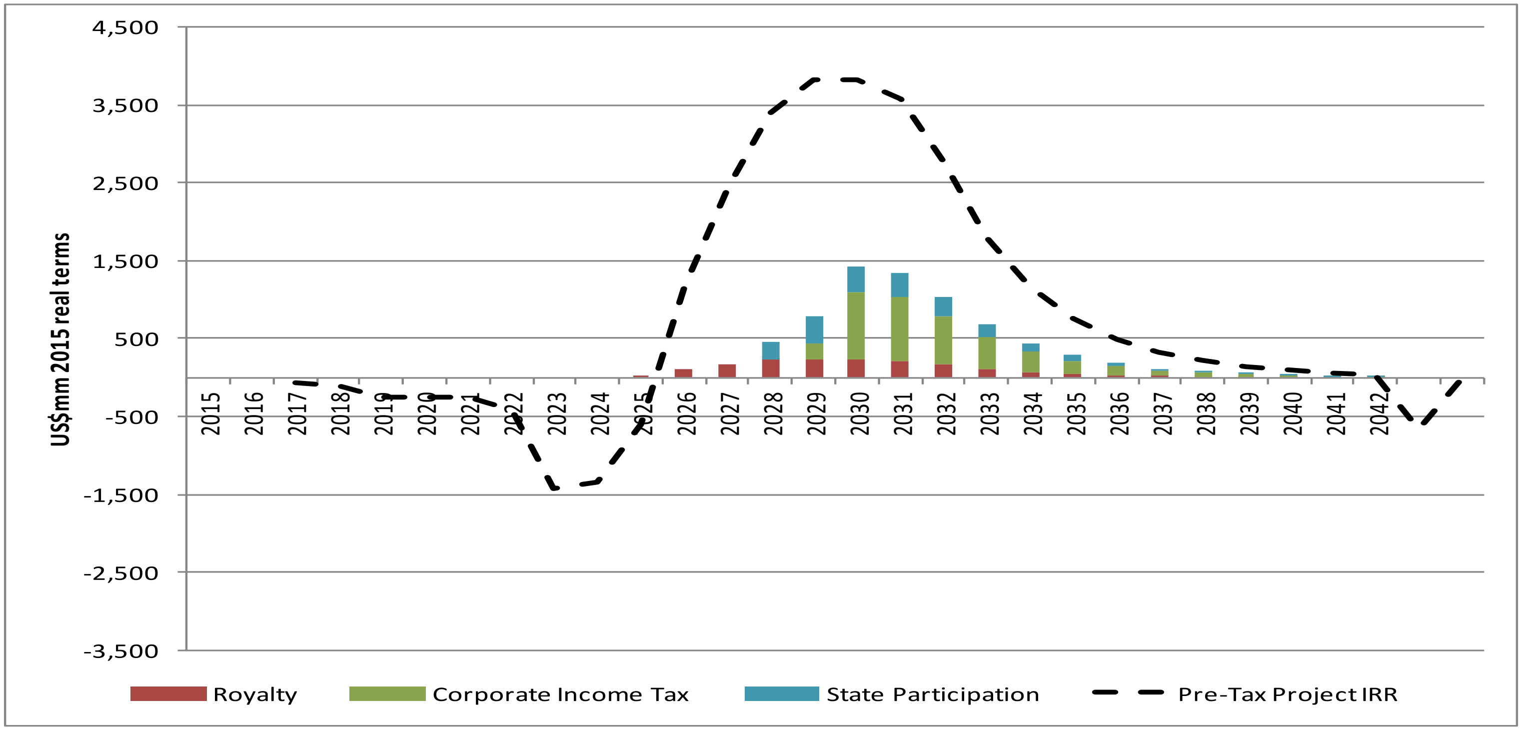
Petroleum Sector: Context

- South Africa is not yet a significant producer of crude oil or natural gas.
- In the past 10-15 years almost all potential offshore acreage has been licensed
- Offshore conditions for exploration and development are extremely challenging: in addition to water depth, deep sea currents and surface weather conditions add to the cost and risk of operations
- Strong interest also exists in shale gas potential in the Karoo Basin.

Petroleum fiscal regime

- Specifics currently less a problem for investor decisions than general uncertainty
- Fiscal regime not confined to tax – has three main elements
  - Variable rate royalty
  - Income Tax (under Schedule 10 of ITA), with immediate expensing of capital + additional uplift of 100 percent of exploration capital expenditure and 50 percent of "post-exploration" (development and production) capital expenditure
  - New state participation proposals under MPRDA
- BEE participation

Current Regime



- Current regime is very generous, with discounted AETR at 35%
- FAD simulations suggest that 60-80% is a more typical range worldwide.

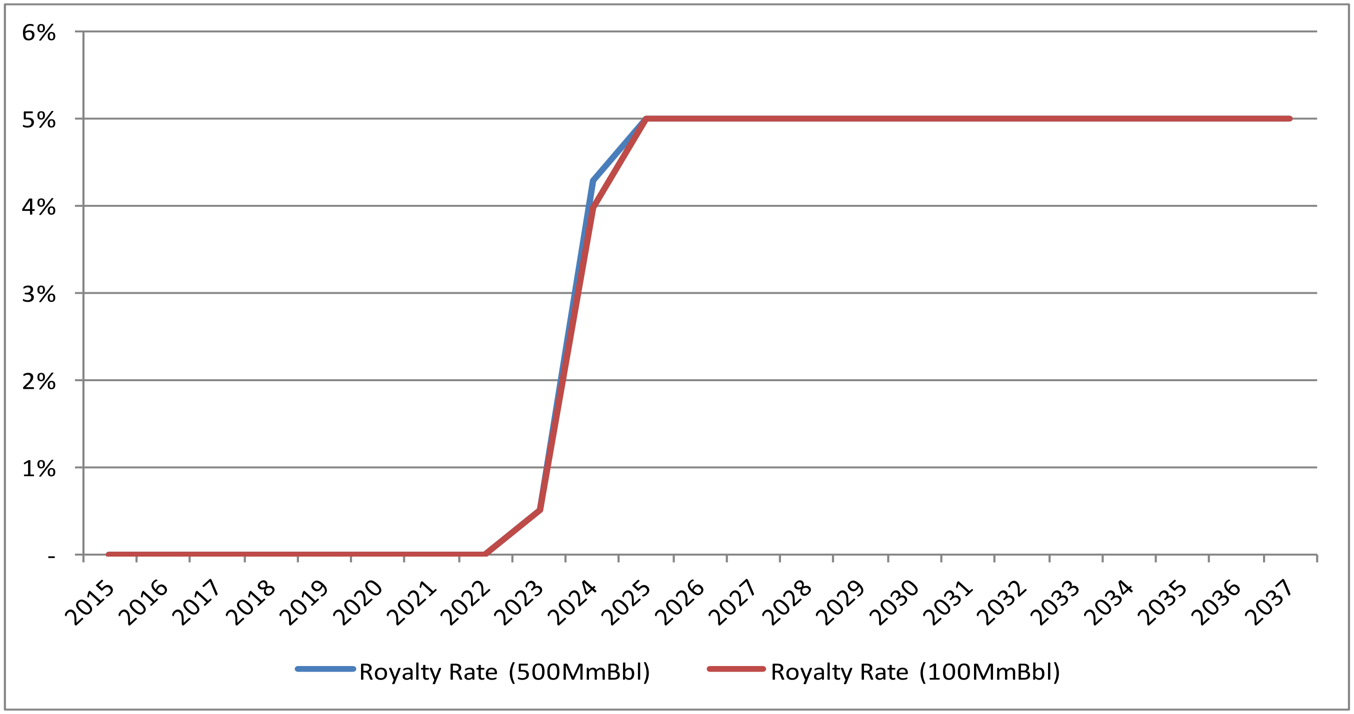
Petroleum Royalty

- Same scheme as for mining
- All petroleum treated as “refined” so maximum royalty rate is 5 percent
- Royalty scale determined by EBIT formula originally designed for mining companies.

ISSUES

- Scheme unsuited to petroleum
- Crude oil and natural gas not normally considered “refined products”
- Countries without significant petroleum development have almost always started with a flat rate royalty or minimum state production share
- Offshore discovery targets are large – economics capable of sustaining flat rate royalty.

Petroleum Royalty



- Analysis suggests that variable royalty is largely ineffective in the petroleum sector

Corporate Income Tax - Petroleum

- Immediate expensing of capital expenditure and uplifts are overly generous
- Recommend 5-year straight line treatment, together with an allowance for corporate capital (ACC)
- Clear ring fence at the level of the petroleum taxpayer.

Petroleum: State Participation

- MPRDA Amendment Bill now referred back to Parliament contains new state participation provisions.
- Wording is unclear but states at least:
  - 20 percent “free carry” with no financial obligation for the State
  - Further participation on terms to be agreed, or “production sharing agreements”
- Key problem is the uncertainty thus introduced – leaves existing holders of exploration rights unclear about their obligations for state participation if they apply for a production right

Petroleum: Three options

1. Delete new provisions altogether in revision of MPRDA amendment bill
   - State would still be free to negotiate participation case-by-case as a commercial transaction
   - Additional tax could be introduced for those without stability agreements (or newcomers)
2. Comprehensive shift to a production sharing agreement (PSA) system.
3. Define state participation option precisely and publish model participation agreement.

- In all cases, royalty and CIT regime needs revision.

SOUTH AFRICA: OTHER EI ISSUES

Other Issues

- Stability assurances:
  - Fragmented and inconsistent position of fiscal stability: yes for royalties, partly for petroleum CIT, none for mining CIT and none for quasi charges such as under proposed MPRDA amendments.
  - Recommend greater uniformity of treatment across EI sectors.

- Transfer of Rights:
  - Consistent tax treatment. Recommend that cash gains from disposal are taxed as revenue in the hands of the seller and the purchase price amortized in the hands of the buyer.

Thank you!