

**THE ALLUVIAL DIAMOND INDUSTRY: A CRITICAL ANALYSIS OF
THE CAPITAL COST ALLOWANCES**

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DEPARTMENT OF TAXATION

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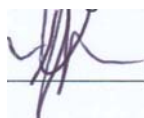
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- ACKNOWLEDGEMENTS -

To my wife, who supported and encouraged me to finish

and

to my children, who shared my burden

I love you dearly.

- ABSTRACT -

**THE ALLUVIAL DIAMOND INDUSTRY: A CRITICAL
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The purpose of the study is to critically analyse sections 15 and 36 of the South African Income Tax Act that deals with capital allowances for mining taxpayers from an alluvial diamond miners' perspective. The South African analysis was also compared to that of Canada and Namibia. In the analysis it was found that the ring-fencing provisos in section 36 is unfair towards the alluvial diamond mine due to the potential loss of capital cost allowances and that there are grey areas in this proviso that may lead to disputes between the SARS and the taxpayer. It was also found that the cross over from prospecting to mining activities in relation to alluvial diamond mining presents a grey area which might lead to disputes between the tax payer and the SARS. There is no case law, SARS interpretation notes or practise notes on the application of these sections to provide certainty as to the tax payers' position. It was recommended that the SARS and Treasury evaluate and address the identified grey areas and short comings in the current legislation and practises to ensure a fair and equitable tax dispensation for the alluvial diamond miners.

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CHAPTER 1

INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

The South African alluvial diamond industry has grown significantly in the past decade. With the adoption of a more formal marketing forum the miners have increased their revenues by realising a much higher and more market related price for the alluvial diamonds per carat that they extract.

Alluvial diamonds differ from the traditional kimberlite diamonds (that are commonly associated with large companies like De Beers). Kimberlite diamonds are found in kimberlite pipes and one can, in general, geologically ascertain the lifespan, size, length and grade of the kimberlite, prior to starting the mining operations, with a fair amount of certainty.

The kimberlite diamond mining operations are in general either large scale underground operations or large scale open cast mining operations. This type of mining requires a significant amount of capital expenditure to establish the underground mining operations similar to that of gold/platinum mining on a reef. The mine is established based on the geological survey which is done on the kimberlite pipe. Due to the large amount of capital outlays, these mines are only established on sites with an acceptable long term life of mine, and the mining operation is concentrated on the area containing the kimberlite.

Compared to the operation that is outlined above, alluvial diamond mining is very different in nature. Alluvial diamonds are found either along current water flows (rivers) or in old river beds. In general these areas cannot be surveyed in a similar

manner to that of the kimberlite diamonds due to the nature of the gravel that holds these diamonds.

The gravel along the same stretch of river might stop at any moment and only start a couple of hundred meters at any given point. The levels of the gravel might also differ significantly between the various points.

Due to the nature of the gravel that is mined, the mining operations of an alluvial diamond miner differs significantly from that of a kimberlite and gold or platinum mining operations which was the main focus of the legislature when drafting section 15 and 36 of the South African Income Tax Act.

The largest difference lies within the type of capital expenditure as well as the way in which capital expenditure is planned and executed. For alluvial diamond mining the largest portion of equipment that is utilized is movable plant and machinery, also known as yellow metal assets.

The yellow metal assets is used, due to the nature of the gravel that is mined, as it would not be economical to establish underground operations, nor is there any need thereof as the gravel is normally found at acceptable levels.

Where it is found that there is diamond carrying gravel, the portion is uncovered in a similar manner as open cast mining although mining is not as deep as the above mentioned. After the gravel is extracted and the portion has been successfully mined, rehabilitation of the area is performed.

All of the above mentioned machinery is moved, as the gravel is mined out and new gravel is found in the area. None of the capital items are left behind due to the nature of the assets.

Similar to the United States Marines, the alluvial diamond miners do not leave any machines or infrastructure behind.

Economically, due to the potential short lifespan of the different sites, capital expenditure is not only incurred for a specific site but based on the whole operation capital needs. It is common practise for the equipment to be utilized at different sites.

In the past it was customary for the assessors of the South African Revenue Service to assess the alluvial diamond miners as if there was only one mine. In essence, no ring-fencing was applied to these operations.

The SARS started to analyze these operations to establish whether, from their point of view, these different sites should be regarded as a single mining operation (contiguous) or as different mines, and that ring-fencing should then be applied.

The alluvial diamond industries perspective is that past precedent have been set by the SARS and that the taxpayer can therefore reasonably expect to be assessed in a similar manner as what has been the past practise.

The alluvial diamond industry is also of the view point that their different sites should be viewed as a single mining operation due to the nature of the capital costs that has been incurred, and that current legislation does not take into account their unique nature of business.

1.2 NEED FOR THE STUDY

In light of the significant differences between the alluvial diamond mining industry and the traditional concept of mining it is imperative to ask: Should there be a specific tax regime for capital expenditure for the alluvial diamond industry in South Africa?

1.3 RESEARCH OBJECTIVES

The primary objective of this study is to critically analyze the current Income Tax Act from the viewpoint of the alluvial diamond industry, with specific reference to section 15 and 36 of the Income Tax Act, and to compare our current legislation to that of Namibia and Canada.

The secondary objective is to provide an Income Tax framework for the alluvial diamond industry, specifically in terms of contiguous mining operations and associated capital expenditure also referred to as ring-fencing. The secondary objective will also include the identification of issues that may cause uncertainty from the perspective of the alluvial diamond miners in interpreting the current South African tax legislation and related case law, and to identify possible short comings in the current South African legislation and practises with specific regard to the alluvial diamond miner.

The Namibian and Canadian Act are used as comparison due to the following:

The Canadian Income Tax Act is highly developed and well defined within a first world country. The Canadian Income Tax Act is widely applied to a large number of mining companies that is Canadian based due to the “flow through shares” provisos in the income tax legislation which is income tax beneficial to tax payers based in Canada.

Namibia forms part of SADC and competes for similar capital inflows to that of South Africa. Namibia’s operating environment is also similar to that of South Africa.

1.4 SCOPE LIMITATIONS

1.4.1 General and South African analysis: scope limitations

The scope of the study will be limited to the taxation implications of the capital expenditure incurred and the ring-fencing thereof in terms of section 36 and 15 of the Income Tax Act of South Africa.

The comparisons to the Income Tax Act of Canada and Namibia will also be limited to those sections dealing with capital allowances for mining operations and the associated ring-fencing thereof should it be included in their respective Income Tax Acts.

The proposed taxation framework for the alluvial diamond industry will also be limited to the capital allowances for mining operations.

The study will be limited to new mines as defined in section 36(7G) of the Income Tax Act being a mine which was started subsequent to 14 March 1990.

The study will exclude any analysis of recoupment on capital allowances and will focus on the allowances available as tax deductions in relation to mining.

1.4.2 Canadian analysis: scope limitations

For comparison to the Canadian tax act, the scope is limited to the Canadian Federal Income Tax Act and Income Tax Regulations.

For analysis of the Canadian Tax Act, the scope is limited to the application of the Canadian Development Expenses, Canadian Exploration Expenses and depreciable asset allowances granted as class 41 assets.

The analysis is limited to specifically exclude the following:

- Canadian flow through share scheme;
- Canadian successor rules
- Recoupment on capital allowances

1.5 IMPORTANCE OF THE QUESTION BEING ASKED

The question as to whether capital expenditure is to be ring-fenced between different sites is very important in the context of the alluvial diamond industry.

Should the ring-fencing of capital expenditure be enforced by the SARS in terms of section 36(10) of the South African Income Tax Act, it will result in significant costs to the industry. This unexpected cost may be too much to bear in the current economic circumstances.

The reason that the tax cost would be unexpected is due to past practises by the SARS where ring-fencing of capital expenditure was not enforced by the assessors of the alluvial diamond miners.

Should there be a collapse of the industry, it will result in widespread economic hardship due to the labour intensive nature of the operations as well as all of the suppliers that depends on the business generated by the alluvial diamond mining operations in the North West and Northern Cape.

It is envisaged that the following users could benefit from this study:

The South African taxpayer – the alluvial diamond miner

The taxpayer may use this study and its findings to determine whether its capital expenditure might be subjected to ring-fencing or not and therefore be able to determine its taxable income in a reliable manner. They will also be able to plan their capital expenditure in the most tax efficient manner.

The South African Revenue Service

The Revenue Service may use the study and its findings as a basis for the evaluation of current taxation legislation applicable to the alluvial diamond industry with specific regard for the provisions of section 36 of the Income Tax Act. They may also use the study as source of information to compile a practise note and/or internal procedure/policy on the handling of capital expenditure in the alluvial diamond mining industry.

Tax practitioners

Tax practitioners may use the study as basis to determine their clients' income tax position reliably and to advice their clients accordingly, in the most tax efficient manner.

The University of Pretoria

The University may use the study as future reference for researchers.

1.6 CURRENT STATUS OF THE TOPIC

The SARS, large business centre, has established a team of auditors and assessors that deal solely with the alluvial diamond miners. They are currently busy transferring all known alluvial diamond miners to this team.

One of the key areas that the team has identified is the large capital expenditure that was incurred by the miners, as well as their wide geographical area of operations.

The operations to them are not contiguous in nature and they would therefore like to ring-fence the capital expenditure between each of the alluvial diamond miners' different sites.

This matter is also receiving attention by policy and risk unit.

1.7 METHODOLOGY

The research is not based on empirical research but rather designed on the qualitative analysis of current literature. The research is interpretative in nature.

The research requires detailed analysis of the sections dealing with mining taxation in the current Income Tax Act in conjunction with the analysis and interpretation of the mining taxation legislation of Canada and Namibia.

The research also entails the analysis of relevant case law of South Africa, Namibia and Canada which deals with the tax deductibility of capital expenditure by mining operations and if applicable the relates ring-fencing legislation contained in their Income Tax Acts.

The background on the alluvial diamond miners operations, management and capital expenditure was obtained through various discussions with alluvial diamond miners. Due to the nature of the diamond industry, and current SARS audits/questions these miners did not want to be identified in this study.

The above research methodology is based on the following:

- Analysis of current taxation legislation in South Africa, Canada and Namibia;

- Analysis and interpretation of current case law in South Africa, Canada and Namibia;
- Correspondence and interviewing of mining taxation experts in South Africa
- Correspondence with mining taxation experts in Canada and Namibia and
- Correspondence and interviewing of the SARS LBC personnel dealing with the alluvial diamond industry
- Personal interviews with alluvial diamond miners

The literary review will be primarily conducted from the following sources:

- The South African Income Tax Act no 58 of 1962
- The Canadian Income Tax Act
- The Canadian Income Tax Regulations
- The Namibian Income Tax Act
- Accepted authority on South African Income Tax
 - Mining Taxation in South Africa – Marius H van Blerck
- Internet web sites
 - South African Revenue Service
 - South African and International auditing and advisory firm websites
 - etaxes.co.za
 - tax talk
 - www.saflii.org
 - www.canlii.org and
- University libraries

1.8 ABBREVIATIONS USED

The following abbreviations are used throughout the study:

Canadian Act and Regulations: Canadian Tax Act in conjunction with Canadian Tax Regulations

Canadian Tax Act: The Canadian Income Tax Act

Canadian Tax Regulations: The Canadian Income Tax Regulations

CCA: Capital Cost Allowances as per the Canadian Act and Regulations

CCCA: Cumulative capital cost allowances as per the Canadian Act and Regulations

CDE: Canadian development expenses

CEE: Canadian exploration expenses

Delwer: Alluvial diamond miner

DME: Department of minerals and energy – South Africa

Miner: Alluvial diamond miner (delwer)

Namibian Tax Act: The Namibian Income Tax Act 24 of 1981

NRCAN: National Resources Department of Canada

PWC: Pricewaterhouse Coopers

SADC: Southern African Developing Countries

SARS: The South African Revenue Service

South African Act: South African Income Tax Act 58 of 1962

CHAPTER 2:

THE SOUTH AFRICAN INCOME TAX ACT AND THE ALLUVIAL DIAMOND MINER (DELWER)

2.1 INTRODUCTION

The deductions allowed for capital expenditure in terms of the South African Income Tax Act is set out in sections 15 and 36 of the Income Tax Act.

Section 36 deals in detail with the capital allowances for mining operations whereas section 15 deals with prospecting.

In this chapter there is an analysis of the South African Income Tax Act and the relevant court cases to establish how these provisos should be applied to the alluvial diamond miner.

2.2 LEGISLATION

The following are extracts from the Income Tax Act 58 of 1962 applicable to capital allowances for mining operations:

2.2.1 Section 15. “Deductions from income derived from mining operations

- 1) There shall be allowed to be deducted from the income derived by the taxpayer from mining operations --

- a) an amount to be ascertained under the provisions of section 36, in lieu of the allowances in sections 11(e), (f) (gA), (gC), (o), 12D, 12DA, 12F and 13quin;
- b) any expenditure incurred by the taxpayer during the year of assessment on prospecting operations (including surveys, boreholes, trenches, pits and other prospecting work preliminary to the establishment of a mine) in respect of any area within the Republic together with any other expenditure which is incidental to such operations: Provided that--
 - i) except in the case of any person who derives income from mining for diamonds in the Republic, the Commissioner may determine that any expenditure referred to in this paragraph shall be deducted in a series of annual instalments, so that only a portion of such expenditure is deducted in the year of assessment in which it is incurred, and the residue in such subsequent years of assessment and in such proportions as the Commissioner may determine, until the expenditure is extinguished;
 - ii) in the case of any company which derives income from different classes of mining operations, the deduction under this paragraph shall be made from the income derived from such class or classes of mining operations and in such proportions as the Commissioner may determine;
 - iii) any expenditure which has been allowed to be deducted from the income of any person in terms of this paragraph shall not be included in such person's capital expenditure as defined in subsection (11) of section thirty-six."

2.2.2 Extracts from Section 36 of the Income Tax Act 58 of 1962:

“Calculation of redemption allowance and unredeemed balance of capital expenditure in connection with mining operations

- 7C Subject to the provisions of subsections (7E), (7F) and (7G), the amounts to be deducted under section 15(a) from income derived from the working of any producing mine shall be the amount of capital expenditure incurred.
- 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 (as determined before the deduction of any amount allowable under section 15(a), but after the set-off of any balance of assessed loss incurred by the taxpayer in relation to such mine or mines in any previous year which has been carried forward from the preceding year of assessment) derived by the taxpayer from mining, and any amount by which the said aggregate would, but for the provisions of this subsection, 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.
- 7F) The aggregate of the amounts of capital expenditure determined under subsection (7C) in respect of any year of assessment in relation to any one mine shall, unless the Minister of Finance, after consultation with the Minister of Mineral and Energy Affairs and having regard to any relevant fiscal, financial or technical implications, otherwise directs, not exceed the taxable income (as determined before the deduction of any amount allowable under section 15 (a), but after the set-off of any balance of assessed loss incurred by the taxpayer in relation to that mine in any previous year which has been carried forward from the preceding year of assessment) derived by the taxpayer from mining on that mine, and any amount by which the said aggregate would, but for the provisions of this subsection, 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 that mine: Provided that where the taxpayer was on 5 December 1984 carrying on mining operations on two or more mines, the said mines shall for the purposes of this subsection be deemed to be one mine.

7G)

- a) Where in the case of any mine in respect of which mining operations or any, related operations were or are commenced by the taxpayer after 14 March 1990 (in this subsection referred to as a new mine) an amount of capital expenditure falls to be disallowed under the provisions of subsection (7F), there shall, notwithstanding the provisions of that subsection. be deducted from the total taxable income derived by the taxpayer from mining (as determined after the deduction of any capital expenditure which does not fall to be disallowed under the said provisions and after the set-off of any assessed loss incurred by him from mining operations in a previous year of assessment which has been carried forward) so much of the total amount of capital expenditure which has been so disallowed in relation to all producing new mines owned by the taxpayer as does not exceed 25 per cent of such taxable income.
 - b) The provisions of paragraph (a) shall not apply to capital expenditure incurred in respect of any new mine--
 - i) which has been disposed of by the taxpayer in the current or any previous year of assessment; or
 - ii) if the taxpayer is a company and its acquisition of the right to mine or the mineral rights in respect of such mine was financed wholly or partly by the issue of any share in respect of which any dividend is to be calculated by reference to that portion of the company's profits which is attributable to the operation of such mine.
- 10) Where separate and distinct mining operations are carried on in mines that are not contiguous, the allowance for redemption of capital expenditure shall be computed separately.
- 11) For the purposes of this section--

"capital expenditure" means--

- a) expenditure (other than interest or finance charges) on shaft sinking and mine equipment (other than expenditure referred to in paragraph (d)); and
- b) expenditure on development, general administration and management (including any interest and other charges payable after the thirty-first day of December, 1950, on loans utilized for mining purposes) prior to the commencement of production or during any period of non-production; and
- d) expenditure (excluding the cost of land, surface rights and servitudes) the payment of which has become due on or after 1 July 1989 in respect of the acquisition, erection, construction, improvement or laying out of--
 - i) housing for residential occupation by the taxpayer's employees (other than housing intended for sale) and furniture for such housing;
 - ii) infrastructure in respect of residential areas developed for sale to the taxpayer's employees;
 - i) any hospital, school, shop or similar amenity (including furniture and equipment) owned and operated by the taxpayer mainly for the use of his employees or any garage or carport for any motor vehicle referred to in subparagraph (vi);
 - iv) recreational buildings and facilities owned and operated by the taxpayer mainly for the use of his employees;
 - v) any railway line or system having a similar function for the transport of minerals from the mine to the nearest public transport system or outlet;
 - vi) motor vehicles intended for the private or partly private use of the taxpayer's employees:

"capital expenditure incurred", 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;

"expenditure" means net expenditure after taking into account any rebates or returns from expenditure, regardless of when such last-mentioned expenditure was incurred.

- 12) The balance of capital expenditure unredeemed at the commencement of the first year of assessment chargeable under this Act shall be the balance shown to be unredeemed at the end of the last year of assessment chargeable under the Income Tax Act, 1941."

2.3 ANALYSIS OF LEGISLATION: SECTION 15

2.3.1 Introduction

Section 15 of the South African Act is divided into two sections. Section 15(a) is the enabling provision for section 36 of the South African Act which is analysed in detail in paragraph 2.4 below. Section 36 deals with capital expenditure subsequent to the establishment of the mine.

Section 15(b) allows for the deduction of prospecting and pre-establishment or production capital expenditure.

The detailed analysis is set out below:

2.3.2 Analysis of section 15

Section 15 (b) deals with the tax deductibility of prospecting expenditure. Prospecting is not defined within the Income Tax Act except for the reference that it refers to expenditure prior to the establishment of the mine.

It is therefore important to ascertain the general interpretation of the above terminology. As per The Collins English Dictionary the terminology prospecting and establish / establishment is defined as follow:

“Establish – 1. To make secure or permanent in a certain place, condition. 2. To create or set up on or as if on a permanent basis”

“Establishment: 1. the act of establishing or state of being established, the place where a business is carried on”

“Prospecting: Mining: a known of likely deposit of ore b. The location of a deposit of ore c. A sample of ore for testing d. The yield of mineral obtained from a sample of ore (8) to work a mine to discover its profitability “

From the above definition the following is interpreted:

Prospecting is to locate a deposit of ore, and to extract a sample of the ore for testing. Prospecting is also to work a mine to discover its profitability. In conjunction with prospecting one needs to ascertain whether a mine has been established or whether the expenditure was incurred prior to establishment. Established refers to a place of business (mining) which is permanent of nature and where business is carried on.

From the above the following deduction is made:

Prospecting expenditure refers to

- a. Capital expenses incurred in finding the alluvial mining deposit;
- b. Capital expenses incurred in extracting a sample of the alluvial gravel and
- c. Capital expenses incurred in setting up a mining operation prior to the tax payer conducting a business of a permanent nature
- d. That the above capital expenditure be incurred prior to commencement of business (commercial production)

The above analysis does not provide clear guidelines for the alluvial diamond delver as to when, in the context of alluvial diamond mining, his expenditure would be prospecting in nature for purposes of Income Tax or when he is deemed to have established a mine.

Prospecting can also not be defined by whether the delver prospects or mines a location by way of a prospecting or mining permit as issued by the department of minerals and energy. This is due to the difference in terminology and criteria that is utilized by the DME.

The reason for the above is that the delver may start operating on premises based on a prospecting license but may complete his operations prior to the prospecting rights being converted into a mining right. The contrast is also true that the delver may start his operations at a specific location based on own rights or contractual or partnership agreements where the partner has new order mineral rights, but that there is no basis for the operations being mining from the offset.

To obtain a better understanding of the above, analysis is required of the Namibian and Canadian Income Tax Acts (see chapters 3 & 4) and related income tax practises.

Prospecting expenditure in a South African context appears to be the same as the Canadian Exploration Expenditure. In the Canadian tax act, the expenses in the pre-production phase are also treated as exploration expenditure. (For a detailed analysis of the Canadian federal tax act, refer to chapter 3) The important date for the change over from pre-production to the production phase is the first day of the first 90 days in which the plant is operated at 60% or more capacity.

The above analogy however also presents a problem in the context of the delver as a central sorting plant, which might already be in existence, is often utilized to process the gravel extracted.

From the above it is suggested that an alluvial diamond operation has been established when the following criteria have been met:

1. Continuous operations in the general geographical area for a continuous period of 90 days
2. During the 90 days referred to above, gravel for production purposes have been transported to either a sorting plant on site or a central sorting plant
3. The “in commercial production date” should be the 91st day of operations
4. Diamond revenue from the above should not be a criteria

The establishment date should be the 91st day as the first 90 days on site should be regarded as prospecting in nature. The expenditure incurred during the 90 day period would therefore be regarded as expenses incurred in establishing the mining operation.

Should the capital expenditure incurred be deemed to be within the definition of prospecting expenses, the following deductions will be allowed:

Section 15(b) allows for a 100% deduction, which may result in an assessed loss, for all expenditure incurred during prospecting, or which is incidental to prospecting, including capital expenditure prior to the establishment of mine.

For diamond mining prospecting there are no potential adjustments to apportion the deductions over a period of years, as diamond mining is specifically excluded from this.

The capital allowance deduction claimed under section 15 is not apportioned for expenditure incurred during the course of a year.

It does not appear as if the capital expenditure allowed as deduction under section 15 is subject to the ring-fencing clauses of section 36(10).

2.4 ANALYSIS OF LEGISLATION: SECTION 36

2.4.1 Introduction

Where a mine has come into production, section 15(a) of the Income Tax Act allows a deduction for capital expenditure calculated in terms of section 36 of the South African Income Tax Act.

Section 36 deals with capital expenditure for mining operations. The capital allowances in this section are subject to ring-fencing provisos contained in section 36(10).

The detailed analysis is set out below:

2.4.2 What is capital expenditure

Capital expenditure is broadly defined within section 36 (11) as being any expense on mining equipment, administration and housing for employees. The definition is very broad and intends to include most items associated with capital expenditure with the exceptions listed within section 36.

The capital allowances for alluvial diamond mining operations, being plant and machinery that is subject to our study, all falls within the definition of capital expenditure as defined within section 36(11).

No apportionment on the capital expenditure deduction is made, as the timing of the expenditure during the tax year is disregarded.

2.4.3 Limitation of deduction of capital expenditure

Section 36(7E) of the Income Tax Act limits the capital expenditure deduction in a tax year for a particular mine to the taxable mining income for the specific mine. This effectively prevents the capital expenditure, which is in excess of the taxable income, to result in an assessed loss for the tax payer. The capital expenditure, which is in excess of the taxable income for that year, is then carried forward as capital expenditure deemed to be incurred in the following tax year as capital expenditure for that particular mine. The deduction in terms of this section is determined prior to taking into account any deductions in terms of section 15.

Section 36(7F) read in conjunction with 36(7G) provides a degree of relief where a tax payer has more than one mine and the mine is a new mine as defined in section 36(7G), being established subsequent to 14 March 1990.

In terms of the above where some of the mines have capital expenditure which is in excess of the taxable income and the other mines are in a net taxable income position, then the taxpayer may offset up to 25% of the total net taxable income of the net taxable mines against the excess capital expenditure of the other mines limited to the available excess capital expenditure.

This relief is not available to mines that are disposed of during the current/prior tax years.

In terms of section 36(10) the capital expenditure of each mine, within the taxpaying entity, should be calculated separately and should not be set off against the other mines within the entity. This is also referred to as ring-fencing of capital expenditure. The ring-fencing and definition of a separate mine will be analysed in detail in section 2.4 of this study.

2.4.4 Detailed example of the workings of section 36

The data contained in the example is not based on true facts. The example only serves to illustrate the effect of section 36 of the South African Act. The situation set out below is based on various discussions with alluvial diamond miners as to how their operations work.

Company A has 2 mines as defined by the SARS. Mine 1 has taxable mining income before capital allowances of R 100. During the year capital expenditure to the value of R 150 was incurred. Mine 2 has taxable mining income before capital allowances of R 200 and unredeemed capital expenditure of R 50.

The taxable income of Company A will be calculated as follows:

DESCRIPTION	MINE 1	MINE 2
Taxable income prior to capital allowances	100	200
Less: Capital redemption section 36(7E)	(100)	(50)
Less: Capital redemption section 36(7G)	0	(37,5)
Taxable income	0	112,50
Calculation of unredeemed capital expenditure		
Opening balance	0	50
Accumulated section 36(7E)	150	0
Redeemed section 36(7E)	(100)	(50)
Redeemed section 36(7G)	(37,5)	0
Unredeemed capital expenditure carried forward	12,5	0

2.5 RING-FENCING

Why ring-fencing?

According to Marius van Blerck (2008) ring-fencing was introduced to maintain the tax base of the mining companies in South Africa. Ring-fencing was implemented to ensure that the mining tax base is not eroded through large capital expenditure by mining companies looking at expanding their mining operations. The essence of ring-fencing is to limit the deduction of capital expenditure incurred by one mine from being deducted from a different mines' taxable income within a single taxpaying entity. This was specifically aimed at the large capital expenditure on underground infrastructure that needs to be incurred to bring the mine into production. When the legislation was drafted all capital expenditure was included as capital expenditure subject to ring-fencing as per section 36(10) of the Income Tax Act.

From our analysis of section 15 it would appear as if the expenditure claimed under this section is not subjected to the ring-fencing clauses as set out in section 36(10). It is therefore very important to differentiate between the capital expenditure that is claimed under section 15 and section 36 due to the implications of ring-fencing. A detailed analysis of the capital expenditure that can be claimed under section 15 is done in paragraph 2.4.1.

Section 36(10) of the Income Tax Act states that the capital allowance should be calculated separately where separate and distinct mining operations are carried on in mines that are not contiguous.

This section implies that where non contiguous mining operations that is, both separate and distinct in nature, is carried on by a single tax payer that the capital expenditure allowance should be computed separately. This could have a significant impact on mining tax payers.

The keywords in this section being, separate, distinct and contiguous are not defined within the Income Tax Act.

The above terminology is defined as follow by The Collins English Dictionary:

- a. *“Contiguous:1. Touching along the side or boundary; in contact 2. Physically adjacent; neighbouring; “*
- b. *“Separate : to be parted from a mass or group; to divide into component parts; existing or considered independently ; distinct, individual or particular”*
- c. *“Distinct : not the same ; separate ; not alike different ; not joined together”*

From the above it appears that one first have to establish whether the different mines are separate and distinct in nature. If the mines are also not contiguous the ring-fencing provisos should be applied.

2.6 THE NATURE OF ALLUVIAL DIAMOND MINING CAPITAL EXPENDITURE

Through various discussions with alluvial diamond operators or delwers, as they are commonly known, the following was established:

The majority of the delwers are relatively small scale operators who operate with a couple of yellow metal machines and pans. The pans are used to liberate the diamonds from the gravel extracted by the yellow metal machines.

The delwer plans his whole operation as a whole, based on his current needs, on the size of his operation and the age of his fleet. Due to the nature of his capital expenditure he knows that he will be able to utilize his equipment on the following sites, should he have to move on due to a lack of gravel. Based on the general size

of the operations the delver is not able to leave his machines or pans behind, as he would then have to incur the capital expenses once more.

Due to the nature of the miner's capital expenditure, it is also not necessary to leave any equipment behind as it can be utilized on the following site that is being mined.

When the gravel deposit on the current location is depleted, according to the delver, he moves on to a new location. All of the equipment currently in use is moved along with the operations. The new location might be in the proximity of his current operation or might be some distance away. This all depends on the delvers access to gravel carrying property.

Larger operators may have various sites on a number of geographical locations. Contrary to large scale underground mining companies the above is necessitated due to the inherent nature of the alluvial gravel and to ensure commercial viability and continuation of the taxpaying entity as a whole.

The capital expenditure program is however managed on a similar basis as that of the smaller operator. On the larger delwery it is common practice to move the plant and equipment between the various sites depending on the needs and production levels of those different sites.

These delwers manage their yellow metal machines, plant and operations as a whole, and not just with a specific site in mind.

The sorting plants erected by the larger operators are commonly centrally located to the various sites to enable all of the sites to sort at a central location. The sorting plants are normally planned in such a manner that they can be disassembled and reassembled at a new location.

Some delwers are of the opinion that they are always prospecting due to the nature of the diamond carrying gravel and the absence of large scale drilling and geological

information on their operations in conjunction with the relative small scale of their operations when compared to underground mining.

The delver is never certain as to how long and at what grade they will be able to extract diamonds on a specific location.

The above approach to capital expenditure appears to be different to conventional mining operations being either open pit or underground mining. In conventional mining, the open pit or underground infrastructure that is required to extract ore carrying material requires significant capital expenditure prior to production commencement. The large capital expenditure is based on extensive geological surveys and drilling to ascertain the commercial viability of extensive capital outlays.

The capital expenditure incurred, to a large extent, is based solely on the specific mine alone. Furthermore, the capital expenditure incurred is with a long lifespan at a single location. In general it would also not be cost effective and safe to extract the underground infrastructure and to utilize it again at a new mining site.

In general, when a conventional mine is closed down a large portion of the capital expenditure is lost.

Therefore it would appear as if there is a significant difference between the nature of the management and incurrence of capital expenditure between conventional mining and alluvial diamond mining (delwery).

2.7 APPLYING SECTION 15 AND 36 TO AN ALLUVIAL DIAMOND MINE

When applying these provisos to the alluvia diamond miner, we initially established whether alluvial diamond mining meets the criteria of mining in terms of the South African Income Tax Act.

Mining operations is defined within the act to “include every method or process by which any mineral is won from the soil or from any substance or constituent thereof.”

Diamonds are regarded as a mineral and falls within the mineral acts of South Africa. The process of liberating diamonds from the earth can therefore be reasonably accepted to fall within the classification of mining operations.

Therefore the alluvial diamond miner should be entitled to the income tax provisos contained in section 15 and 36 of the South African Income Tax Act.

In the past it has been common practise be the SARS to assess the alluvial diamond miners (delwers) as being a single mine. Full capital deductions were allowed in terms of either section 15 or section 36 of the Income Tax Act, without applying the ring-fencing provisos of the Income Tax Act. It can therefore be realistically expected by tax payers in a similar position to be treated in a similar manner. (see for example ITC 1751 (2002) SATC 294 (C))

The most pertinent questions in applying section 15 and section 36 would be the following:

- To what extent is the alluvial diamond mining prospecting in nature?
- When is the alluvial diamond mine established?
- The tax treatment of movable capital expenditure under section 36 and
- Whether ring-fencing should be applied to the alluvial diamond miner based on the nature of its operations.

A basic area is identified by the alluvial diamond miner as having economic potential for diamond carrying gravel. The miner then applies either to DME or to the current mineral rights holder for access rights to both the surface rights holder and the mineral rights holder.

The above may either consist of either a relatively large geographical area or a small area depending on the rights attached to the property. The miner then commits

capital (either new or existing) to the property to perform test operations. In conjunction with the earthmoving equipment, a pan (used for sorting) or sort house is also moved to, or purchased new for the area. In other instances a nearby sort house is utilized to process the gravel.

The above may be seen as prospecting in nature from the traditional mining perspective. The most important question however is when this mine was established and when will it come into commercial production?

In applying these sections it is best illustrated by a detailed example with a step by step application of section 15 and 36 of the South African Act. Our illustration will be based on common practise within the alluvial diamond mining industry.

In applying section 15 and 36 the following assumptions is used:

1. A narrow interpretation of prospecting that prospecting stops when revenue stream come online and that the mine has been established when “site 1” moves to “new site”
2. The assumption that the different sites should be classified as “separate mines” for income tax purposes.

Background facts:

The data contained in the example is not based on true facts. The example only serves to illustrate the effect of section 15 and 36 of the South African Act. The situation set out below is based on various discussions with alluvial diamond miners as to how their operations work.

ABC (Pty) Ltd is an alluvial diamond miner. ABC has two different sites on farms along the Vaal river in the Wolmaranstad area. ABC has no unredeemed capital at the beginning of the year due to exceptional diamond finds in the previous financial year.

Site 1: Site one is nearing the end of life as ABC has delved all over the property. Some of the extraction equipment needs replacement and knowing that he has recently obtained access to a different area, the equipment is replaced with the net purchase price being R 1 500 000. The site is closed during the tax year and the new and used equipment is transferred to the new site.

The taxable profit from the site is R 300 000 up to the day the site closes.

Site 2: Site two was started last year and ABC expects to be on this relatively large property for the next 2 years based on the size of the property. This all depends on whether enough diamonds are found in the area. ABC spends R 1 000 000 on the pans and earth moving equipment to ensure that he maintains his tons of production.

The taxable profit from the site is R 800 000 for the tax year.

New site: ABC spent R 250 000 in performing basic exploration work on the new property. He also bought an excavator to speed up the process of exploration to the value of R 500 000. ABC also utilizes the new pans on site 2 to process the gravel extracted.

For the first 4 months ABC did find gravel but the grade was very low. After site 1 was moved over in month 6 they continued to extract gravel along the river bed in the hope of finding high grade gravel. In month 8 they found high-quality gravel and extracted fine diamonds which was processed through the pans transferred from site 1.

Due to the high grade of diamonds extracted, ABC decides to move some of the new pans that were purchased for site 2 to the new site. The cost price of the pans were R 350 000.

The taxable profit from the site is R 900 000 for the tax year.

Calculation of income tax for ABC (Pty) Ltd

Description	Site 1	Site 2	New Site
Profit before capital expenditure	300 000	800 000	900 000
Less:			
Section 15(b) exploration	0	0	(750 000)
Section 36			
Unredeemed :Opening balance	0	0	0
Plus: Additions in the year	1 500 000	1 000 000	0
Less: Redemption for the year	(300 000)	(800 000)	0
Unredeemed :Closing balance	0	200 000	0
Taxable income	0	0	250 000
Unredeemed capital loss	1 200 000	0	0

2.8 COMMENT ON THE EFFECT OF THE APPLICATION IN 2.7

When evaluating the effect of section 36, in particular on the alluvial diamond miner, it becomes clear that when the legislation was drafted the legislature did not have this type of mining and movement in capital equipment in mind.

Also, due to past practises by the SARS, the application of these sections to the alluvial diamond miner has never been tested in a court of law.

The relief measures contemplated in section 36(7G) in addition does not affect any relief on the alluvial diamond miner, as it is not the new mine which has incurred significant capital costs.

From the above it can be seen that the effect of the ring-fencing provisos results in a very unfair situation for the alluvial diamond miner. Even though he transfers mining equipment from the one site to the other, he is not able to offset the intended capital deduction in his operations due to ring-fencing. Furthermore, even though the

different sites utilize some of the same plant equipment, he is not able to claim the intended capital allowances due to the ring-fencing provisos.

Even more the alluvial diamond miner (due to his way of operations) loses a potential future capital allowance to the value of R 1 200 000, as he is deemed to no longer be in operation on mine 1.

On top of that the alluvial miner's net result is also a taxable income for the current year.

The effect of the above appears to be biased against the alluvial diamond industry when one looks at the original intention of these sections of the act.

2.9 CONCLUSION

In our analysis of the above it is clear that the original intention of the special allowances granted to the mining industry was to incentivise companies involved in these operations to continue to explore, prospect and develop new mines. The incentive was to allow the mining companies to recoup some of their risk and capital outlays through tax relief by enabling tax deductions upfront.

On section 15(b) of the South African Act it is concluded that its application within the alluvial diamond industry might be problematic for some in ascertaining when the line between prospecting and mine establishment has been crossed, due to the inherent nature of the alluvial diamond mining industry.

With regards to the application of section 36 it is concluded that except for the ring-fencing provisos contained in section 36(10) of the South African act, the impact of this section would be universally accepted throughout the mining fraternity as meeting the objectives set out when the legislation was drafted.

With specific regards to section 36(10) which deals with the ring-fencing of the section 36 allowances it is concluded as follow: the legislature had to bring in measures to maintain some form of direct tax base in the mining industry. This is due to the huge amount of capital investment required by mining companies involved in underground and pit operations to explore and develop commercially viable mines. Therefore the ring-fencing proviso has been brought in.

It cannot be reasonably concluded that the intended effects of the legislation was to give effect to the situation as outlined in 2.7 and 2.8 above.

The outlined consequences to the delver is also not fair when considering the original objective of the ring-fencing provisos, being to limit new mines' capital cost deductions to that particular mine, and to prevent that new mines' costs from being offset against the taxable income generated from other mines, operated by the same tax payer, where there has already been a significant contribution by treasury in the way of capital cost deductions.

From the above it would be administratively unfair by the SARS to apply the provisions of section 36(10) to the delver as it would adversely affect the commercial viability and operations of the delver. Specifically as it was past practise by the SARS to assess the alluvial diamond industry taxpayer on the assumption that it is a single mine for purposes of the South African Income Tax Act. The taxpayer may therefore have reasonable expectations to be treated similarly in the future.

The legislature also acknowledged the problems that aroused out of the ring-fencing provisos by including section 36 (7G) in the Income Tax Act. This proviso however only provided limited relief from ring-fencing which does not address the specific shortcomings of the Act when applying it to the alluvial diamond miner.

During our research we did not find any SARS practise note, interpretation note or legal precedents set by the courts to give any guidance in this matter.

To establish whether the above legislation is common practise and to determine whether there are already solutions to the above, further analysis of other countries mining income taxation and relevant case law is required.

For guidance and analyses of the Canadian (chapter 3) and Namibian (chapter 4) Income Tax Acts was done. The overall conclusion is presented in chapter 5.

CHAPTER 3

THE SOUTH AFRICAN INCOME TAX ACT COMPARED TO THE CANADIAN TAX ACT

3.1 INTRODUCTION

The Canadian Income Tax Act was chosen to compare to the South African Income Tax Act as the Canadian Income Tax Act is highly developed and well defined within a first world country. The Canadian Income Tax Act is widely applied to a large number of mining companies that is Canadian based due to the “flow through shares” provisos in the income tax legislation which is income tax beneficial to tax payers based in Canada.

The focus of our study would be the Canadian Federal Income Tax Act and Income Tax Regulations. Each of the provinces/states in Canada has their own set of Income Taxes Acts and Regulations but in general these taxes are aligned with the Federal Income Tax Act.

No comment or analysis on the flow through shares and its related effects on the deductible capital allowances will be done.

The study will be focused on the capital allowances granted by the federal Income Tax Act.

3.2 THE CANADIAN INCOME TAX ACT AND REGULATIONS

3.2.1 Extracts from the Canadian Income Tax Regulations

“PART XI

CAPITAL COST ALLOWANCES

DIVISION I

Deductions Allowed

1100. (1) For the purposes of paragraphs 8(1)(j) and (p) and 20(1)(a) of the Act, the following deductions are allowed in computing a taxpayer's income for each taxation year:

RATES

(a) subject to subsection (2), such amount as he may claim in respect of property of each of the following classes in Schedule II not exceeding in respect of property (xx) of Class 28, 30 per cent, (xxvii) of Class 41, 25 per cent, of the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) of property of the class;

CLASS 28 (short extract replaced by Class 41)

Property situated in Canada that would otherwise be included in another class in this Schedule that

(a) was acquired by the taxpayer

(C) that is machinery or equipment that is a fixed and integral part of a building, structure, plant facility or other property that was under construction by or on behalf of the taxpayer on June 18, 1987, and that

(b) was acquired by the taxpayer principally for the purpose of gaining or producing income from one or more mines operated by the taxpayer and situated in Canada

Class 41

Property

(a) not included in Class 28 that would otherwise be included in that Class if that Class were read without reference to paragraph (a) of that Class, and if subparagraphs (e)(i) to (iii) of that Class were read as follows:

“(i) property that was acquired before the mine came into production and that would, but for this Class, be included in Class 10 because of paragraph (g), (k), (l) or (r) of that Class or would have been so included in that Class if it had been acquired after the 1971 taxation year, and property that would, but for this Class, be included in Class 41 because of subsection 1102(8) or (9),

(ii) property that was acquired before the mine came into production and that would, but for this Class, be included in Class 10 because of paragraph (m) of that Class, or

(iii) property that was acquired after the mine came into production and that would, but for this Class, be included in Class 10 because of paragraph (g), (k), (l) or (r) of that Class, and property that would, but for this Class, be included in Class 41 because of subsection 1102(8) or (9); (a.1) that is the portion, expressed as a percentage determined by reference to capital cost, of property that

(i) would, but for this Class, be included in Class 10 because of paragraph (g), (k) or (l) of that Class, or that is included in this Class because of subsection 1102(8) or

(9), (ii) is not described in paragraph (a) or (a.2), (iii) was acquired by the taxpayer principally for the purpose of gaining or producing income from one or more mines that are operated by the taxpayer and situated in Canada, and that became available for use for the purpose of subsection 13(26) of the Act in a taxation year, and (iv) had not, before it was acquired by the taxpayer, been used for any purpose by any person or partnership with whom the taxpayer was not dealing at arm's length, where that percentage is determined by the formula

$100 \times (([A - (B \times 365 / C)]) / A)$ where is the total of all amounts each of which is the capital cost of a property of the taxpayer that became available for use for the purpose of subsection 13(26) of the Act in the year and that is described in

Sub paragraphs (i) to (iv) in respect of the mine or mines, as the case may be, is 5% of the taxpayer's gross revenue from the mine or mines, as the case may be, for the year, and is the number of days in the year; (a.2) that (i) is property that would, but for this Class, be included in Class 10 because of paragraph (g), (k) or (l) of that Class or that is included in this Class because of subsection 1102(8) or (9), (ii) was acquired by the taxpayer in a taxation year principally for the purpose of gaining or producing income from one or more mines each of which (A) is one or more wells operated by the taxpayer for the extraction of material from a deposit of bituminous sands or oil shales, operated by the taxpayer and situated in Canada, (B) was the subject of a major expansion after March 6, 1996, and (a.3) that is property included in this Class because of subsection 1102(8) or (9), other than property described in paragraph (a) or (a.2) or the portion of property described in paragraph (a.1); (b) that is property, other than property described in subsection 1101(2c), (i) described in paragraph (f.1), (g), (j), (k), (l), (m), (n), (t) or (u) of Class 10 that would be included in that Class if this Schedule were read without reference to this paragraph, or (ii) that is a vessel, including the furniture, fittings, radio communication equipment and other equipment attached thereto, that is designed principally for the purpose of (A) determining the existence, location, extent or quality of accumulations of petroleum, natural gas or mineral resources, or (B) drilling oil or gas wells, and that was acquired by the taxpayer after 1987 other than property that was acquired before 1990 (iii) pursuant to an obligation in writing entered into by the taxpayer before June 18, 1987, (iv) that was under construction by or on behalf of the taxpayer on June 18, 1987, or (v) that is machinery and equipment that is a fixed and integral part of property that was under construction by or on behalf of the taxpayer on June 18, 1987; (c) acquired by the taxpayer after May 8, 1972, to be used directly or indirectly by the taxpayer in Canada primarily in Canadian field processing, where the property would be included in Class 29 if (i) Class 29 were read without reference to subparagraphs (b)(iii) and (v) and paragraph (c) of that Class, (ii) subsection 1104(9) were read without reference to paragraph (k) of that subsection, and (iii) this Schedule were read without reference to this Class, Class 39 and Class 43; or (d) acquired by the taxpayer after December 5, 1996 (otherwise than pursuant to an agreement in writing made before December 6, 1996) to be leased, in the ordinary course of carrying on a business in Canada of

the taxpayer, to a lessee who can reasonably be expected to use, directly or indirectly, the property in Canada primarily in Canadian field processing carried on by the lessee, where the property would be included in Class 29 if (i) Class 29 were read without reference to subparagraphs (b)(iii) and (v) and paragraph (c) of that Class,

ADDITIONAL ALLOWANCES — CLASS 41

(y) such additional amount as the taxpayer may claim in respect of property acquired for the purpose of gaining or producing income from a mine and for which a separate class is prescribed by subsection 1101(4c), not exceeding the lesser of

(i) the taxpayer's income for the year from the mine, before making any deduction under this paragraph, paragraph (x) or (ya), section 65, 66, 66.1, 66.2 or 66.7 of the Act or section 29 of the *Income Tax Application Rules*, and

(ii) the undepreciated capital cost to the taxpayer of property of that class as of the end of a taxation year (computed without reference to subsection (2) and before making any deduction under this paragraph for the taxation year);

(ya) such additional amount as the taxpayer may claim in respect of property acquired for the purpose of gaining or producing income from more than one mine and for which a separate class is prescribed by subsection 1101(4d), not exceeding the lesser of

(i) the taxpayer's income for the year from the mines, before making any deduction under this paragraph, section 65, 66, 66.1, 66.2 or 66.7 of the Act or section 29 of the *Income Tax Application Rules*, and

(ii) the undepreciated capital cost to the taxpayer of property of that class as of the end of the taxation year (computed without reference to subsection (2) and before making any deduction under this paragraph for the taxation year);

ADDITIONAL ALLOWANCES

DIVISION II

Separate Classes {Ring-fencing provisos}

Businesses and Properties

INDUSTRIAL MINERAL MINES

(4) For the purposes of this Part and Schedule V, where a taxpayer has

- (a) more than one industrial mineral mine in respect of which he may claim an allowance under paragraph 1100(1)(g),
- (b) more than one right to remove industrial minerals from an industrial mineral mine in respect of which he may claim an allowance under that paragraph, or
- (c) both such a mine and a right, each such industrial mineral mine and each such right to remove industrial minerals from an industrial mineral mine is hereby prescribed to be a separate class of property.

NEW OR EXPANDED MINES PROPERTIES

(4a) Where more than one property of a taxpayer is described in Class 28 in Schedule II and

- (a) one of the properties was acquired for the purpose of gaining or producing income from only one mine, and
- (b) one of the properties was acquired for the purpose of gaining or producing income from another mine, a separate class is hereby prescribed for the properties that
- (c) were acquired for the purpose of gaining or producing income from each mine;
- (d) would otherwise be included in the class; and
- (e) are not included in a separate class by virtue of subsection (4b).

(4b) Where more than one property of a taxpayer is described in Class 28 in Schedule II and

- (a) one of the properties was acquired for the purpose of gaining or producing income from particular mines, and
- (b) one of the properties was acquired for the purpose of gaining or producing income from only one mine or more than one mine other than any of the particular mines, a separate class is hereby prescribed for the properties that
- (c) were acquired for the purpose of gaining or producing income from the particular mines; and
- (d) would otherwise be included in the class.

(4c) Where one or more properties of a taxpayer are described in paragraph (a), (a.1) or (a.2) of Class 41 in Schedule II and

(a) where all of the properties were acquired for the purpose of gaining or producing income from only one mine, or (b) where

(i) one or more of the properties were acquired for the purpose of gaining or producing income from a particular mine, and

(ii) one or more of the properties were acquired for the purpose of gaining or producing income from another mine, a separate class is hereby prescribed for the properties that

(c) were acquired for the purpose of gaining or producing income from each mine,

(d) would otherwise be included in the class, and

(e) are not included in a separate class by reason of subsection (4d).

(4d) Where more than one property of a taxpayer is described in paragraph (a), (a.1) or (a.2) of Class 41 in Schedule II and

(a) one of the properties was acquired for the purpose of gaining or producing income from particular mines, and

(b) one of the properties was acquired for the purpose of gaining or producing income from only one mine or more than one mine other than any of the particular mines, a separate class is hereby prescribed for the properties that

(c) were acquired for the purpose of gaining or producing income from the particular mines, and

(d) would otherwise be included in the class.”

3.2.2 Extracts from the Canadian Income Tax Act

“Allowance for oil or gas well, mine or timber limit

Section 65.

(1) There may be deducted in computing a taxpayer’s income for a taxation year such amount as an allowance, if any, in respect of

(a) a natural accumulation of petroleum or natural gas, oil or gas well, mineral resource or timber limit, as is allowed to the taxpayer by regulation.

Regulations

(2) For greater certainty it is hereby declared that, in the case of a regulation made under subsection 65(1) allowing to a taxpayer an amount in respect of a natural accumulation of petroleum or natural gas, an oil or gas well or a mineral resource or in respect of the processing of ore,

(a) there may be allowed to the taxpayer by that regulation an amount in respect of any or all

(i) natural accumulations of petroleum or natural gas, oil or gas wells or mineral resources in which the taxpayer has any interest, or

(b) notwithstanding any other provision contained in this Act, the Governor in Council may prescribe the formula by which the amount that may be allowed to the taxpayer by that regulation shall be determined.

Section 66.

(1) A principal-business corporation may deduct, in computing its income for a taxation year, the lesser of

(a) the total of such of its Canadian exploration and development expenses as were incurred by it before the end of the taxation year, to the extent that they were not deductible in computing income for a previous taxation year, and

(b) of that total, an amount equal to its income for the taxation year if no deduction were allowed under this subsection, section 65 or subsection 66.1(2), minus the deductions allowed for the year by sections 112 and 113.

Limitation

(13) Where a taxpayer has incurred an outlay or expense in respect of which a deduction from income is authorized under more than one provision of this section or section 66.1, 66.2 or 66.4, the taxpayer is not entitled to make the deduction under more than one provision but is entitled to select the provision under which to make the deduction.

Amounts deemed deductible under this subdivision

(14) For the purposes of section 3, any amount deductible under the *Income Tax Application Rules* in respect of this subsection shall be deemed to be deductible under this subdivision.

Designation respecting Canadian exploration expense

(14.1) A corporation may designate for a taxation year, by filing a designation in prescribed form with the Minister on or before the day on or before which it is required to file a return of its income for the year under section 150, a particular amount not exceeding the lesser of

- (a) its prescribed Canadian exploration expense for the year, and
 - (b) its cumulative Canadian exploration expense at the end of the year,
- and the particular amount shall be added in computing its cumulative offset account immediately before the end of the year and deducted in computing its cumulative Canadian exploration expense at any time after the end of the year.

Designation respecting cumulative Canadian development expense

(14.2) A corporation may designate for a taxation year, by filing a designation in prescribed form with the Minister on or before the day on or before which it is required to file a return of its income for the year under section 150, a particular amount not exceeding (a) where a deduction has been made under subsection 66.2(2) in computing its income for the year, the lesser of

- (i) 30% of its prescribed Canadian development expense for the year, and
 - (ii) the amount, if any, by which 30% of its cumulative Canadian development expense at the end of the year exceeds the amount, if any, deducted for the year under subsection 66.2(2) in computing its income for the year, or
- (b) where a deduction has not been made under subsection 66.2(2) in computing its income for the year, the lesser of
- (i) 30% of its prescribed Canadian development expense for the year, and
 - (ii) 30% of the amount, if any, of its adjusted cumulative Canadian development expense at the end of the year, and the particular amount shall be added in computing its cumulative offset account immediately before the end of the year and deducted in computing its cumulative Canadian development expense at any time after the end of the year.

Definitions

"Canadian resource property" of a taxpayer means any property of the taxpayer that is

- (ii) prospect, explore, drill or mine for minerals in a mineral resource in Canada,
- (e) any rental or royalty computed by reference to the amount or value of production from a mineral resource in Canada,
- (f) any real property in Canada the principal value of which depends on its mineral resource content (but not including any depreciable property), or

Other definitions

(15.1) The definitions in subsections 66.1(6), 66.2(5), 66.21(1), 66.4(5) and 66.5(2) apply in this section.

Section 66.1

Deduction for certain principal-business corporations

(2) In computing the income for a taxation year of a principal-business corporation (other than a corporation that would not be a principal-business corporation if the definition "principal-business corporation" in subsection 66(15) were read without reference to paragraphs (h) and (i) of that definition), there may be deducted any amount that the corporation claims not exceeding the lesser of

(a) the total of

(i) the amount, if any, by which its cumulative Canadian exploration expense at the end of the year exceeds the amount, if any, designated by it for the year under subsection 66(14.1), and

(ii) the amount, if any, by which

(A) the total determined under subparagraph 66.7(12.1)(a)(i) in respect of the corporation for the year exceeds

(B) the amount that would be determined under subsection 66.1(1) in respect of the corporation for the year, if that subsection were read without reference to paragraph (c) thereof, and

(b) the amount, if any, by which

(i) the amount that would be its income for the year if no deduction (other than a prescribed deduction) were allowed under this subsection or section 65 exceeds

(ii) the total of all amounts each of which is an amount deducted by the corporation under section 112 or 113 in computing its taxable income for the year.

Definitions

(6) In this section,

"Canadian exploration expense" of a taxpayer means any expense incurred after May 6, 1974 that is:

(f) any expense incurred by the taxpayer (other than an expense incurred in drilling or completing an oil or gas well or in building a temporary access road to, or preparing a site in respect of, any such well) for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada including any expense incurred in the course of

(i) prospecting,

(ii) carrying out geological, geophysical or geochemical surveys,

(iii) drilling by rotary, diamond, percussion or other methods, or

(iv) trenching, digging test pits and preliminary sampling,

but not including

(v) any Canadian development expense, or

(vi) any expense that may reasonably be considered to be related to a mine that has come into production in reasonable commercial quantities or to be related to a potential or actual extension thereof,

(g) any expense incurred by the taxpayer after November 16, 1978 for the purpose of bringing a new mine in a mineral resource in Canada into production in reasonable commercial quantities and incurred before the new mine comes into production in such quantities, including an expense for clearing, removing

overburden, stripping, sinking a mine shaft or constructing an adit or other underground entry,

Application of ss. 66(15), 66.2(5) and 66.4(5)

(6.1) The definitions in subsections 66(15), 66.2(5) and 66.4(5) apply to this section.
Section 66.2

Deduction for cumulative Canadian development expenses

(2) A taxpayer may deduct, in computing the taxpayer's income for a taxation year, such amount as the taxpayer may claim not exceeding the total of

(a) the lesser of

(i) the total of

(A) the taxpayer's cumulative Canadian development expense at the end of the year, and

(B) the amount, if any, by which

(I) the total determined under subparagraph 66.7(12.1)(b)(i) in respect of the taxpayer for the year exceeds

(II) the amount that would, but for paragraph 66.2(1)(d), be determined under subsection 66.2(1) in respect of the taxpayer for the year, and

(ii) the amount, if any, by which the amount determined under subparagraph 66.4(2)(a)(ii) exceeds the amount determined under subparagraph 66.4(2)(a)(i),

(b) the lesser of

(i) the amount, if any, by which the amount determined under subparagraph 66.2(2)(a)(i) exceeds the amount determined under subparagraph 66.2(2)(a)(ii), and

(ii) the amount, if any, by which the total of all amounts each of which is (A) an amount included in the taxpayer's income for the year by virtue of a disposition in the year of inventory described in section 66.3 that was a share, any interest therein or right thereto, acquired by the taxpayer under circumstances described in paragraph (g) of the definition "Canadian development expense" in subsection 66.2(5) or paragraph (i) of the definition "Canadian exploration expense" in subsection 66.1(6), or

(B) an amount included by virtue of paragraph 12(1)(e) in computing the taxpayer's income for the year to the extent that it relates to inventory described in clause 66.2(2)(b)(ii)(A)

exceeds

(C) the total of all amounts deducted as a reserve by virtue of paragraph 20(1)(n) in computing the taxpayer's income for the year to the extent that the reserve relates to inventory described in clause 66.2(2)(b)(ii)(A), and

(c) 30% of the amount, if any, by which the amount determined under subparagraph 66.2(2)(b)(i) exceeds the amount determined under subparagraph 66.2(2)(b)(ii).

Definitions

(5) In this section,

"Canadian development expense" of a taxpayer means any cost or expense incurred after May 6, 1974 that is

(d) any expense (other than an amount included in the capital cost of depreciable property) incurred by the taxpayer after 1987

(i) in sinking or excavating a mine shaft, main haulage way or similar underground work designed for continuing use, for a mine in a mineral resource in Canada built or excavated after the mine came into production, or

(ii) in extending any such shaft, haulage way or work,

Application of ss. 66(15), 66.1(6) and 66.4(5)

(5.1) The definitions in subsections 66(15), 66.1(6) and 66.4(5) apply to this section."

3.3 ANALYSIS OF THE CANADIAN INCOME TAX ACT

The capital allowances available for mining companies are separated into 3 sections or classes of capital expenditure namely Canadian exploration expenses (CEE), Canadian development expenses (CDE) and capital cost allowances (CCA).

Each of the allowances results in the creation of a separate pool of assets/allowances that is deductible against taxable income in the current or future tax years. This mechanism for each of the pool assets works similarly to the unredeemed capital balance as set out in the South African Income Tax Act (see chapter 2).

In determining in which pool of allowances the company falls, it is important to establish in what phase the mine is. For purposes of our study we will focus on the first 2 stages of mining, namely the exploration and pre-production phase and the production phase.

CEE allowance is, in general, for pre-production expenditure and CDE allowance for expenditure other than resource-property relates to expenditure subsequent to the mine coming into production. The allowance percentages for CCA depend on whether the mine is already in production or not.

As guideline to differentiate between pre - and post production stages the following definition was used:

As per the PWC Canadian Income Tax Guide 2007, pre-production phase is defined as being the time before the commencement of commercial production.

The Natural Resources department of Canada (NRCAN) has developed a rule of thumb test to determine whether a mine has come into commercial production. Commencement of commercial production is generally the first day of the first 90 day period where the mill/plant operated at a rate of more than 60%. NRCAN however

qualifies that discretion should be exercised if the mill is too small for the mine or where the mine does not have a dedicated mill.

<http://www.nrcan.gc.ca/miningtax/index.htm>)

This analogy was used throughout our analysis of the Canadian Act and Regulations.

We will analyse the workings of the three types of allowance classes separately below:

3.3.1 Canadian exploration expenses (CEE)

The definition of the CEE as set out in section 61(6) of the Canadian Act is very broad. Included in the definition is all exploration and pre-production development expenses including the following:

- Any expense to determine the existence, location, extent or quality of a mineral resource in Canada including – prospecting, geological, geophysical or geochemical surveys, drilling, trenching, digging test pits and preliminary sampling
- Expenses incurred for the purpose of bringing a new mine into production including the following: clearing, removing, overburden, stripping, sinking a mine shaft or constructing an adit or other underground entry

CCE specifically do not include the following:

- Any expenditure classified as Canadian development expense or
- Any expense which can be reasonably related to a mine that has come into production in reasonable commercial quantities or can be related to a potential or actual extension to a mine in production

Based on the above a broad range of capital expenditure may be claimed under CCE prior to the commencement of production on the mine.

The Canadian exploration expenses allowance in terms of section 61 of the Canadian Act is to allow a 100% deduction for capital expenditure incurred for pre-production development and exploration expenditure. The deduction under this allowance is limited to the taxable income of the tax payer.

Until the taxpayer has started to generate income the expenditure incurred the capital expenses are pooled under “*Cumulative Canadian Exploration Expenses*”. The unused portion of the allowance pool can be carried forward to future tax years indefinitely.

3.3.2 Canadian development expenses (CDE)

CDE is defined within section 66(5) of the Canadian Act and includes the following:

- Acquisition costs of Canadian Resource Properties
- The cost of sinking mine shafts, haulage ways or other similar underground infrastructure incurred subsequent to the mine coming into production

Very important for CDE is that it specifically excludes expenditure which falls within depreciating assets which is dealt with as capital cost allowances (CCA). (This pool of deductions is dealt with later in this chapter.)

Practise is that should an asset satisfy both the criteria of CDE and depreciable assets (CCA) that the asset should be treated as part of CCA and not in terms of the CDE.

Similar to the CEE, CDE is pooled as an asset class. Tax payers may claim up to 30% of the CDE per annum of the expenditure incurred. CDE may be claimed irrespective of whether the tax payer is generating income or not. CDE may also create an assessed tax loss and can be carried forward indefinitely.

The Canadian Act also makes provision for the fact that the resource property may be written off for income tax purposes using CDE at a rate of 30% per annum.

Very importantly the tax payer may elect to claim CDE in a particular year or to carry it whole balance forward to future tax years.

3.3.3 Capital Cost Allowances (CCA) depreciable assets

The Capital Cost Allowance (CCA) as defined within the Canadian Act has various different classes of assets which is included in the CCA. The majority of assets utilized in mining operations falls within the ambit of Class 41 assets (*Canadian Income Tax Guide 2007*). We will therefore limit the scope of our study to the application and interpretation of the assets which falls within this class.

Class 41 asset classification includes nearly all tangible assets that are utilized within the mining industry. Similar to the CDE and CEE analysed above the assets which falls within this group of assets is maintained as a separate pool of assets/allowances.

What are Class 41 assets?

Class 41 assets include the following assets as set out in the Canadian Act:

- Electricity generating and distributing equipment that was incurred for use at the mine
- Machinery, equipment and buildings which was acquired for purposes of extracting or processing the diamond gravel
- Processing machinery and equipment acquired for the purpose of generating income from the ore, which is not past the prime metal stage or its equivalent

As can be seen from the above the majority of plant and equipment utilized on an alluvial diamond mine would fall into this class of asset.

The general workings of the CCA:

The CCA costs are pooled into a cumulative capital cost allowance. The unclaimed balance carried forward is known as “undepreciated capital costs”. This balance can be carried forward indefinitely. Therefore the workings are similar to those of the CEE and CDE allowances as discussed above.

Except where there has been major capital expansion on a mine, CCA is apportioned for capital costs incurred during the year by assuming that 50% of the capital costs incurred in the current year can be attributed to the current year. Where major capital expansion has taken place (see “production phase” below) there is no apportionment for CCA.

Capital costs which is claimed under class 41 assets as a CCA is subject to ring-fencing clauses. Our analysis on the ring-fencing is set out in section 3.3.4.

A detailed example of the workings of the CCA will be set out in section 3.3.5.

What allowance is given for Class 41 assets?

There are different allowances given depending on the phase in which the capital expenditure was incurred, being either pre-production phase or within the production phase.

Pre-production phase:

During the pre-production phase depreciable assets which falls within Class 41 is allowed up to a 100% deduction.

The Natural Resources department of Canada (NRCAN) has developed a rule of thumb test to determine whether a mine has come into commercial production, the pre-production phase being defined as the time before the commencement of commercial production.

Commencement of commercial production is generally the first day of the first 90 day period where the mill/plant operated at a rate of more than 60%. NRCAN however

qualifies that discretion should be exercised if the mill is too small for the mine or where the mine does not have a dedicated mill.

Production phase:

Subsequent to the commencement of production the CCA rate is 25% per annum on capital expenditure incurred. In practice these are classes as Class 41(b) assets.

If however the mine has done major capital expansions the capital costs incurred may qualify for accelerated CCA.

Accelerated CCA is allowed where the capital cost incurred exceeds 5 % of the gross mining income from a particular mine. The accelerated CCA then allowed is up to a rate of 100% of the expenditure incurred. When accelerated CCA is allowed, no apportionment is made for current year capital expenditure. The capital expenditure is then classified as Class 41(a) assets.

The prime metal stage as referred to within the Canadian Act is to define up to where the production extraction and processing is classified as mining and where production commences. Prime metal stage is where the mineral extracted is still in its primary form. Therefore it would appear that diamond extraction from the earth and processing via either screens or DMS plants would all fall within the pre-prime metal stage.

Based on the above, CCA would be allowable at a rate of 25% during normal production years and should there be major expansions the capital cost incurred to acquire Class 41 assets would satisfy the criteria to qualify for accelerated CCA.

CCA allowance is only allowed where the assets are available for use. In general available for use is when the asset/property is available for the production of producing income for the tax payer.

3.3.4 Ring-fencing of CCA class 41 allowances

The ring-fencing clauses pertaining to the assets that are classified as Class 41 assets are set out in section 4(d) of the Canadian Income Tax regulations.

Section 4(d) deals exclusively with Class 41 assets, which are depreciable assets.

The section clearly outlines that when property (assets) are acquired for the purpose of producing income from a particular mine and other property (assets) are purchased for the purpose to produce income from a mine other than the particular mine, the assets for the different mines should be classified as separate classes.

The effect of the above is that where a single tax payer has two separate mines, each mine's capital allowances in terms of the class should be computed separately and the capital allowances of one mine cannot be offset against the other mine's taxable income.

This might result in a tax payer having to pay taxes due to the ring-fencing even if his complete operations are in a net loss position.

Separate mines are not defined within either the Canadian Income Tax Act or the Canadian Income Tax Regulations.

As per NRCAN there has been a number of case law which set precedents as to what is classified as a separate mine for the purposes of the Canadian Act.

From the case law the definition of a separate mine has been determined as being:

“A body of ore together with the workings, equipment and machinery capable of producing it.” (http://nrcan.gc.ca/miningtax/inv_2d5.htm). This was confirmed in the judgement of the Canadian Federal Appeals Court **M.N.R. v. Bethlehem Copper Corporation Ltd.**, 74 D.T.C. 6520 (S.C.C.)

From the above definition, when applied to physical mining operations, separate mines are indicated by the following:

- a. Where a tax payer has mining operations which is not adjacent/contiguous to the other mining operation and;
- b. There is a separate body of ore at both of the operations and;
There are sufficient workings, equipment and machinery at each of the operations capable of extracting and processing the ore independently from each of the operations

Then the mines can be classified as separate operations.

3.3.5 Detailed example of the workings of the Canadian capital allowances

The example below is to illustrate the workings of the Canadian capital allowances. The example is not based on true facts.

Taxpayer ABC has alluvial diamond mining operations within Canada. During the tax year ABC was involved in the following mining activities

- Exploration Activities for new diamond fields CAN1 000
- ABC is in the process of commissioning a new plant at a different location where they have spent CAN5 000 on the capital equipment to date
- ABC has another mine which is in commercial production. The income from that mine is CAN10 000. During the year they spent CAN3 000 on new capital property to increase production levels during the year.
- ABC has CAN4000 in Cumulative Canadian Capital Allowances brought forward from the prior year.

For Federal income tax purposes the Income Tax calculation would be as follow:

1. CAN 1000 would be allowed as a deduction under CEE as ABC has taxable income from mining activities. CEE is not subject to ring-fencing provisos.
2. The new plant which is commissioned appears to be from a separate mine as defined within 3.3.4 of this study. Plant used in the processing of gravel falls within Class 41 – depreciable assets. The plant has not come into commercial production and therefore a 100% deduction would be allowed under CCA. CCA which falls within Class 41 assets are subject to the ring-fencing provisos as set out in 3.3.4 and therefore the CCA cannot be offset against the other mining income of ABC. There is no taxable income to deduct the CCA against from this mine. Therefore the CCA incurred would be carried forward as Cumulative Canadian Capital Allowance (CCCA) for future deductions against taxable income.(see 3.3.3)
3. The mine which is in production has incurred capital expenditure of 3000. The capital expenditure falls within the Class 41 assets and is subject to CCA provisos as set out in 3.3.3. The capital expenditure would not be classified as major expansion due to the fact that the 3000 capital expenditure compared to the 10 000 income from the mine represents 3% of mining revenue. To qualify for major expansion this percentage should be 5% or more, of mining income.

The capital expenditure was incurred during the course of the year therefore only 50% of the current year capital expenditure would be added to the CCA.

The CCCA which is available for deduction against taxable mining income is therefore: CAN4000 brought forward from prior year plus $CAN3000 \times 50\% = CAN 1500$. This in total is CAN5500 which is allowed at a rate of 25% per annum. Therefore the CCA allowance would be CAN 1375.

The CCCA carried forward to the following year is then $(4000+3000-1375) = CAN5625$.

4. The taxable income for ABC is then calculated as follow:

Mining income	10 000
Less: CCA (point 3)	(1 375)
Less: CEE (point 1)	(1 000)
Taxable income for the year	7 625

Allowances carried forward:

CCCA (new mine)	5 000
CCCA (current mine)	5 625

3.4 COMPARISON TO THE SOUTH AFRICAN INCOME TAX ACT

Similar to the South African Act the Canadian Act and Regulations acknowledge the fact that mining operations in general are very costly and capital intensive.

The Canadian Act and Regulations contains a lot more specific definitions and criteria than the South African Act which attempts to clarify a number of the sections and definitions of the Canadian Act and Regulations.

Both acts have very specific allowances for the capital costs to ensure that the capital costs are deducted for Income Tax purposes before having to pay tax on the income of the mines. Both acts also separate the pre-production or exploration phase from the production phase of the mining operations. Both acts also contain specific ring-fencing provisos pertaining to capital expenditure incurred in the production phase of the mines.

Both acts make use of carry forward provisos for capital expenditure incurred during the production phase which limits the creation of assessed losses for income tax purposes.

Our detailed comparison of the two acts is set out below:

3.4.1 Exploration, prospecting and pre-production capital expenditure

Both acts allows for a 100% deduction of exploration and prospecting capital expenditure in the pre-production phase. The Canadian Act however limits the write off to mining income generated by the tax payer whereas the South African Act has no income limitations and the allowance may result in an assessed loss.

The Canadian Act specifically includes a broader range of pre-production expenditure and also defines more clearly as to when it can be deemed for the pre-production phase to end. The South African Act has broader scope of inclusion but does not as clearly define the line between the cross over from exploration and prospecting to being in production.

In Canada a “rule of thumb” was devised where a mine is deemed to have come into commercial production on the first day of the first 90 days in which the mill has operated at 60% or more. Based on our study there is no such rule of thumb in South Africa. It could also not be established whether there is any case law setting precedent in this matter, the research indicated that there was none.

From the analysis it would appear however that the tax payer in the different countries should be able to claim the same deductions under these provisos.

3.4.2 Capital expenditure during in production mining operations

When in production, both legislations allowances for capital expenditure are subject to similar ring-fencing provisos. The ring-fencing provisos will be dealt with in section 3.4.3 below.

As the majority of capital expenditure incurred by alluvial diamond miners falls within the CCA (Class 41) definition, our comparison will focus on this section compared to South African legislation.

The general workings of Undepreciated Capital Cost (UCA) and Unredeemed Capital Expenditure (UCE) during production phase:

Both acts allows for the capital expenditure to be grouped under an accumulated balance which can be set off against future mining income. Similarly, these balances can be carried forward indefinitely.

The most significant difference between these is in the computation of the balance and in the amount that can be redeemed against mining income in the current year:

The South African Act allows blanket 100% inclusion into the UCE in year one which is not apportioned in any manner for capital expenditure incurred in the current tax year. In contrast, the Canadian Act apportions current year expenditure by 50% to be included in the current year unless there has been major capital expansion where there is then no capital apportionment.

For redemption or utilization of the UCE the South African Act allows for a 100% redemption limited to the mining income from that mine.

In comparison, the Canadian Act firstly differentiates between the capital expenditure normally incurred and those that was incurred as part of a major capital expansion project. The normal rate of redemption is up to 25% per annum. Where major capital expansion is deemed to have taken place, where the capital expenditure is more than 5% of the gross mining income from the mine, a redemption rate of 100% is allowed.

Neither of the acts allows the redemption of capital expenditure to create an assessed income tax loss.

3.4.3 Ring-fencing

The ring-fencing provisos for both the South African and Canadian Act and regulations are similar in nature. The ring-fencing is based on the same principal that where there are separate mines that is distinct in nature, the deduction of capital expenditure incurred in the production phase should be limited to that particular mine.

It is noted that section 36(10) of the South African Act makes use of the words: separate, distinct and contiguous. Our research showed that there is no available public legal precedent in South Africa on this matter.

These are also the terminology that is used within the Canadian courts: separate and distinct in conjunction with the criteria: “*A body of ore together with the workings, equipment and machinery capable of producing it.*”

(http://nrcan.gc.ca/miningtax/inv_2d5.htm). This was confirmed in the judgement of the Canadian Federal Appeals Court ***M.N.R. v. Bethlehem Copper Corporation Ltd.***, 74 D.T.C. 6520 (S.C.C.)

(<http://www.canlii.org/en/ca/scc/doc/1974/1974canlii193/1974canlii193.pdf>)

The effect of the ring-fencing provisos is the same in both countries.

Canada does however have no relief measures for the ring-fencing provisos compared to section 37(G) of the South African Act.

3.5 CONCLUSION

From the above analysis of the Canadian Act and Regulations it is clear that each type of mine and each mining tax payers' position pertaining to the provisos contained in the act and regulations should be carefully analysed to assess the influence on the tax payer's taxable income. It is also clear that the Canadian Act and Regulations become complex when taking into account the practicalities of a

mining operation. The Canadian Act and Regulations also have legal precedent that guides the tax payer as to the practical effects of the Canadian Act and Regulations, and also clarifies a number of aspects from a Canadian perspective, which are grey areas in the South African context.

Although the provisos contained in the Canadian Act and Regulations is different from the South African Act the overall objectives and effect of these acts appear to be the same.

Both these acts consider the risk and capital commitments involved in the mining process with specific regard to the high value capital outlay that is needed to bring a mine into operation.

Both of these acts also attempt to secure the tax base of the mining companies by implementing ring-fencing provisos that limit the capital allowances to a particular mine within the taxpaying entity.

From our analysis it is furthermore clear that the Canadian Act is also based on large scale underground mining or pits and is not tailored for the unique nature of the alluvial diamond mining taxpayers.

The Canadian Act and Regulations, in conjunction with legal precedent, does however give us certain guidelines which can be applied in a South African context with specific reference to when a mine comes into production and what should be classified as a separate mine.

Our overall conclusion and recommendations is presented in chapter 5.

CHAPTER 4

THE SOUTH AFRICAN TAX ACT COMPARED TO THE NAMIBIAN TAX ACT

4.1 INTRODUCTION

The Namibian Income Tax Act was selected to be compared to the South African Tax Act due to the fact that Namibia also forms part of SADC and competes for similar capital inflows to that of South Africa. Namibia's operating environment is similar to that of South Africa, and is a member of SADC. Correspondence was entered into with Deloitte Namibia to clarify specific tax matters pertaining to the capital allowances granted under Namibian Legislation.

4.2 THE NAMIBIAN INCOME TAX ACT

The following is extracts from the Namibian Income Tax Act 24 of 1981:

“Deductions from income derived from mining operations

18(1) There shall be allowed to be deducted from the income derived by the taxpayer from mining operations

- a. An amount in respect of capital expenditure to be ascertained under the provisions of section 36, in lieu of the allowances in section 17(1)(e),(f),(g) and (i)

Calculation of redemption allowances of capital expenditure in correction with mining operations

36(1) The capital expenditure to be deducted under section 18(1)(a) from income derived during the year of assessment from the working of a mine may consist of either exploration expenditure or development expenditure or both exploration and Development expenditure incurred during the year of assessment in question, subject to subsection (2) and (3)

(2) Where a mine commences with production for the first time in a year of assessment all exploration expenditure incurred before such a year of assessment shall for the purposes of subsection (1) be deemed to have been incurred in that year of assessment.

(3) The amount of any developmental expenditure incurred during a year of assessment shall not be fully deductible in the same year of assessment, but shall be deducted, on-third in the year of assessment in which such expenditure is incurred, one-third in the first ensuing year of assessment and one-third in the second ensuing year of assessment: provided that where a mine commences with production for the first time in a year of assessment all development expenditure incurred before such a year of assessment shall for the purposes of this subsection be deemed to have been incurred in that year of assessment.

(4) For the purposes of this section

“development expenditure” means expenditure actually incurred, whether directly or indirectly, in or in connection with the carrying out or development operations in any area in Namibia, including expenditure incurred in respect of –

- (a) the acquisition of motor vehicles, machinery, implements, utensils and other articles used for the purposes of such operations, including pipes, units for purposes of production, treatment and processing, wellhead equipment, subsurface equipment, enhances recovery systems, onshore and offshore drilling;
- (b) the acquisition of furniture, tools and equipment used in offices and accommodation, referred to in paragraph (c) of the definition of “development operations” and in warehouses, export terminals, harbours, piers, marine

vessels, vehicles, motorised rolling equipment, aircraft, fire and security stations, water and sewage plants and power plants;

- (c) labour, fuel, haulage, supplies, materials and repairs in connection with development operations;
- (d) charges, fees or rent for, or in respect of, land or buildings occupied for the purposes of carrying out development operations;
- (e) the general administration and management directly connected with the development operations;

“development operations” means operations carried out for or in connection with the development of a mine and includes –

- (a) the sinking of shafts;
- (b) the installation of machinery, implements, utensils and other articles required for the purposes of mining operations;
- (c) the construction and erection of
- (d) facilities for production, storage, gathering and conveyance of minerals;
- (e) offices and residential accommodation for the use by persons employed in or in connection with mining operations, or facilities for purposes of health, education and recreation;
- (f) the construction of roads in or to the area where mining operations are or will be carried out;

“exploration expenditure”, means expenditure actually incurred, whether directly or indirectly, in or in connection with the carrying out of exploration operations in any area in Namibia, including expenditure actually incurred in respect of –

- (a) the acquisition of motor vehicles, machinery, implements, utensils and other articles used for the purposes of such operations, including pipes, units for purposes of production, treatment and processing, wellhead equipment and subsurface and drilling equipment;
- (b) labour, fuel, haulage, supplies, materials and repairs in connection with exploration operations;
- (c) charges, fees or rent for, or in respect of, land or buildings occupied for the purposes of carrying out development operations;

- (d) the general administration and management directly connected with the exploration operations

“exploration operations” means any operations carried out for or in connection with the exploration for minerals, and includes –

- (a) geological, geophysical, geochemical, paleontological, aerial, magnetic, gravity or seismic surveys,
- (b) the study of the feasibility of any mining operation or development operations to be carried out or of the environmental impact of such operations.”

4.3 ANALYSIS OF THE NAMIBIAN INCOME TAX ACT

4.3.1 Mining exploration activities

The section 36 of the Namibian Income Tax Act allows for the following deductions for mining exploration:

a.) Existing mining companies:

A 100% deduction, for taxation without any apportionment for all exploration activities in the tax year in which it is incurred. This deduction may create an assessed loss which is carried forward to the following tax year.

b.) Newly formed mining companies:

Mining exploration expenditure prior to production is carried forward to the year in which production commences. A 100% deduction of all the cumulative exploration expenditure in the year in which production commences is allowed in full. This deduction may create an assessed loss.

4.3.2 Mining development expenditure

The mining development expenditure and operations deductions are defined within section 36 and includes a broad spectrum of capital expenses which falls within the ambit of this section including, capital machinery, production facilities and administrative buildings.

Prior to the commencement of production all of the mining development expenditure is accumulated. In the first year of production all of the accumulated mining development expenditure is allowed as a deduction in full. This deduction may result in an assessed loss.

The development expenditure which is incurred in the year in which production commences, in conjunction with the years following this year is allowable over a three (3) year write off period. Again, these expenses are not apportioned in the year in which the expense is incurred. All of the above deductions may result in an assessed loss.

There are no guidelines as to when exploration ends and development begins, except that the mine is in production when development expenditure can be claimed.

4.3.3 Ring-fencing

As per our analysis of the Namibian Income Tax Act there are no references to any type of ring-fencing pertaining to either the mining exploration expenditure or to the mining development expenditure.

The fact that there is no ring-fencing applicable to these expenses was concurred in the Deloitte Namibian Income Tax Guide.

4.4 COMPARISON TO THE SOUTH AFRICAN INCOME TAX ACT

Both the South African and Namibian Act acknowledges the large initial capital costs that need to be undertaken in order to produce taxable income from mining operations.

Both acts make provision for exploration and pre-production expenditure. Once in production however the South African Act allows for a more generous 100% deduction compared to the 3 year write off from a Namibian perspective. The above however is offset with the South African Act containing ring-fencing provisos whereas Namibia does not have any.

Our detailed comparison is set out below:

4.4.1 Exploration, prospecting and pre-production capital expenditure

Exploration activities, dealt with in section 15 of the South African Income Tax Act as prospecting activities, are not defined within this particular act, and therefore a general interpretation of the expenditure that may be claimed under this section is applicable to the expenditure incurred. Contrary thereto exploration activities and the applicable expenditure that is deemed to fall within this category is well defined and set out within the Namibian Income Tax Act.

For diamond mining the impact of the sections would be similar in nature. Both acts allow for a 100% deduction of the expenditure that is incurred prior to production. In both acts the deduction of the exploration/prospecting expenditure may result in an assessed loss.

Subsequent to the start of production, section 15 of the South African Income Tax Act still retains its 100% deduction of prospecting activities whereas the Namibian Act now only allows for a write off over a three year period.

4.4.2 Capital expenditure during in production mining operations

The major differences between the capital allowances granted by the Namibian Act compared to the South African Act are firstly that the Namibian allowance may result in an assessed loss, whereas the South African allowance is limited to the amount of mining income and which is more than the mining income is carried forward to the following year as unredeemed capital expenses.

Secondly the South African Act allows for a 100% deduction of expenditure incurred whether it is prior or subsequent to the start of production. Here the Namibian Act allows for 100% deduction up to the year in which production commences.

Subsequent to the commencement of mining operations this changes to a 3 year straight line write off.

4.4.3 Ring-fencing

Contrary to the South African Act the Namibian Act makes no provision for any form of ring-fencing of the capital expenditure that is allowed as a deduction.

4.5 CONCLUSION

From our analysis we conclude that in principle both acts acknowledge the fact that mining operations have large initial capital outlays that is recouped through revenue over an extended period of time. This is compensated for in the 100% write off that is allowed for the expenditure that is incurred for prospecting and establishment of mine. Both of the allowances may create an assessed loss.

Subsequent to the commencement of operations, the Namibian legislation allows for a 3 year straight line write off of the capital expenditure without any apportionment. The write off may create an assessed loss. The legislation also does not distinguish

between different mines owned by the tax payer as there are no provisions for ring-fencing.

In contrast, the South African Act allows for the retention of the 100% write off of capital expenditure limited to the taxable mining income per mine.

The Namibian Act therefore has less capital allowances for a mine that is in operation but there are no ring-fencing provisos. The Namibian Act therefore does not present the same challenges to the alluvial diamond miner as the South African Act does, with specific reference to the ring-fencing provisos.

It is concluded that even with ring-fencing provisos the South African Income Tax Act is in general more favourable to mining entities than the Namibian Income Tax legislation.

The Namibian legislation which excludes ring-fencing provisos is not in line with other SADC countries which in general have ring-fencing provisos.

CHAPTER 5

CONCLUSION

5.1 INTRODUCTION

Capital cost allowances for mining taxation globally give recognition to the fact that mining operations requires large scale upfront capital costs to enable the generation of future taxable income.

Each country tailors their mining legislation according to their domestic requirements and includes best practises from other selected countries.

The South African Act is in line with the Income Tax Acts of the countries that was included in our analysis. Canada also has ring-fencing provisos in their Income Tax Act with some of the key elements of their proviso that have been tested in court and legal precedents that have been set.

From a South African perspective a lack of case law, SARS practise -, or interpretation notes that could clarify the application of terminology and definitions or SARS assessment practise with regards to section 15 and 36 was found.

Due to the above one could only rely on experience, logical thinking and current legislation to complete the study.

5.2 ANALYSIS

The relevant sections of the Income Tax Acts of South Africa, Canada and Namibia, each in their respective chapters were analysed.

The South African Act, with specific reference to sections 15 and 36, was analysed in detail in chapter two. In chapter three the Canadian Income Tax Act and Regulations were analysed in detail. A comparison between the effects of the Canadian Act and Regulations and the South African Act was completed. A detailed analysis on the Income Tax Act of a SADC country – Namibia - was conducted in chapter four. The analysis of the Namibian Act included a comparison to the South African Act.

In these chapters the objectives of the study were reached in that:

- a. The South African Income Tax Act sections 15 and 36 was analysed and discussed in detail;
- b. The application of the South African Act to the alluvial diamond miner was discussed and analysed;
- c. Key areas which give rise to uncertainty and potential disputes between the SARS and the alluvial diamond miner were identified;
- d. Areas which requires legislative or administrative attention were identified
- e. The Canadian Income Tax Act and Regulations in conjunction with relative case law was analysed and compared to the South African Act
- f. The Namibian Income Tax Act was analysed and compared to the South African Act

5.3 CONCLUSION AND RECOMMENDATIONS

Section 15 and 36 of the South African Income Tax Act was drafted to ensure that recognition is given to the large upfront capital investments that are needed in the mining industry. Section 36(10) which contained proviso commonly referred to as ring-fencing provisos was included to maintain the fiscus's mining tax base in a reasonable manner.

In the past it was common assessment practise by SARS, that alluvial diamond miners or delwers' operations should be assessed as a single mine. There is however a review of the application of these sections with specific reference to their application to a delwer.

This necessitated the need to review the implication of the direct application of these sections to the delwer, given their unique operating nature and associated capital spends.

It was found that in there is a lack of definitions of terminology used in sections 15 and 36 of the South African Act compared to the Canadian act. There is also no SARS practise or interpretation notes on the capital allowances for mining companies. This may result in disputes in interpretation between the SARS and the tax payer.

From the analysis we found that the sections in the South African Act dealing with capital allowances for mining in general is in line with the legislation and tax practises of Canada. The same applies to the Namibian Act except that the Namibian Act does not provide for the ring-fencing. This is however offset with lower initial capital allowances than the South African and Canadian Acts.

Except for the ring-fencing proviso contained in section 36(10) the remainder of section 15 and 36, when reasonably applied, results in the same tax position for the alluvial diamond miner as other mining companies.

Should the current legislation be enforced and the different sites classified as separate mines, the ring-fencing proviso will result in unintended and unfair consequences for the miner based on the normal mining activities conducted.

Based on the conclusion the following recommendations are made:

For the alluvial diamond miner:

It is recommended that the alluvial diamond miner takes cognisance of the fact that currently there are no specific exclusions for the alluvial diamond miner from any of the sections or provisos of the South African Act. It is also recommended that the tax payer takes notice of the apparent change in assessment policy, in this regard by the SARS. It is also recommended to pro-actively in consultation with their tax advisors to do income tax assessment and planning on the capital expenditure program to, where possible, minimise the potential negative effects of section 36(10) of the Income Tax Act.

For the SARS and the legislature:

Based on our findings it is recommended that the SARS and the South African legislature evaluate whether the current income tax regime and related practises provides the alluvial diamond miners with reasonable and fair treatment for Income tax purposes with specific reference to sections 15 and 36 of the South African Act and their intended effects.

It is recommended that the SARS consult with the alluvial diamond industry to gain a better understanding of the operations and the potential impact of current legislation, if enforced on the individual diamond miner, and the industry as a whole.

Subsequent to which we recommend that the SARS issue a practise note in this regard to provide clear and guidelines as to their current assessment practises with specific regards to the definitions of prospecting, mine establishment and what constitutes a separate mine. This practise note should also specifically deal with the unique nature of the alluvial diamond industry.

It is also recommended that the legislature review the current definitions of the Income Tax Act pertaining to sections 15 and 36 as there are shortcomings in these definitions when comparing it to comparative Canadian legislation

Further recommendation is that both the SARS and the legislature need to evaluate the application of the ring-fencing provisos to the alluvial diamond industry and the associated potential cost to the South African economy as a whole through the potential collapse of an industry.

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7. ABBREVIATIONS USED

Canadian Act and Regulations: Canadian Tax Act in conjunction with Canadian Tax Regulations

Canadian Tax Act: The Canadian Income Tax Act

Canadian Tax Regulations: The Canadian Income Tax Regulations

CCA: Capital Cost Allowances as per the Canadian Act and Regulations

CCCA: Cumulative capital cost allowances as per the Canadian Act and Regulations

CDE: Canadian development expenses

CEE: Canadian exploration expenses

Delwer: Alluvial diamond miner

DME: Department of minerals and energy – South Africa

Miner: Alluvial diamond miner (delwer)

Namibian Tax Act: The Namibian Income Tax Act 24 of 1981

NRCAN: National Resources Department of Canada

PWC: Pricewaterhouse Coopers

SADC: Southern African Developing Countries

SARS: The South African Revenue Service

South African Act: South African Income Tax Act 58 of 1962