The tax treatment of interest incurred by mining companies to finance mining capital expenditure.

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ABSTRACT

This dissertation examines the tax treatment of interest incurred in financing mining capital expenditure. The capital expenditure under consideration is shaft-sinking and mining equipment. The reason for concern as regards this form of capital expenditure lies in the provisions of section 36(11)(*a*) of the Income Tax Act 58 of 1962 ('the Act'). This provision counteracts section 15(*a*) read with sections 36(7E) and 36(7F) promulgated to encourage investment in mining through the immediate redemption of capital expenditure. Although mining companies generally finance shaft sinking and the acquisition of mining equipment, interest or finance charges are not capital expenditure for the purposes of section 36 of the Act.

The study finds that on the basis of the exclusion referred to above, interest or finance charges cannot be deducted in terms of section 15(*a*) of the Act, against income earned from mining operations. The study, however, finds that section 11(*a*) or section 24J of the Act, can be relied on to deduct interest incurred to finance shaft-sinking and mine equipment. In order to rely on section 11(*a*), the interest or finance charges must have been incurred, but not however necessarily, by a person conducting trade for the production of income. It must further not be capital in nature. In contrast, section 24J(2), requires a person who is conducting trade to have incurred the interest in the production of income – there is no requirement that it must not be of a capital nature. Section 24JA works hand-in-hand with section 24J in that any amount deemed as interest in terms of a diminishing *musharaka* or *murabaha* arrangement, can be deducted against income under section 24J(2).

The study recommends that section 36(11)(*a*) be amended by including interest or finance as capital expenditure. If this is done mining operators will no longer have to use sections 11(*a*) or 24J – provisions which fall outside of the mining tax regime – to claim a deduction. Amending section 36(11) would ensure that interest or finance charges are fully deductible against mining income because a deduction under section 11(*a*) or 24J(2) depends on the quantum of non-mining income. The study concludes that this recommendation is unlikely to be considered as the 2016 Davis Tax Committee Report on Hard Rock Mining recommended to the Minister of Finance that the entire mining tax regime be scrapped and that the taxation of mining be aligned with the tax regime for manufacturing.

CHAPTER 1

INTRODUCTION

1. Introduction

South Africa is endowed with vast natural resources such as gold, coal, platinum, manganese and iron ore. As a result of these vast deposits, the South African economy has developed around mining and for many years mining has formed the backbone of the South African economy.[1]

The legislature has enacted special provisions ('the provisions') in the Income Tax Act 58 of 1962 ('the Act') for the taxation of mining companies. "For many decades the income tax dispensation for miners (as well as farmers) has been different from that governing other businesses. Miners are given privileged treatment in order, we are told, to encourage investment."[2] The provisions that afford the privilege are found in section 15*(a)* read with section 36(7C), section 36(7E), and section 36(7F) of the Act.

Section 15*(a)* is the enabling provision which permits deductions of amounts, determined under section 36, from income derived from mining operations. Section 36(7C) identifies the type of expenditure to be deducted in terms of section 15*(a)* as capital expenditure incurred. The determination of this capital expenditure is provided for in sections 36(7E) and 36(7F). To limit the erosion of the tax base within mining resulting from abuse of the provisions, limits to the deductions have been set to ensure that the capital expenditure is deducted against mining income, and more importantly, income from the very same mine for which the expenditure has been incurred.[3]

Not all expenditure incurred by a mining company is deductible. The Act in sections 36(11)*(a)* to *(f)* defines, with qualifications and exclusions, what constitutes capital expenditure. Although investing in mining requires substantial funds, whether borrowed or contributed as equity to be used up-front to meet capital expenditure, the deduction of the capital expenditure incurred will depend on whether it is capital expenditure as contemplated in section 36(11)*(a)* to *(f)*.

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[1] Davis Hard Rock Report para 3.

[2] *Benhaus Mining v CSARS* [2019] ZA SCA 17 para 3.

[3] *Benhaus Mining v CSARS* [2019] ZA SCA 17 para 5.

Interest or finance charges incurred in financing expenditure connected with shaft sinking and mining equipment are specifically excluded from the definition of capital expenditure in section 36(11). This means that the interest and finance charges incurred by mining companies on large sums of funds borrowed to facilitate shaft sinking and to acquire mining equipment, do not qualify for a deduction under section 15*(a)*.

That said, no similar prohibition exists in respect of interest incurred in connection with financing other types of capital expenditure contemplated in section 36(11). Accordingly, it appears that such interest or finance charges may be deducted under section 15*(a)*.

Having regard to the purpose of the provisions as, in the main, to allow the up-front deduction of capital expenditure, it is concerning that interest and finance charges connected with shaft sinking and mining equipment cannot be deducted as part of capital expenditure in terms of section 15*(a)*. In the light of this position, the issue, as set out below in the problem statement and objective of the study, is whether this interest can be deducted at all by taxpayers, and if so, under which provisions of the Act and under what circumstances.

1.1 Problem Statement and Objective of the Study

In mining tax there are no decided cases on whether it is permissible to deduct interest and finance charges relating to capital for shaft sinking and mining equipment in terms of section 15*(a)* read with sections 36(7C), 36(7E) and 36(7F) of the Act.

The case of *ARM Gold / Harmony Freegold Joint Venture (Pty) Ltd* v *Commissioner, South African Revenue Service ('Harmony case')*[4] settled only the question of the determination of capital expenditure in terms of sections 36(7E) and 36(7F), excluding shaft sinking and mining equipment interest, deductible in terms of section 15*(a)*.

There is considerable capital outflow during the development stage in the life of a mine, and to the extent that debt is used to finance shaft sinking and the acquisition of equipment, there may be taxpayers who are incorrectly deducting the interest incurred against income. For this reason, it will not be long before South African Revenue Service

[4] 2013 (1) SA 353 (SCA).

('the SARS') discovers these impermissible deductions by taxpayers and disputes will then ensue.

The objective of the study is to determine how interest and finance charges relating to shaft sinking and mining equipment can be deducted from income, just as other capital expenditure contemplated in section 36(11) is deducted from mining income.

1.2 Research questions

The study addresses the following research questions:

1.2.1 Primary question

**The applicability of section 15(a) read with section 36(7E) and 36(7F) to interest or finance charges incurred in financing shaft sinking and mine equipment*

Section 36(11)*(b)* to *(f)* set out types of capital expenditure without excluding interest or finance charges. Interest and finance charges connected with shaft sinking and mining equipment are therefore excluded for deduction in terms of section 15*(a)*. Put differently, the exclusion of interest or finance charges in section 36(11)*(a)* cannot be applied as a blanket exclusion to all forms of capital expenditure set out in section 36(11)*(b)* to *(f)*.

The manner in which the definition of capital expenditure is arranged makes it patently clear that the exclusion only applies to the expenditure contemplated in section 36(11)*(a)* and not to expenditure contemplated in section 36(11)*(b)* to *(f)*. Therefore, in practice, taxpayers should not deduct interest or finance charges relating to shaft sinking and mining equipment.

From the above it appears that, in law, there is a difference between the treatment of interest incurred in relation to funding shaft sinking and mining equipment on the one hand, and, on the other hand, interest involving other forms of capital expenditure.

1.2.2 Secondary question

**How, if not in terms of section 15(a), can interest and finance charges relating to shaft sinking and mining equipment be deducted from income?*

In considering the secondary question, the study analyses provisions of the Act which allow taxpayers a deduction of expenditure, including interest, from the income of a person derived from carrying on any trade. There is a requirement, for example in section 11*(a)* of the Act, that the expenditure and losses actually incurred must have been incurred in the production of income and must not be of a capital nature.

Section 11*(a)* of the Act permits the deduction of money expended and/or lost by a person who generates income from undertaking business activities. However, this deduction is only permitted if the money expended or lost is revenue in nature. For the purpose of determining whether expenditure was incurred in the production of income, Streicher JA stated, "in order to determine whether expenditure has been incurred in the production of income important, sometimes overriding, factors are the purpose of the expenditure and what the expenditure actually affects".[5] Interest incurred in funding the acquisition or creation of a capital asset such as a shaft or mining equipment, would not ordinarily qualify as a deduction to reduce the taxable income of a mining company under section 11*(a)* of the Act. The study will show – through circumstances which have arisen in case law and how these have been addressed – where interest is seen to be incurred in the production of income and revenue.

As in mining operations expenditure and interest are generally incurred before the mine produces ore and income, the provisions of section 11A of the Act are discussed and applied as part of the answer to the secondary question. Section 11A of the Act provides for the deduction of pre-trade expenditure and losses provided the requirements in section 11A(1)(*a*) to (*c*) have been met.

In contrast to section 11*(a)* of the Act, section 24(J)(*2*) provides a benefit by recognising the interest paid as a result of money borrowed during a particular tax period. The person who borrows money and is contractually obliged to repay the funds and interest incurred on the borrowed funds, is termed an 'issuer'. The interest recognised is be an amount

(a) equal to the interest calculated to be due and owing for the interest period on the borrowed funds; or

[5] *CSARS v BP South Africa (Pty) Ltd* [2006] SCA 60 (RSA) para 6.

(b) equal to an amount determined in terms of the alternative method as set out in section 24(J)(*2*).

The amounts determined in terms of (*a*) or (*b*) above are permitted to be deducted from income generated through business activities if they were used to generate income. The operative word in section 24(J)(*2*) is 'instrument'. Instrument means the agreement providing for the provision of the loan, levying of interest, and the repayment of the loan by the issuer.

The provisions of section 24(J)(*2*) can be used to structure an interest-bearing arrangement for funding capital expenditure connected to shaft sinking and mining equipment. The taxpayer would, in terms of section 24(J), issue an instrument that satisfies the requirement of deducting interest incurred thereon. Unlike section 11*(a)* of the Act, which requires that expenditure should not be capital in nature, the section 24(J)(*2*) requirement is limited to the expenditure incurred in the production of income.

Section 24(J) does not only deal with the timing of interest, 24J(*2*) is a provision used for deducting interest incurred in funding capital expenditure connected with shaft sinking and mining equipment. If a person conducting mining operations subscribes to the principles of Islam, for the purposes of financing, the provisions of section 24JA read with section 24J are available for the financing of shaft sinking and mining equipment. Sharia-compliant financing arrangements relevant to financing shaft sinking and mining equipment are *diminishing musharaka* and *murabaha*. The study discusses the characteristics of these two arrangements and how the amounts paid to the bank and deemed to be interest, can be deducted under section 24J(*2*).

1.3 Literature review

How to deduct capital expenditure under section 15*(a)* read with sections 36(*7E*) and 36(*7F*) of the Act has long been a point of contention between the SARS and mining companies. This is evidenced by the number of tax cases dealing with the application of sections 36(*7E*) and 36(*7F*) litigated from the Tax Court up to and adjudicated in the Supreme Court of Appeal.

In addition, prominent cases, amongst others, and literature such as articles, tax commission reports, books, and SARS directives on redemption of capital expenditure, sections 11(*a*), 11A, 24J, and 24JA are considered.

1.4 Research methodology

Research for the study is based on existing literature consisting of books, journals, cases, SARS directives, and legislation.

Sources such as journal articles, books, and SARS directives are analysed. Having analysed the literature, the study contributes to the extant body of knowledge by suggesting an appropriate tax structure for securing a deduction of the interest incurred in financing expenditure relating to shaft sinking and mining equipment.

1.5 Chapter outline

Chapter 1: Introduction

This chapter deals with the introduction, problem statement, and objective of the study. It sets out the research questions, the research methodology followed, and literature consulted.

Chapter 2: Tax framework for treatment of mining capital expenditure

Here I address the primary question. The chapter sets out and discusses the provisions of the Act relevant to treatment of mining capital expenditure. It evaluates whether interest incurred in financing shaft sinking and mine equipment constitutes capital expenditure deductible under section 15*(a)*. The mining capital expenditure redemption provisions of the Botswana Income Tax Act ('the BITA')[6] are discussed and compared with the provisions of section 36(7E) and 36(7F) of the Act.

Chapter 3: The application of general deduction formulae: Sections 11*(a)*, 11A, 24J and 24JA

This chapter addresses the secondary question. It sets out and discusses the provisions of the Act, other than section 15*(a)*, which apply to the treatment of interest incurred in financing shaft sinking and mining equipment. These provisions are sections 11(*a*), 11A, 24J and 24JA. The chapter states the requirements for each of the sections and shows how they would apply to the deduction of interest incurred in financing shaft sinking and mining equipment.

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6 CAP 52-01.

This chapter also evaluates decided cases on the interpretation of fiscal legislation, and applies the principles extrapolated to interpret sections 11(*a*), 11A, 24J and 24JA. Additionally, the provisions of section 39(2) of the BITA are compared with the provisions of section 11(*a*).

To test the interpretation and views expressed regarding sections 11(*a*), 11A, 24J and 24JA, the principles governing the interpretation of legislation drawn from *Natal Joint Municipal Fund v Endumeni Municipality*[7] are discussed and applied.

Chapter 4: Conclusion and recommendations

This chapter sets out the conclusions drawn from the study and thereafter recommendations for the deduction of interest incurred in financing shaft sinking and mining equipment are made.

The study contributes to the existing body of knowledge of mining tax law. As mentioned in the introduction, there are no decided cases dealing with whether or not capital expenditure interest may be deducted in terms of section 15*(a)* read with section 36(7E) or 36(7F) of the Act. This has created the need for the research undertaken in this study.

[7] [2012] ZA SCA 13 (15 May 2012).

CHAPTER 2

TAX FRAMEWORK FOR TREATMENT OF MINING CAPITAL EXPENDITURE

2.1 Introduction

This chapter sets out, discusses, and analyses the provisions of the Act, and case law, dealing specifically with the taxation of mining companies. It explains what constitutes mining, what mining capital expenditure is in relation to mining, and the circumstances under which capital expenditure may be deducted from the income of a mine(s) under section 15*(a)* of the Act.

2.2 Mining Capital Expenditure

The genesis of the tax framework for the treatment of mining capital expenditure is found in section 15*(a)* of the Act. It provides:

> "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 section 11(*e*)."

Section 15*(a)* is the provision enabling the deduction of capital expenditure, whereas section 36 contains provisions used to establish the quantum of the capital expenditure deductible. Two requirements must be met before an amount established in terms of section 36 may be deducted. First, the income against which the deduction is made must be mining income. This means it must have been derived by the taxpayer from mining operations. Second, the taxpayer's operations that produce the income must qualify as mining operations.

To better understand the capital expenditure regime, an understanding of what constitutes mining operations and the meaning of capital expenditure are essential.

2.3 What are Mining Operations?

Section 1 of the Act defines 'mining operations' or 'mining' to include every method or process by which any mineral is won from the soil or from any substance or constituent thereof. This definition does not require that the person conducting the mining operations or mining must hold a mining right as contemplated in section 23 of the Minerals and Petroleum Resources Development Act ('the MPRDA').[8]

Commenting on the definition of mining operations with regard to mining income, Friedman JP states that:

> "*[P]rima facie,* income derived from mining operations means income derived from the process by which minerals are extracted from the soil. But that was too narrow a construction, he stated, properly construed, in the context of the Act and the schedule, the phrase income from mining operations means income derived from the business of extracting minerals from the soil."[9]

The view of the court quoted makes it clear that a person involved in the business of extracting minerals from the soil is conducting mining operations – mining income is received or accrues from mining operations. Section 98*(a)* of the MPRDA makes mining without a licence[10] a criminal offence punishable by a fine not exceeding R100 000 or imprisonment for a period not exceeding two years, or both. It must be noted, however, that in the case of contract mining, the contract miner is not mining illegally but is mining on behalf of the right holder, usually in terms of a mining contract agreement. For purposes of income tax, a person who conducts mining or mining operations, whether with or without a licence, is entitled to make use of the provisions of section 15*(a)* read with section 36. This has, however, not been without controvesy between the SARS and taxpayers.

In a case recently decided by the Supreme Court of Appeal – *Benhaus Mining* v *CSARS*[11] – the issue was whether Benhaus had earned income from mining operations between 2005 and 2009 as the basis for capital expenditure deductions in terms of section 15*(a)* read with section 37(7C) of the Act.[12] Benhaus was engaged in the business of contract mining in terms of which it had to extract mineral ore for the client in return for a fee calculated at a rate per ton.[13]

In its tax returns for the 2005 to 2009 years of assessment, Benhaus claimed deductions in each year of assessment in terms of section 15*(a)* of the Act. These deductions

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8 28 of 2002.

9 *CIR v BP Southern Africa (Pty) Ltd* 1997 (1) SA 375 (C), 59 SATC 97.

10 Section 5(4)(*a*) of the MPRDA provides that no person may mine or commence with any work incidental thereto on any area without a mining right.

11 *Benhaus Mining v CSARS* (165/2018) [2019] ZA SCA 17 (22 March 2019) (hereafter *Benhaus*).

12 *Benhaus* para 1.

13 *Benhaus* para 12.

were amounts determined under section 36 expended on the equipment used in extracting the mineral-bearing ore. The SARS did not accept this practice and issued additional assessments. It asserted that Benhaus was not conducting mining operations or mining, in that it did not itself process the extracted ore or trade in it.[14]

The court held,

> "that mining operations commenced when Benhaus moved on to site and starts the preparation for digging the mineral bearing ore out of the earth. It matters not that a fee is paid for delivering the ore to a client instead of deriving income from the sale of minerals, it is conducting mining operations and it is entitled to the benefits conferred by section 15*(a)* and section 37(7C)."[15]

The court reasoned that the clear meaning of *mining*, as defined in section 1 of the Act, must be given effect. Within the meaning of *mining* as defined, the court correctly found that Benhaus's extraction of the ore from the ground amounted to mining.

The court correctly applied the definition of mining strictly. It therefore followed that the money expended on the mining equipment was capital expenditure and had to be deducted in terms of section 15*(a)*. There is no requirement in the Act that a person must be in possession of a mining licence to conduct mining. Income derived illegally is also subject to tax. If a mining licence was a requirement, the deductions permitted under section 15*(a)* would be withheld but the income would still be taxed. It does not follow that a mining licence automatically entitles a person to a deduction in terms of section 15*(a)*, as the person must be conducting mining operations to qualify.

Within the context of the definition of mining or mining operations read with sections 15*(a)*, 36(7E) and 36(7F), for tax purposes prospecting does not amount to mining operations. Mining commences only when a mine produces income from which capital expenditure can be deducted. Had the legislature intended to include prospecting in the definition of mining, it would have included the words 'searching for minerals' and not have been limited to any method of extracting minerals.

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14 *Benhaus* para 12.
15 *Benhaus* para 41.

Comparatively, in South Africa's neighbour, Botswana, mining operations are mining operations carried on by any person on a mining property in Botswana for the extraction of minerals from their natural site, and their treatment, transportation, or storage.[16] First, as the definition refers to 'any person' as opposed to 'any person with a mining right', one may assume that this definition does not require a person to hold a mining right. Second, mining operations are described as the extraction of minerals from where they are found on earth or attached to the earth, d include beneficiation and transportation.

The definition of mining operations in Botswana is wider than its South African equivalent. For example, in South Africa treatment of the mineral ore for the better utilisation of the minerals, has been held not to constitute mining.[17] In Botswana this is taken to be included under mining, as are the transportation and storage of minerals – in short, in Botswana the entire value chain from extraction, improvement, and storage to delivery to the end user, is mining.

2.4 The Meaning of Capital Expenditure for Purposes of Section 36

Capital expenditure is defined in section 36(11)*(a)* to *(f)*. It means money expended on:

(a) Digging the vertical hole used to access the ore underground and purchasing equipment utilised to conduct mining operations. To the extent that this expenditure is financed, interest or finance charges are excluded.

(b) Constructing the mine and management costs before the mine commences to produce income and while the mine is not producing income.

(c) Expenditure mentioned in (a) and (b) above in respect of post-1973 and -1990 gold mines. It must be noted that there are various qualifications and limitations within paragraph (*c*) regarding the deductibility of the expenditure; however, these limitations and qualifications are not pertinent to the study as they refer specifically to gold mines.

(d) The establishment of infrastructure, utilised by or sold to the employees of the taxpayer, associated with and/or necessary for mining. The infrastructure is for

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16 Section 2 of the Botswana Income Tax Act CAP 52-01.
17 Lewis ADP in *Benhaus* para 31.

mining purposes, but includes, residential accommodation, hospitals, schools, shops, recreational facilities, railway lines for transporting minerals, motor vehicles, and expenditure incurred in improving these.

(e) Acquiring or being awarded a mining right, excluding expenditure relating to mine rehabilitation and related infrastructure.

The capital expenditure contemplated in sections 36(11)*(a)* to *(f)* is distinguishable from the expenditure categorised as capital in nature in section 11*(a)* of the Act. There is vast body of case law on the meaning of 'capital in nature'; however, there is no single test to determine what capital in nature is as each case must be assessed on its merits. In the context of section 11*(a)* of the Act, expenditure of a capital nature is expenditure that is concerned more with improving or establishing the source of income. On the other hand, expenditure linked more to generating or producing income from the source, is revenue in nature. This general guide was formulated in *Secretary of Inland Revenue v Cadac Engineering Works.*[18]

Mining Capital Expenditure in Botswana is defined in section 2 of the Botswana Income Tax Act. It means expenditure:

(a) To acquire a mining or prospecting right or information whichever the case is. This must have been done solely for the purpose of carrying on mining operations.

(b) To prepare the site from which mining operations will be conducted. This includes the prospecting to determine the best means of mining operations.

(c) On buildings, permanent structures, plant equipment, machinery, other improvements directly or primarily connected with the carrying of the mining operations;

(d) On provision or contributing to provision of water, telecommunication or power for use and access to the site of carrying mining operations;

(e) On accommodation and welfare of employees;

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[18] 1965 (2) SA 511 (A).

(f) On general administration and management, including any interest payable on any loan for the time being used to finance such mining operations incurred before commencement of mining and during any time the business of mining is not being carried on.

There are striking similarities between the definition of capital expenditure in South Africa and mining capital expenditure in Botswana as can be seen in the items (a) to (e) under each definition. The striking difference is in paragraph (*a*) of the South African definition comparable to paragraph (*e*) of the Botswana definition. In Botswana, interest on finance mining operations incurred to establish the mining operation and when mining is not being carried on, is included. Having regard to the Botswana definition of mining operations and paragraph (*c*) of the definition of capital expenditure, interest incurred to finance shaft sinking and mining equipment constitutes mining capital expenditure.

2.5 The Scope and Application of Section 36

From the outset, it must be noted that sections 36(1) to 36 (7B) have been deleted from the Act. In the main tax framework for treatment of mining capital expenditure was put in place to attract investment and to cushion the risk associated with investing large sums of capital during the life of a mine.

2.5.1 Section 36(7C)

This section identifies the amount to be established as required by section 15*(a)*. This amount is capital expenditure incurred which can only be deducted against mining income – ie, income produced through mining or mining operations. Section 15*(a)* is applicable when the following factors are present:

(a) There must be income.

(b) The income must be generated from a producing mine.

(c) The deduction must be capital expenditure as defined hereunder.

Once the requirements of sections 15*(a)* and 36(7C) have been met, the enquiry progresses to determining the amount to be deducted. How this amount is determined is found in sections 36(7E) and 36(7F) of the Act.

2.5.2 Section 36(7E)

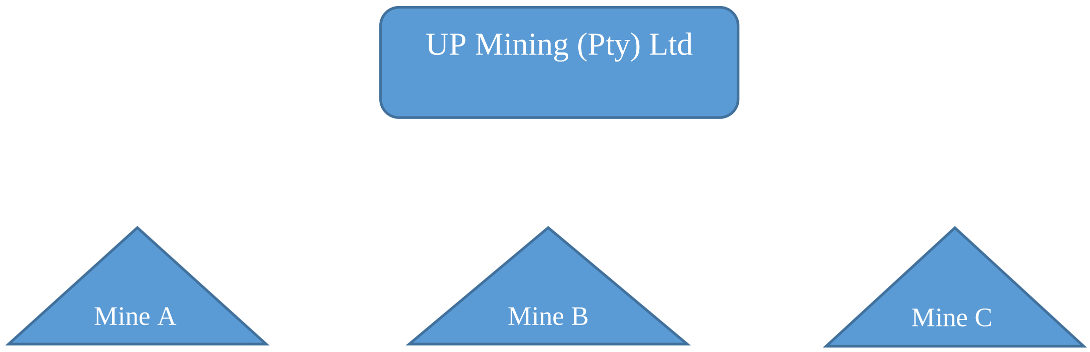
The key principles of this section are as follows:

(a) The aggregate capital expenditure in a year of assessment for one or more mines of a single company shall not exceed its taxable income generated from mining before deducting allowable section 15*(a)* deductions in the current year of assessment.

(b) In the event that there is excess capital expenditure – ie, capital expenditure exceeds taxable income – such excess capital expenditure is rolled over to the next year of assessments as if it was incurred in that year in respect of the mine or mines.

(c) The taxable income generated from mining is determined after setting-off the balances of assessed losses of the mine or mines from a previous year.

This can be explained by way of the following example.



Assuming that the taxable income of UP Mining (Pty) Ltd (UP Mining) for the 2020 year of assessment is R300 million, the balance of assessed losses from the previous year (2019) is R50 million per mine, deductions permitted in terms of section 11*(a)*, the capital expenditure of Mine A is R15 million, that of Mine B is R10 million and of Mine C is R7 million. In practice, the principles of section 36(7E) would apply by first determining the taxable income of UP Mining as per calculation below.

Calculation on taxable income:

Income	R300 000 000.00
Less balance of assessed losses	R150 000 000.00
Less section 11*(a)* deductions	R120 000 000.00
Taxable income	R30 000 000.00

The aggregate capital expenditure of mines A, B and C operated by UP Mining is R32 million. Therefore, it exceeds UP's taxable income determined before the section 15*(a)* deduction of R2 million. As per the provisions of section 36(7E), the excess capital expenditure of R2 million will be rolled over and treated as if it were incurred in 2021 in respect of mines A, B and C. Having determined the taxable income before deduction of section 15*(a)* amounts, a second calculation is necessary to determine the taxable income.

Calculation 2: Capital expenditure redemption:

Income	R300 000 000.00
Less section 11*(a)* deductions	R120 000 000.00
Less balance of assessed losses	R150 000 000.00
Less section 15*(a)* capital expenditure	
Limited to taxable income	R30 000 000.00
Taxable income	R0.00

2.5.3 Section 36(7F)

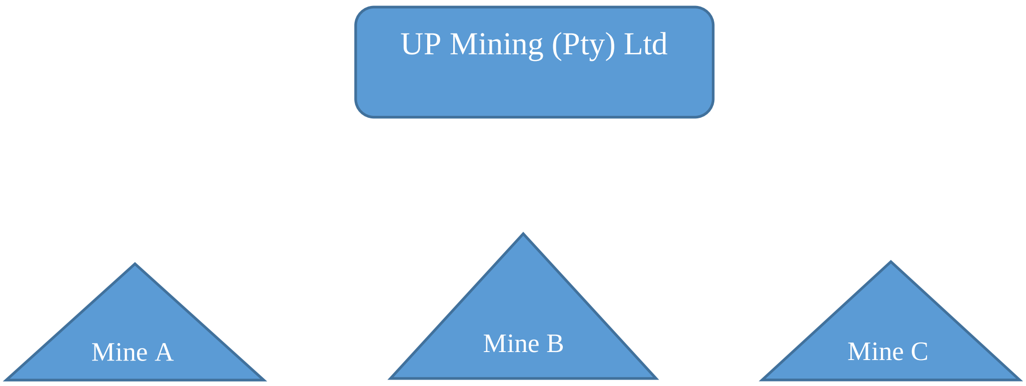
The key principles of this section are as follows:

(a) The aggregate capital expenditure in a year of assessment for one mine of one company shall not exceed the taxable income generated by taxpayers from that mine unless stated otherwise by the Minister of Minerals and Energy.

(b) Capital expenditure exceeding taxable income is rolled over to the next year of assessment. Rolled-over capital expenditure is treated as if it was incurred in that year in respect of the mine.

(c) Capital expenditure is determined by setting off the balances of losses of the mine from a previous year against its taxable income in the current year of assessment before the deduction/s permitted in terms of section 15*(a)* are applied.

In contrast to section 36(7E), section 36(7F) provides for determining the quantum of capital expenditure to be deducted per mine where the taxpayer operates one or more mines. This provision ring-fences the capital expenditure available for deduction from the taxable income generated from one mine instead of all mines. This can be explained by way of the following example:



Assuming that the income of UP Mining (Pty) Ltd (UP Mining) for the 2020 year of assessment is R100 million for each of its mines (A, B and C), the balance of assessed losses from the previous years for each mine is R50 million, deductions permitted in terms of section 11*(a)* are R30 million for mine B and C, and R60 million for mine A. The aggregate capital expenditure of mines A, B and C is R15 million, R10 million, and R7 million respectively.

Calculation 3: Capital expenditure redemption:

	Mine A	Mine B	Mine C
Income	R100 000 000	R100 000 000	R100 000 000

S 11*(a)* deduction	R60 000 000	R30 000 000	R30 000 000
Assessed losses	R50 000 000	R50 000 000	R50 000 000
Taxable income	-R10 000 000	R20 000 000	R20 000 000
Less allowable			
S 15*(a)* deduction	R0	R10 000 000	R7 000 000

The losses of Mine A are ring-fenced; thus, no capital expenditure is deductible for Mine A until such time as the mine starts generating taxable income (ie, not making losses). The capital expenditure of Mine B and Mine C are deductible in full, since the taxable income of both mines surpasses allowable section 15*(a)* capital expenditure deduction.

Therefore, due to the further limitation imposed by section 36(7F), the aggregate capital expenditure deductible in the current year of assessment for UP Mining is limited to R17 million [R10 000 000 (Mine B) + R7 000 000 (Mine C)]. The remaining balance of R15 million will be rolled over to the next year of assessment in the event that Mine A generates taxable income.

The application of sections 36(7E) and 36(7F) was settled by the Supreme Court of Appeal in the case of *ARMGold/ Harmony Freegold Joint Venture (Pty) Ltd* v *Commissioner, South African Revenue Service*[19] in which the taxpayer operated a number of mines some of which were profitable and others not. The SARS issued revised assessments for the 2003 to 2004 years of assessment and set-off the losses of St Helena Mine against the taxable income of the Freegold and Joel Mines before deducting the capital expenditure incurred.

This had an effect of reducing the capital expenditure available to be deducted.[20] The taxpayer objected to the revised assessments. The disputes were essentially about the application of the provisions of sections 36 (7E) and 36(7F) in circumstances where some of the mines operated by a company were making a loss.

[19] [2012] ZA SCA, 2013 (1) SA 353 (hereafter *ARMGold/Harmony*).
[20] *ARMGold/Harmony* para 2.

The court held that "it is not permissible to set-off losses of St Helena Mine against the taxable incomes of Freegold and Joel Mines. The taxable incomes of the mines must be ascertained separately and without the operating expenses of one mine being used to reduce the taxable income of another."[21]

The court further held that,

> "section 36(7F) provides for a maximum (further cap) that may be deducted for capital expenditure in respect of each of the Freegold and Joel Mines. It does not necessarily entitle the Appellant to deduct the full amount of each such cap. The answer seems to be for the individual capital expenditure caps of the Freegold and Joel Mines to be reduced so that their total does not exceed the general cap imposed by section 36(7E). In this way the two subsections will work in tandem, setting a maximum total deduction and reducing the Freegold and Joel Mines maximum caps proportionally."[22]

The *Harmony* case is authority for the proposition that sections 36(7E) and 36(7F) are intended to work hand-in-hand. The former places caps the capital expenditure redemption to the taxable income from all mining operations, whereas the latter limits the capital expenditure redemption per mine.

The capital expenditure redemption per mine cannot be greater than the taxable income derived from mining all mines. Therefore, where it is the case it must be reduced. The reduction is achieved not by deducting the losses of one mine against another, since this is impermissible, but by subtracting the taxable income determined for purposes of section 36(7E), from the total taxable income determined for the purposes of section 36(7F). Thereafter, the difference must be apportioned between the mining operations based on the ratio of their incomes.[23]

The court did not apply the provisions of sections 36(7E) and 36(7F) correctly to solve the issue. The issue at hand was not concerned with taxable income, the issue arose from the capital expenditure of one mine exceeding the taxable income of that mine and also exceeding the taxable income of all mines operated by the taxpayer. The court did not correctly diagnose the issue and so arrived at an incorrect solution.

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21 *ARMGold/Harmony* para 31.
22 *ARMGold Harmony* para 32.
23 *ARMGold/Harmony* para 34.

The issue as identified above, did not require any great ingenuity of the court to coming up with formulas for reducing individual capital expenditure of the Freegold and Joel Mines. Section 36(7E) is clear that whenever the capital expenditure of any mine or mines exceeds the taxable income derived from mining all mines, it must be carried forward and treated as if it was incurred in the following year. In the next succeeding year, this capital expenditure reverts to and is the allocated to each individual mine by which it was incurred.

Section 36(7F) is equally clear that whenever the capital expenditure of a mine exceeds the taxable income derived from mining that mine, it must be carried forward and treated as if it was incurred in the following year by that mine. When the capital expenditure of one mine exceeds the taxable income derived from mining, it follows that it would have first exceeded the taxable income of the mine by which it was incurred.

For so long as the capital expenditure does not *exceed*[24] the taxable income of the mine which incurred it or by all the mines, there is nothing in sections 36(7E) and 36(7F) to prevent full deduction of capital expenditure.

> "It is important to bear in mind that the 100% capital redemption allowance is not elective; once a taxpayer satisfies the requirements of the definition of mining operations and mining, such a taxpayer is compelled to claim the 100% capital redemption allowance as envisaged in section 15 read with 36 of the Income Tax Act."[25]

Accordingly, the court's reasoning that the further cap on capital expenditure found in section 36(7F) does not necessarily entitle the appellant to deduct the full amount of capital expenditure, is incorrect.

The correct reasoning the court should have adopted is that for so long as the capital expenditure of one mine does not exceed the taxable income derived from mining and from that mine, it is deductible in full. And that for so long as capital expenditure derived from a mine or mines does not exceed the taxable income derived from mining all the mines, it is deductible in full.

2.5.4 Sections 36(7G) and 36(10)

Section 36(7G) applies only to mining operations that started producing ore after 14 March 1990. This section allows the deduction of capital expenditure that was previously

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24 My emphasis. In this case, 'exceeds' refer to the maximum amount.

25 Surtheland J, *ABC Trading (Pty) Ltd v CSARS* 13686 SATC para 48.

disallowed under section 46(7F). The difference between sections 36(7E) and 36(7F) is that the deduction under section 36(7G) is permitted against the total mining taxable income.

The taxable income is computed differently to sections 36(7E) and 36(7F) in that the allowable capital expenditure in terms of these sections is deducted from the income together with the losses of the previous year. The effect is that the total taxable income would be reduced significantly to minimise maximum benefit to the taxpayer. However, the capital expenditure deduction may not exceed 25 per cent of the taxable income determined. Sections 36(7E) and 7(F) limit the deductibility of the capital expenditure to the taxable income, whereas section 36(7G) limits it to a quarter of the taxable income.

The reduction of the taxable income and the limitation of deductibility of capital expenditure to a quarter of the taxable income, makes section 36(7G) to have a different effect in comparison with section 36(7E) and 7(F). Finally, the provisions of section 36(7G) do not apply where the mine in which that expenditure has been incurred is sold in that year or past years of assessment, and where the legal entitlement to the mine has been obtained with funds consisting of equity where the return is tied to the profits produced by the mine.

2.6 The Davis Tax Committee: Recommendations on Capital Expenditure in Mining

The mining tax regime has recently been reviewed by the Davis Tax Committee. The recommendations made to the Minister of Finance as to whether the framework should be changed and aligned with other methods of taxing manufacturing, are as follows:

(a) The current 100 per cent mining capital expenditure redemption in section 15*(a)* read with sections 36(7E) and 36(7F) should be discontinued and replaced by a capital expenditure allowance apportioned over four years similar to the section 12C[26] manufacturing allowance in the ratio 40:20:20:20.

(b) The above write-off periods would cover the cost of the capital expenditure contemplated in sections 36(11)(*b*) and 36(11)(*e*).

26 The 40:20:20:20 manufacturing deduction is provided for in s 12C(1)(*c*). This provision applies to new or unused machinery or plant acquired on or after 1 March 2002 and brought into use on or after this date to manufacturing or similar process carried on for trade. In terms of this provision, 40 per cent of the cost shall be deducted in the first year the machinery is put into use and 20 per cent for three subsequent years to make up 100 percent deduction.

(c) The longer write-off periods set in sections 36(11)(*d)* and 36(11)(*f*) should be retained.[27]

Recommendation (a) means that 100 per cent of capital expenditure would not be deducted against income in year one. The capital expenditure deduction would be split and spread out over four years. For example, if the capital expenditure permitted to be deducted is R100 million, R40 million would be deducted in year one, R20 million in year two, R20 million in year three, and the balance of R20 million in year four.

Recommendation (b) means that interest-related charges and costs of acquiring the mining rights would likewise not be 100 per cent deductible in year one. The deduction would again be be split (40:20:20:/20) and spread out over four years as above.

The effect of the suggested reforms to mining tax would result in collection of more tax from mining in a specific year of assessment. The tax will be greater because the deductions from income are lower as they are spread over four years instead of a once-off deduction limited by the taxable income.

Notwithstanding these recommendations, neither the National Treasury nor the SARS has announced amendments to the Act for the purposes of implementing the recommendations made to the Minister of Finance.

2.7 Conclusion

In this chapter the study found that persons involved in mining or mining operations enjoy a unique and preferential tax regime. This regime is found in section 15*(a)* read with sections 36(7C), 36(7E), 36(7F), 36(7G) and 36(10). Provided a person is mining, the capital expenditure, limited to taxable income incurred, is deductible against income.

If the capital expenditure permitted for deduction exceeds the taxable income, it is rolled over to the following year of assessment and treated as if it were incurred in that year. More importantly, the study discovered that interest and finance charges incurred to fund shaft-sinking and mining equipment do not qualify as capital expenditure and are, therefore, not deductible in terms of section 15*(a)*.

[27] Davis Hard Rock Report 68.

In Chapter 3, the study identifies and discusses alternative provisions in the Act which could be used to deduct interest and finance charges incurred to fund shaft-sinking and mining equipment. The method interpretation of fiscal legislation is also discussed.

CHAPTER 3

THE APPLICATION OF GENERAL DEDUCTION FORMULA:

SECTIONS 11(A), 24(J) AND 24 JA

3.1 Introduction

This chapter sets out the requirements and discusses sections 11*(a)* and 24(J) of the Act. Having found in Chapter 2 that interest or finance charges incurred in financing shaft-sinking and mine equipment are not deductible in terms of section 15*(a)* read with sections 36(7E) and (7F), this chapter considers whether section 11*(a)*, 24(J) and/or 24JA can be used in their place.

The provisions of section 15 read with sections 36(7E) and (7F) are limited to deducting capital expenditure as that expenditure may not be deducted under section 11*(a)*. These sections do not make provision for the deduction of all expenditure incurred in mining operations, but capital expenditure alone. Other expenditure, not of a capital nature, incurred by a mining operation can still be deducted under the provisions of section 11*(a)* or any other relevant provisions of the Act.

3.2 Interest

Interest is the cost payable for borrowing money.[28] Williams J says "(i)nterest is, after all, a periodic charge for the use of money in the same way as rent is a periodic charge for the use of property".[29] Courts have in various decisions defined what interest is. Wunsh, in *Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd*,[30] finds interest to be "compensation for the receipt and retention of money".[31] The court's use of the term 'receipt of money', in my view, extends what interest is to once-off costs such as raising and/or arranging professional fees associated with borrowing money. Receipt of money is a once-off occurrence – it is the period of retention, the 'term of the loan' to which the compensation is linked.

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28 *A v CSARS* SATC (Johannesburg) 11691 para 18.
29 RC Williams "can expenditure on interest be 'of a capital nature' and on that ground be non-deductible for income tax purposes" 1997 SALJ IV at 644.
30 1997 59 SATC 1 (T).
31 *CIR v Cactus Investments (Pty) Ltd* 1997 59 SATC 1 (T) para 28.

The definition of interest in section 24(J) of the Act is not a universal definition that can and must be applied to references to of interest in other sections of the Act. Subsection 1 of section 24(J) makes it clear that the meanings ascribed to the words listed thereunder are for purposes of section 24(J) only. This means that interest contemplated in section 24(J)(1) is a type of interest formulated and acceptable for deduction under section 24(J)(2) only.

What 24(J)(1) includes as interest is the following:

(a) Gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement. This means compensation for use of money payable by the borrower or received by the lender as taxable interest income in the context of an arrangement of a financial nature. There is no definition of *financial arrangement* in section 24(J)(1).

(b) Amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as representing compensation for any amount to which the lender would, but for such lending arrangement, have been entitled. This means that a lender must be compensated for the return that would have been received had the money not been lent; i.e., utilised for other purposes to the borrower. This is in essence for compensation for opportunity cost.

(c) Absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement to which such a person is a party. This means the difference between the sale consideration and the rental paid for an asset sold and made available by the purchaser to the seller is interest. The interest is based on the value of the assets sold by the seller."

To the extent that a taxpayer compensates a lender for permitting him/her to use his/her funds for shaft-sinking and mining equipment, that compensation qualifies as interest. The first requirement of section 24(J)(2) is met.

The deduction of interest permitted by section 24(J)(2) is dependent, among other requirements, on interest incurred as defined in common law and in section 24(J)(1). The deductibility of interest in terms of section 11*(a)* of the Act depends, among other requirements, on whether or not the interest is regarded as expenditure of a revenue nature.

3.3 Application of sections 11*(a)*, 24(J) and 24JA to interest on shaft-sinking and mining equipment

3.3.1 Section 11(a)

General deductions allowed in determination of taxable income are found in section 11 of the Act. Section 11*(a)* provides:

> "For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from income of such person so derived–
>
> (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature."

In *CSARS v Labart Africa*[32] the Supreme Court of Appeal resolved the question of what constitutes expenditure. The case concerned the deduction of the value of shares issued to a seller to settle the purchase consideration for a trademark, from income. The court pointed out that the term 'expenditure' is not defined in section 1. Drawing on the precepts governing the interpretation of statutes, Harms JA stated that as the term 'expenditure' is not defined in the Act, and as it is an ordinary English word, it must be accorded its 'usual' English meaning unless context indicates otherwise. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. Expenditure, therefore, requires a diminution (even if only temporary) in or, at the very least, movement of assets of the person who expends.[33]

The implication of the passage referred to above is that a company must part, permanently or temporarily, with its own asset for it to have 'expended'. Shares clearly cannot be an asset of a company, this is forbidden by section 35(3) of the Companies Act[34] which provides that a company may not issue shares to itself. Although Harms JA held that the issue of company shares did not reduce its assets and there had consequently been no expenditure, he could have dealt concisely with the matter on the basis of section 35(3) of the Companies Act without even considering the reduction of assets.

In the event, if a mining company enters into an arrangement with a financier in terms of which interest incurred to finance shaft-sinking and mining equipment is paid by the

32 2011 ZA SCA 157.
33 *CSARS v Labart Africa* 2011 ZA SCA 157 para 12.
34 71 of 2008.

transfer of any sort of assets (including shares held in another company) owned by the company, there would be diminution and this would be expenditure. However, if the interest is settled through the issuing of the mining company's own shares, *CSARS v Labart Africa* is authority that this would not be expenditure.

In order for expenditure to qualify for deduction in terms of section 11*(a)*, it must be expenditure that is not of a capital nature and that is actually incurred to produce income.

> "The expression 'expenditure actually incurred' incurred in section 11*(a)* does not mean expenditure actually paid during the year of assessment, but means all expenditure for which a liability has been incurred during the, whether the liability has been incurred during the year, whether the liability has been discharged during that year or not."[35]

For the purposes of section 11*(a)*, this interpretation by the court permits a situation in which a taxpayer is able to claim a deduction of expenditure to be paid in the future, provided that expenditure has been incurred.

To qualify for deduction in terms of section 11*(a)*, interest and finance charges incurred in financing shaft-sinking and mining equipment must have been incurred in the production of income and not be of a capital nature. In contrast to section 15*(a)* read with sections 36(7E) and 36(7F), section 11*(a)* does not restrict the income against which a deduction must be made to mining income. Interest incurred in financing shaft-sinking and mining equipment must be tested, irrespective of whether it is of a capital nature and is incurred the production of income.

3.3.2 Section 11A

Section 11A provides for the deductibility of pre-trade expenditure and losses. Section 11A and section 11*(a)* differ in that the former deals with expenditure and losses incurred before trade commences, while the latter applies after trade has commenced. A pre-trade expense qualifies as a deduction against the income from the trade to which it relates subject to the following four key requirements in section 11(A)(1):

(a) First, the trade in respect of which the pre-trade expense was incurred must have been commenced by the taxpayer.

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35 *Port Elizabeth Electric Tramway Co v CIR* 1936 CPD 241, 244.

(b) Secondly, the pre-trade expenses must have been actually incurred before the commencement of and in preparation for carrying on that trade.

(c) Thirdly, had the pre-trade expense been incurred after the commencement of the trade it relates to, it would have been allowed as a deduction under section 11 [other than section 11(x), 11B, 11D or 24J].

(d) Fourthly, the pre-trade expense must not have been allowed as a deduction in that or any previous year of assessment.[36]

The expenditure incurred in preparation of the trade is only deductible against income derived from that trade. Where the taxpayer has multiple trades such as various mining operations, it is not permitted to deducted expenditure or losses in excess of income derived, against income of any other trade it has.[37]

3.3.2.1 Does interest incurred to finance shaft sinking and mining equipment constitute expenditure incurred in the production of income and not capital in nature?

3.3.2.1a In the production of income

The purpose of expenditure is significant in the determination of whether it is capital or revenue in nature. Once a connection has been established between the expenditure incurred on interest and the taxpayer's income-generating operation, the interest is *prima facie* in the production of income.[38] The court in *Commissioner for Inland Revenue v Nemojin* correctly gave the connection limited recognition. This means that a further enquiry to probe the relationship between the interest expenditure and income generated is necessary.

In *Sub-Nigel Ltd v Commissioner for Inland Revenue*[39] it was held that:

> "[A]ll expenses attached to the performance of a business operation *bona fide* performed for the purposes of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient

36 SARS Interpretation Note 51, 6.
37 Section 11A(2) of the Income Tax Act 58 of 1962.
38 *CIR v Nemojin (Pty) Ltd* 1983 (4) SA 935 (A) para 947.
39 1948 (4) SA 580.

performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it."[40]

In *CIR v Genn & Co (Pty) Ltd*[41] an explanation of the judgment of *Sub-Nigel Ltd* quoted above was offered. Schreiner JA stated that the court held that "the words 'regarded as part of the cost of performing them' required an assessment whether it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation".[42]

Two years after the decision of *Commissioner for Inland Revenue v Nemojin (Pty) Ltd,* Corbet JA in *Commissioner for Inland Revenue v Standard Bank of SA Ltd,*[43] shared views which are relevant to the study. He stated, "where a taxpayer's purpose in borrowing money upon which it pays interest, is to obtain means of earning income, the interest paid on the money so borrowed is prima facie an expenditure incurred in the production if income".[44]

In the case of an underground mine, a shaft and equipment used to extract ore are required for the mine to produce income. The underground ore reserves cannot be accessed in any way other than sinking a shaft and using equipment to dig and extract the ore. Unless funded in cash, interest incurred on the funds borrowed to sink a shaft and acquire mining equipment are indispensable to generation of income in an underground mine. The interest incurred to finance shaft sinking and mining equipment is concomitant to the production of income, without cash resources to sink the shaft and acquire mining equipment, mining operations would not commence and no mining income could be produced.

This analysis of mining expenditure for shaft sinking aligns with the test stated in *Port Elizabeth Electric Tramway Co Ltd v CIR*[45] that, "two questions arise (a) whether the act to which the expenditure is attached, is performed in the production of income, and (b) whether the expenditure is linked to it closely enough".[46] Writing in a special edition of the *Southern African Business Review,*[47] Goldswain states that these two questions have come to be known as the 'subjective-purpose test' and the 'objective-nexus test'. The objective

[40] *Sub-Nigel Ltd v Commissioner for Inland Revenue*1948 (4) SA 580 (A) p 246.
[41] 1995 (3) SA 293 (A).
[42] *CIR v Genn & Co (Pty) Ltd* 1995 (3) SA 293 (A) 299.
[43] 1985 (4) SA 485 (A).
[44] *CIR v Standard Bank of SA Ltd* 1985 (4) SA 485 (A) 489F-G.
[45] 1936 CPD 241, 8 SATC 13.
[46] *Port Elizabeth Electric Tramway Co Ltd v CIR* 8 SATC 13, 16.
[47] Goldswain & Swart (2015) 19 *SABR* 71-96.

test is also referred to as the 'closely-connected test' or, as later described in *Joffe & Co Ltd* v *CIR*, the 'inevitable test'. The concomitant test requires a case-by-case consideration in that there can be no general standard as businesses operate differently and generate income in different ways.

By way of example, mining companies use the services of security companies to secure minerals. The minerals secured upon sale produce income. Notwithstanding that the security services do not produce mining income, they are so closely linked and necessary for the production of income, that their cost must be regarded as having been incurred in the production of income. This analogy is in consonance with the analogy of Watermeyer AJP discussed by Goldswain, where he stated that employment of drivers is required to produce income from trams and with that comes risk of liability arising from injury. The payment to the driver as compensation for injuries had therefore to be regarded as part of the cost of its operations, and had thus been incurred in the production of income.[48]

Deduction of expenditure under section 11*(a)* does not depend on whether the expenditure was necessary – qualifying expenditure must simply have been incurred. This view is shared by Goldswain when he states that:

> "[I]t is important to note that the Income Tax Act (both past and present legislation) uses the words 'actually incurred' and not 'necessarily incurred' when prescribing the requisite for deduction of the expenditure. Using the qualification necessarily incurred would certainly have narrowed the type of expenditure that can be claimed."[49]

However, comparatively, in Botswana this is the case. Section 39(2) of Botswana's Income Tax Act[50] provides:

> "In ascertaining the chargeable income of any person for any tax year there shall be, upon due claim and subject to such evidence as the Commissioner General may require, be deducted from the assessable income of such person all expenditure wholly, exclusively, and necessarily incurred by that person during the tax year in the production of his or her assessable income."

From the above it appears that the expenditure must not only be necessarily expended, it must also have been expended wholly and exclusively for the purpose of generating income during the tax year. This means that a taxpayer must be able to prove that one hundred per cent of the expenditure contributed to the production of income, and that it was

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48 Goldswain & Swart (2015) 19 *SABR* 79.
49 Goldswain & Swart (2015) 19 *SABR* 78.
50 CAP 52-01.

necessary to incur the expenditure. In terms of section 39(2), the Commissioner is empowered to call for evidence proving that the expenditure was wholly, exclusively, and necessarily incurred by that person during the tax year in the production of his or her assessable income. This is a very high three-pronged standard for the deductibility of expenditure. The scope of expenditure which can be deducted in Botswana is very limited by South African standards.

3.3.2.1b Not capital in nature

Although it has been seen above that the interest has been incurred in the production of income, this does not, without more, mean the expenditure is of a capital nature. "The question whether the interest is expenditure of a capital or revenue nature can be answered only by ascertaining the purpose for which the loan was obtained during the period for which interest was paid."[51]

A mine shaft and mining equipment are capital assets and so funds expended in their creation or acquisition are categorised as capital expenditure in section 36(11) of the Act. Interest associated with funding this expenditure can be said to be expenditure of a capital nature, especially if the interest is recognised as a base cost of the capital asset. Wunsh, in *ITC 1604 58*,[52] sees it differently. This case involved the acquisition of an income-generating property with debt finance and interest thereon having been deducted as expenditure. In his judgment, Wunsh states that, "there can be no doubt that the interest expenditure incurred by the appellant in the year of assessment was for the purpose of financing the acquisition of the property from which it derived income. Interest recurrently so expended is not of a capital nature".[53]

From this it appears that once it has been found that the interest has been incurred in respect of an income-producing asset, interest thereon is not of a capital nature. This means that the treatment of interest incurred in creation or establishment of an income- generating asset, follows the treatment of the income. Put differently: If the income constitutes gross income as defined in section 1 of the Act, then interest incurred to produce that income is not capital in nature.

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[51] *Wharf Properties Ltd v IRC* 1997 AC 505 (PC) para 8.
[52] SATC 263.
[53] SATC 263, 271.

There is no fundamental difference between the interest incurred in the circumstances of the case in *ITC 1604* (acquisition of an income-generating property) and interest incurred in respect of funds borrowed to construct a shaft and acquire mining equipment. The mine produces income from selling the ore extracted underground, whereas the property produces income from its being let to tenants as an office, residential property, or a factory.

In addition to the discussion above, Schedule Eight to the Act provides for the determination of taxable capital gains and assessed capital losses. Paragraphs 20(1)*(a)* and 20(1)*(g)* of the Schedule provide that

> *(a)* the base cost of an asset acquired by a person is the sum of the expenditure actually incurred in respect of the cost of acquisition or creation of that asset;
>
> (g) one-third of the interest as contemplated in section 24(J) …"

Paragraph 20(2) of the Schedule provides that the expenditure incurred by a person in respect of an asset does not include any borrowing costs, including any interest as contemplated in section 24(J) or any raising fees.

Although expenditure incurred to construct a shaft and acquire mining equipment is expended on capital assets and forms the base cost of those assets, paragraph 20(2) specifically excludes costs of a capital nature such as interest and fees paid to an advisor to raise the debt. Although a portion of section 24(J) interest is included as a base cost in paragraph 20(1)*(g)*, this does not make the interest capital in nature. The legislator refers to section 24(J) of the Act expressly because this interest is not interest which depends on whether it is capital or revenue in nature to be deductible. The requirements of section 24(J) interest are distinguishable from the requirements of interest that would be deductible in terms of section 11*(a)*.

From the foregoing it becomes clear that interest does not form part of the base cost of an asset. For this reason the arguments for categorising the interest as capital in nature can be supported. There are strong arguments for the proposition that the interest incurred for the income-generating asset has no association with the income produced and is thus not incurred in the production of income and is not of a capital nature.

Interest incurred to fund a shaft and mine equipment can, on the basis of the arguments above, be said to be deductible in terms of section 11*(a)* because it is used in the process of winning minerals sold for income and it is not of a capital nature. There is, however, no certainty that interest incurred for funding shaft-sinking and mine equipment will be allowed by the SARS to be deducted under section 11*(a)* of the Act.

3.4 Section 24(J)

The application of section 24(J) of the Act was previously limited to the timing and quantifying of interest. This was changed by section 24(1)*(b)* of the Revenue Laws Amendment Act 32 of 2004 which included the deductibility of interest in terms of section 24(J)(2).

We turn now to discuss and apply to the secondary questions set in the study: namely provisions dealing with deduction of interest in terms of section 24(J)(2). A discussion of the provisions dealing with timing and quantification of interest – save for the definitions in section 24(J)(1) that are crucial to the application of section 24(J)(2) – falls outside the scope of this study.

Section 24(J)(2) provides:

> "Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to –
>
> *(a)* the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument;
>
> *(b)* an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument which must be deducted from the income of that person derived from carrying on trade, if that amount is incurred in the production of income."

In terms of section 24(J)(2) the salient requirements for deduction of interest from income derived by a person from carrying trade are that:

(a) the person must be an issuer of an instrument;

(b) the person must derive income from carrying on any trade;

(c) the amount incurred as interest must have been incurred in the production of income.

In a matter concerning the assessment by the SARS of interest accrued in terms of section 24(J), Van Staden AJ stated that:

> "[T]he definition of interest circularly includes the word "interest" and therefore does not ascribe a meaning to this word. The term interest is also not further defined in any other part of the Act. With reference to *Natal Joint Municipal Pension Fund v Endumeni Municipality* and the Shorter Oxford English Dictionary it is submitted that the correct definition of 'interest' is money paid the use of money lent or for the forbearance of a debt and this definition is consistent with the meaning that our courts have generally given to the notion of interest."[54]

From the foregoing, it is clear that compensation paid to a financier for use of his or her funds to construct a shaft and acquire mining equipment constitutes interest. Interest further includes all finance-related charges such as raising fees, default interest, administration costs, and service fees. This view was confirmed by Van Staden AJ when he held that "in respect of the definition of 'interest' in section 24(J) it bears noting that interest includes finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement".[55]

Ordinarily, financing would involve a loan agreement concluded between the person borrowing the funds and the person lending the funds, providing for, among others, accrual and payment of interest. Once this agreement has been concluded, the definition of *issuer* in section 24(J)(1) of the Act labels the borrower as an issuer. Even in circumstances where there is no written loan agreement, ie, the agreement is oral, but funds are advanced, for as long as there is an obligation to pay interest, the person who is liable for interest is an issuer.

In both above examples of how a person can become an issuer, an instrument must have been issued. An instrument is an arrangement where interest must be paid by the borrower in terms of the agreement and where a person disposes of or purchases or acquires a right to be paid interest. An instrument is also a transaction if it involves a repurchase or resale agreement issued on or before 15 March 1995, or issued on that date and transferred after 19 July 1995. An instrument is also a repurchase or resale agreement if it was issued on or before 15 March 1995 and remained unredeemed on 14 March 1996.[56]

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54 *ABC (Pty) Ltd v CSARS* SATC 13193 para 52.
55 *ABC (Pty) Ltd v CSARS* SATC 13193 para 64.
56 Definition of instrument in s 1 of s 24(J)(1) of the Income Tax Act 58 of 1962.

The interest which may be deducted in terms of section 24(J)(2) amounts to the quantum of all interest which the holder is entitled to receive in all the periods in which that interest is to be derived. This interest is determined in terms of the formula[57] set out in the definition of 'accrual amount' in section 24(J)(1). Put simply: an accrual amount, as determined, is interest that is calculated on the capital over the term of the loan. This interest may, depending on the agreement, be calculated daily, monthly, quarterly, bi- annually or annually. Payment is not necessarily linked to the calculation of interest in that it may be deferred. In other words, interest be payable on a date later than the date on which it was calculated.

An accrual period is the period during the term of instrument between the payment intervals of equal length, provided that the intervals do not exceed twelve months. Any period of payment selected by either the issuer or the holder is an accrual period provided that it does not exceed twelve months. For example, in circumstances where payment of interest must be made in April, August, and December, the accrual period would be four months. Had the interest payment be payable every seventh month, the payment intervals would not be equal and would exceed twelve months. The period would not qualify as an accrual period.

A person involved in mining or mining operations is carrying on a trade.[58] Therefore, the income derived from mining or conducting mining operations is income derived from carrying trade. Section 24(J)(2), as in the case of expenditure under section 11*(a)*, requires that the interest incurred must have been in the production of income. The discussion under section 3.3.2.1 above applies equally with regard to the requirement in the production of income. In principle, the concept 'in the production of income' is the same in both sections 11*(a)* and 24(J)(2).

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57 A = B x C. A represents the amount to be determined; B represents yield to maturity; and C represents adjusted initial amount. Sub-paragraphs (i), (ii) and (iii) set out the determination of interest where the commencement of end-of-year assessment falls within an accrual period; an instrument is transferred during a year of assessment.

58 Trade in terms of s 1 of the Income Tax Act 58 of 1962 includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Design Act or any copyright as defined in the Copyright Act or any other property of a similar nature.

"Section 24(J) does not draw a distinction between interest of a capital nature or revenue nature."[59] The main feature distinguishing section 24(J)(2) from section 11*(a)* is that section 24(J)(2) allows only interest to be deducted, whereas under section 11*(a)* provides for the deduction of general expenditure. Interest is also expenditure. In my view, section 24(J)(2) is a special provision for interest expenditure only, whereas section 11*(a)* is a general provision for expenditure, including interest if it qualifies as a deduction thereunder.

Section 24(J)(5) actually states that amounts taken into account for the purposes of deduction in terms of section 24(J)(2) shall not be taken into account for deduction under other provisions of the Act. This makes perfect sense. Had it been otherwise, a double deduction of expenditure would be possible – something not permitted by section 24(J)5A. Section 24(J)5A provides that an amount which is deductible in terms of section 24(J)(2) shall not be deductible in terms of other provisions – eg, section 11*(a)* – of the Act. Section 23B(1) also prohibits the double deduction of any amount.

As we saw above, section 24(J)(2) has unique requirements regarding interest. The main feature which distinguishes it from section 11*(a)* is that there is no requirement that the interest must not be of a capital nature. With regard to the requirements in section 24(J)(2), Oguttu[60] states that, "the only issue that has to be determined in terms of section 24(J)(2) is whether the interest was incurred in the production of income and for the purposes of the taxpayers trade".[61] This view is shared by Brincker[62] where he states that, "section 24(J)(2) provides that the interest is deductible from the income of the taxpayer derived from carrying on a trade, if the amount is incurred in the production of the income in carrying such trade".[63]

I disagree. Section 24(J)(2) is clear that there must be an issuer of an instrument in a year of assessment and the interest incurred shall be deductible from income if derived from carrying a trade. The operative words are *issuer, instrument,* and *interest*. Sections 24(J)(2)*(a)* and *(b)* are provisions addressing how much may be deducted. What is key, is that there must be an issuer, interest, and an instrument as defined in section 24(J)(1).

[59] SARS Interpretation Note 51, 3.
[60] Oguttu (2005) 13/4 *Juta Business Law* 162.
[61] Oguttu (2005) 13/4 *Juta Business Law* 163.
[62] Brincker *Taxation Principles* PM-6.
[63] Brincker *Taxation Principles* PM-6.

Interest which does not qualify as section 24(J) interest, and interest that does not arise from an instrument issued by an issuer cannot be deducted even if it has been incurred in the production of income and for the purposes of the taxpayer's trade. Put differently, if the interest arises from a transaction between a borrower and a lender who does not meet the requirements set for an 'issuer' and an 'instrument', it may not be deducted under section 24(J)(2).

The interest or finance charges excluded under the definition of *capital expenditure* in section 36(11) of the Act, is/are included in the definition of *interest* in section 24(J)(1). It is stated that interest includes interest and similar finance charges. Accordingly, any cost or compensation for obtaining, retaining, and using another person's money is interest.

Deduction of interest incurred to finance shaft-sinking and mining equipment is doubtful under section 11*(a)* because it is associated with capital assets or capital expenditure. It can, however, be deducted in terms of section 24(J). To ensure certainty, the interest must meet the requirements for its deductibility as discussed above. This view is consistent with Mazansky's[64] view that interest does not always fit the provisions of section 24(J). For example, if a loan and interest thereon has no set date for repayment it cannot be said that the issuer has an obligation to pay interest. This arrangement does not qualify as an instrument – although interest has been incurred there is no obligation to pay it. Section 24(J) does not apply.

The amount of interest that may be deducted is an amount equal to that determined under section 24(J)(2)*(a)* or *(b)*. Section 24(J)(2) permits the deduction of interest incurred by a person in the production of income from carrying on any trade. This means that for section 24(J)(2) to apply, the taxpayer must be producing income.

In circumstances where a taxpayer incurs interest to fund shaft-sinking and mining equipment before income is produced, the interest contemplated in section 24(J) can be deducted in terms of sections 11A(1)*(a)* to *(c)*. The amount deductible is provided for under section 11A(2). It is an amount of expenditure and losses that exceeds the income derived from conducting trade.

64 Mazansky 2008 *Tax Planning* 86.

3.5 Limitations to the deduction of section 24(J) interest

There may be circumstances in which a taxpayer is involved in an arrangement and finance is secured to fund shaft-sinking and mining equipment but the taxpayer receives interest and is also liable to pay interest. In this situation, section 24(J)(2) will not apply if the interest to be received exceeds the interest to be paid, or the interest to be paid exceeds the interest received. In these two scenarios, the taxpayer will not qualify either as a holder or an issuer, as the context requires, as provided in section 24(J)(8). Section 24(J)(8) strengthens the view above that for 24(J)(2) to apply, there must be an issuer and an instrument. Accordingly, a taxpayer in the trade of mining, sourcing funds to sink a shaft, and acquiring mine equipment must ensure that it is an issuer of an instrument within the meaning of section 24(J).

For interest incurred by a taxpayer in financing shaft-sinking and mine equipment to be unconditionally deductible under section 24(J)(2), it must not be payable to a person for whom such interest is not taxable or not included in gross income. This applies provided the lender holds 50 per cent of that person's equity shares. Additionally, the lender, if not a 50 per cent equity shareholder, must not have advanced funds received from a person holding 50 per cent of the equity shares of the taxpayer. But if not, in terms of section 23M(2), the deductibility of interest shall be limited to an amount determined in terms of section 23M(3). Any amount of interest that remains after the deduction of interest determined under section 23M(3) shall be rolled over to the following year of assessment and be treated as if incurred in that year.

3.6 Section 24JA Sharia-compliant financing arrangements

The provisions of section 24JA are, as is shown further below, intertwined with the provisions of section 24(J). Section 24JA applies to financiers, banks,[65] and the general public, on condition that the Sharia arrangements are marketed as being Sharia-law compliant.[66] This means that other bank institutions such as the Land Bank and the Development Bank of Southern Africa cannot offer Sharia financing products to their clients as they are not banks for the purposes of section 24JA.

65 In s 24JA(1) a bank is, for the purposes of the section, defined as a bank as defined in the Banks Act 94 of 1990, the mutual bank as defined in the Mutual Banks Act 124 of 1993, and a co-operative bank as defined in Co-Operative Banks Act 40 of 2007.

66 See definition of Sharia arrangement in sub-s 1 of s 24JA.

Currently, the Act makes provision for four types of Sharia financing arrangement, these are diminishing *musharaka, mudaraba, murabaha,* and *sukuk*. This chapter three of the study is concerned with provisions of the Act, other than section 15(*a*), that can be relied on to deduct interest incurred in the financing of shaft sinking and the acquisition of mining equipment. Accordingly, the characteristics and tax implications of diminishing *musharaka* and *murabaha* arrangements are discussed as the *mudaraba* arrangement is concerned with a taxpayer receiving investment income. *Sukuk* arrangements, on the other hand, apply to transactions involving the government or an organ of state. Accordingly they are not relevant or applicable to the study.

3.6.1.1 Diminishing *musharaka*

A diminishing *musharaka* arrangement has two requirements. First, it entails a situation in which a bank and a person conducting mining operations, acting together, acquire a mine shaft and or mine equipment from a manufacturer of such equipment ('mine equipment'). Alternatively, where a bank enters the picture after the fact and acquires an interest in the mine equipment already acquired by a person carrying on mining operations, the first requirement is also met. Second, the intention between the bank and the client must be that the bank will dispose of its interest in the mine equipment to its partner with the consideration for the disposal payable in agreed instalments between the bank and its client.

This is clearly an arrangement that assists a person conducting mining operations to purchase mining equipment using external funding. This is because from the onset it is known that the bank will sell its interest to the client – obviously at a profit and without charging interest – because the bank's funds were used to acquire mining equipment. Although the bank's money was used to assist in the acquisition of equipment, the bank cannot charge interest because "under shari'ah one is not able to receive or generate income from money; indeed, the generation of money from money, ie interest, is defined as *riba* (excess) and [is] strictly forbidden".[67]

In a diminishing *musharaka* arrangement the consequences are that,

> 'from a tax perspective, the client is deemed not to have disposed of the asset or the interest in the asset to the bank if the bank has acquired that interest from the client. If the bank and the client have jointly acquired the asset, the client is deemed to have acquired the banks

[67] Brincker *Taxation Principles* B 17.

> interest in the asset for an amount equal to the amount paid by the bank in respect of the interest in the asset and at the same time the seller of the asset was divested of its interest in the asset.'[68]

A portion[69] of the agreed instalments payable by the client to the bank for disposing of its interest in the asset, is deemed to be interest as contemplated in section 24J.[70] Having regard to the discussion of the application of the provisions of the deductibility of interest in terms of section 24J, the portion (deemed interest), of the agreed instalments payable by a person carrying on mining operations, would be deducted in terms of section 24J(*2*), the requirements are met. I say this because the portion of the instalment is deemed interest. Thus, the diminishing *musharaka* arrangement constitutes an interest-bearing arrangement and, therefore, an instrument. Additionally, the person conducting mining operations qualifies as an issuer because it would have incurred the deemed interest as per the agreement contemplated in paragraph (*c*) of the definition of diminishing *musharaka*.

3.6.1.2 *Murabaha*

A *murabaha* occurs between a bank or a listed entity and its client in terms of which: (i) the bank will acquire, on the basis of an agreement between its clients and the seller, an asset from the seller; (ii) the client acquires the asset from the bank within 180 days of the bank's acquisition of the asset; (iii) the client agrees to pay the bank an amount that exceeds the consideration paid by the bank for the asset, calculated with regard to the cost of the assets and the duration of the arrangement, ie a period up to 180 days; and (iv) this amount may not be greater than the amount initially agreed upon when the arrangement was concluded, and no other amount must be received or accrue to the bank in respect of the asset.[71]

This arrangement is distinguishable from diminishing *musharaka* in that only the bank acquires the assets, and that the period in which the assets must be acquired by the client is determined by law rather than being left to agreement between the bank and client. This arrangement can be used by a person conducting mining operations who will have access to cash within 18 months as from the day the bank acquires the mine equipment. This

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68 Brincker *Taxation Principles* B 18.5.

69 The amount making up this portion is determined by the formula X = A (total agreed mount to be paid by instalments) – B (total amount expended by the bank to acquire the interest in the asset). Accordingly, the interest is the difference between what the bank actually pays to acquire the interest and the total amount it receives as instalments over the period.

70 See the provisions of s 24JA(*6*).

71 See definition of *murabaha* in s 1 of s 24JA.

arrangement would work perfectly to secure mine equipment in circumstances where the mine operator would not be able to immediately secure the equipment by paying for it cash.

In terms of section 24J(2), a person conducting mining operations would, in terms of *murabaha*, be able to deduct the interest incurred or amount paid to the bank, over and above the cost of the asset. This is because section 24JA(3)(*c*) of the Act provides that the *murabaha* is deemed to be an instrument for the purpose of section 24J. Additionally, in section 24JA(*3*)(*d*) it is stated that the difference between the amount paid by the bank to the seller and amount the bank receives, is a premium as contemplated in section 24J(1). The requirements of section 24J(*2*) are met because the mine operator would be an issuer of an instrument as a result of the deeming provision in section 24JA(*3*)(*c*), and would have incurred interest as a result of section 24JA(*3*)(*d*).

3.7 Interpretation of fiscal legislation

In *Natal Joint Municipality Pension Fund v Endumeni Municipality*,[72] Wallis J set out the framework applicable to the interpretation of legislation – including tax legislation. He stated that in the interpretation of legislation, the focus falls on ascertaining the meaning of the words used rather than searching for the 'mind' or intention of the legislator. He states that the present state of the law can be expressed as follows. Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or a contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence.[73]

From this it emerges that text and context play an important role in modern-day interpretation. The role of both text and context will depend, in the main, on the circumstances of each case and the legislation in issue. The clearer the language used in the text and the more obvious its meaning in accordance with the ordinary understanding of language, the less the influence of context in arriving at a conclusion as to its meaning.[74]

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72 920/2010 [2012] ZA SCA 13 (15 May 2012).

73 *Natal Joint Municipality Pension Fund v Endumeni Municipality* 920/2010 [2012] ZA SCA 13 (15 May 2012) 15.

74 Wallis (2019) 22 *PER* 13–14.

In the event that the words used are clear and there is no ambiguity, effect must be given to the interpretation arising in the normal course. Context, and not the intention of the legislator, as per Wallis J in *Natal Joint Municipality Pension Fund v Endumeni Municipality*, must be resorted to when text fails to provide a clear meaning. The framework laid down by Wallis J cannot be applied to produce an unconstitutional result. Whatever the outcome, it must be one that renders the legislation in question consistent with the Constitution – without this the interpretation and or the provision in the legislation will be invalid.

The interpretative framework discussed above as set by Wallis J *Natal Joint Municipality Pension Fund v Endumeni*, must be applied having regard for the principle that an ambiguous provision must be interpreted to the benefit of the taxpayer – the *contra fiscum* rule. "In other words, when a provision of ITA is reasonably capable of two constructions, the court will adopt the construction that imposes the smaller burden on the taxpayer."'[75] Swain JA, in *Telkom SA SOC Ltd* v *The Commissioner for the South African Revenue Service*,[76] qualified the general understanding of the *contra fiscum* rule by stating that a provision can only be construed favourably to the subject if it is capable of supporting that construction.[77]

The test for the application of the *contra fiscum* rule is twofold: there must be doubt as to the meaning of a statutory provision; and the provision must be capable of the construction that would result upon application of the rule. This means that even if a provision is ambiguous, if it is too great a stretch to construe the provision as favouring the taxpayer the *contra fiscum* rule cannot be applied. Swain JA thus contradicted himself when he stated, in his evaluation of arguments on how to apply the *contra fiscum* rule, that: "I agree with the submission by Counsel for the Commissioner that, the rule should only be invoked, after an interpretational analysis results in an irresoluble ambiguity as to the meaning of the particular provision in the fiscal statute."[78] He should have stated further that the *contra fiscum* rule can only be invoked if the provision is able to support the result required by the rule. Naturally, this means that before the rule is applied, the relevant

75 Legwaila & Ngwenya (2013) 46 *De Jure* 5.
76 [2020] ZA SCA 19 (25 March 2020).
77 *Telkom SA SOC Ltd* v *CSARS* [2020] ZA SCA 19 (25 March 2020) para 18.
78 *Telkom SA SOC Ltd* v *The CSARS* [2020] ZSCA 19 (25 March 2020) para 20.

provision must be closely examined to establish whether it can be construed to afford a result beneficial to the taxpayer.

Turning to the questions of this study, the starting point has always been to consider the words used before resorting to context and purpose. The words used to define what capital expenditure is and what it is not, are clear and unambiguous. No two meanings are possible in that section 36(11) clearly provides that interest and finance charges relating to shaft-sinking and mining equipment do not constitute capital expenditure deductible under section 15*(a)* read with sections 36(7E) and 36(7F). For the purposes of interpretation of the crucial provisions in the questions posed in the study, there is no need to venture into the interpretation of sections 36(7E) and 36(7F), as they do not apply to interest incurred in financing shaft-sinking and mining equipment.

Under paragraph 3.3 above, the provisions of sections 11*(a)* and 24(J) of the Act are discussed at length, interpreted, and applied. The interpretation given to the words used is the plain grammatical meaning; the text is clear and there is no ambiguity. Accordingly, there has been no need to search for the context and purpose of the enactment of the provisions. There are various case law incidents cited on the question of the nature of expenditure capital. The courts have pronounced at length on this issue. Moreover, the provisions of section 24(J) are clearly analysed and the ordinary meaning of the words given; therefore, there is no ambiguity present, the text is clear.

3.8 Conclusion

Oguttu and Mazansky agree that section 24(J)(2) does not require that interest or finance charges incurred to finance shaft-sinking and mining equipment must not be of a capital nature. It can be of a capital nature and still be deducted in terms of section 24(J)(2). Furthermore, section 24(J)(2) can be used to deduct deemed interest incurred from financing mining equipment through diminishing *musharaka* and *murabaha* Sharia arrangements as fully set out in section 24JA. Although interest can be deducted in terms of section 11*(a)*, authorities indicate that a taxpayer must be able to show that the interest expenditure was incurred in the production of income and is not capital in nature. There has been considerable litigation on these requirements and it appears that the safer route is to deduct interest on the basis of section 24(J)(2).

The study has, however, found that the interest incurred to finance shaft-sinking and mining equipment must qualify as interest as contemplated in section 24(J)(1). The taxpayer must be an issuer and must issue an instrument as contemplated in this section. Oguttu and Mazansky are incorrect in stating that the only requirements for deductibility under section 24(J)(2) are that the interest is deductible from the income of the taxpayer derived from carrying on a trade, provided the amount is incurred in the production of the income in carrying on that trade. These are not the only requirements; they are additional to the requirement of there being an issuer, an instrument, and interest.

Section 24(J) states that interest incurred to finance shaft-sinking and mining equipment prior to the production of income from mining, is deductible under section 11A(2) of the Act. Interest incurred to finance shaft sinking and mining equipment and deducted in terms of section 24(J)(2) cannot be deducted a second time under section 11*(a)* as this is precluded by sections 24(J)5A and 23B(1). The full deduction of interest in terms of section 24(J)(2) is limited when interest is payable to a person who holds 50 per cent equity shares, or the interest accrued is not taxable in his or her hands.

In the following chapter I set out my conclusions and make certain recommendations based on the primary and secondary questions posed at the outset.

CHAPTER 4

CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

Two questions informed the objective of the study: first, whether section 15*(a)* read with section 36(7*E*) and (7*F*) of the Act can be relied on for the deduction of interest incurred in financing shaft-sinking and mine equipment? This question is addressed in Chapter two of the study. The second question is, if not by section 15*(a)* read with section 36*(*7*E)* and *(*7*F)*, in terms of which provisions in the Act can interest incurred in financing shaft sinking and mine equipment be deducted? This question is addressed in Chapter three of the study.

In Chapter two, the study found that in order to benefit from the redemption of mining capital expenditure provided for in section 15(*a*) read with section 36(7*E*) and 36(*7F*), a person must: (i) be conducting mining operations; and (ii) the expenditure sought to be deducted must be capital expenditure falling within the definitions in section 36*(11)(a)* to *(f*). The study, however, found that interest incurred by a person conducting mining activities to finance shaft-sinking and mining equipment is not engaged in capital expenditure. Accordingly, such interest cannot be determined or quantified under section 36(*7E*) and (7*F*) and deducted in terms of section 15(a).

Comparatively, in Botswana interest incurred before commencement of operations and when operations are suspended, constitutes mining capital expenditure. This interest would be interest incurred to finance shaft-sinking and mining equipment because that expenditure is generally incurred before commencement of mining operations and is necessary for the development of the mine. Accordingly, in terms of the Botswana Income Tax Act,[79] the interest is deductible under section 43(1) – provision governing the redemption of mining capital expenditure.

Although all expenditure wholly, exclusively, and necessarily incurred in the production of income is deductible under section 39(2), interest expenditure to finance shaft-sinking and mining equipment cannot be deducted under section 39(2). It is specifically

[79] CAP:52-01.

provided for under section 43(1). Additionally, the mine is not producing income before it commences operations.

In Chapter three the study found that the interest incurred to finance shaft-sinking and mine equipment can be deducted in terms of section 11(*a*) or section 24(J)(2) of the Act. In order to deduct interest in terms of section 11*(a*), it must have been incurred in the production of income and must not be of a capital nature. It was clearly stated in *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* by Corbet JA that where a taxpayer's purpose in borrowing money upon which it pays interest is to secure a means of earning income, the interest paid on the money so borrowed is *prima facie* an expenditure in the production of income.[80] *ITC 1604* supports the view that once expenditure has been found to be in the production of income, it follows that it is revenue in nature. Despite these authorities, there is no general standard on which it can be established whether the expenditure is in the production of income and is not of a capital nature, each matter must be considered on its own merits.

In Chapter Three it was also found that section 24(J)(2) has three key requirements: (i) there must be an issuer of an instrument; (ii) income must be derived from carrying on trade by that issuer; and (iii) the amount incurred as interest must have been incurred in the production of income. Although section 24(J)(2) has different requirements, the requirement that interest must be incurred in the production of income is identical to section 11*(a*). The authorities applicable to this aspect as regards section 11*(a)* apply equally to section 24(J)(2). There is no requirement in section 24(J)(2) that interest incurred must not be of a capital nature, thus section 24(J)(2) offers certainty in the deduction of interest incurred to finance shaft-sinking and mine equipment. I say this because it would be easier for a taxpayer to meet the requirements of section 24(J)(2) than those of section 11(*a*). The taxpayer merely has to show that it is conducting trade (mining operations in this case), and that interest was incurred in the production of income in that trade. This excludes the need to show that the interest is not of a capital nature as is required by section 11(*a*). This is the requirement which distinguishes section 11(a) and 24(J)(2).

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80 *CIR v Standard Bank of SA Ltd* 1985 (4) SA 485 (A) 489F-G.

4.2 Recommendations

The findings reveal that there is a gap in the provision dealing with redemption of mining capital expenditure, the reason is that deduction of interest incurred to finance shaft sinking and mining equipment has to be deducted on the basis of a provision other than section 15(*a*) read with section 36(7*E*) and 36(7*F*) of the Act. This interest is concomitant to mining or mining operations and I see no reasons why it has been excluded from the definition of capital expenditure – when regard is had to the provisions of section 36(11)(*b*).[81]

A shaft sunk and mining equipment acquired are used for mining operations and are instrumental in the generation of mining income. Therefore, interest incurred to finance these assets should be included under capital expenditure. Although it has been found that the interest can be deducted in terms of section 11(*a*) or 24J(2), the benefits under section 15(*a*) are lost because the income from which the interest would be deducted would be non-mining income. This is because capital expenditure under section 15(*a)* is deductible against mining income. This means that if the interest in a particular year of assessment is greater than the income, there is a loss which would be dealt with in terms of section 20(1)(*b)*[82] of the Act, and the benefit of immediate redemption of capital expenditure is lost.

Where mining income exceeds capital expenditure deductible in terms of section 15(*a*), the loss resulting from the interest and rolled over for deduction under section 20(1)(*b*), would result in a higher taxable income from mining income. In my view, this defeats the object of the special capital redemption provisions – had interest incurred to finance shaft sinking been included in the capital expenditure all expenditure concomitant to mining operations would effectively reduce taxable mining income thus improving returns of investors. Additionally, investors in mining would benefit from the inclusion of interest in that as large sums of capital are borrowed, naturally interest incurred on such amounts would be substantial. Mining income is usually substantial, there would thus be certainty that all capital expenditure and all accessory expenditure are fully taken into account, instead of relying on non-mining income which is usually insignificant for mining companies.

81 Interest and any other charges on loans used for mining purposes and payable after 31 December 1950 constitutes interest.

82 For purposes of determining the taxable income derived by any person from carrying on trade, there shall, subject to s 20A, be set off against the income so derived by such person – (b) any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company whereof the capital is divided into shares.

The SARS has issued no practice note which would lead to a different application of the legislation as it stands. It is patently clear that interest incurred to finance shaft sinking and acquisition of mining equipment is not capital expenditure. Even if one could argue that there is some ambiguity in the interpretation of the definitions of capital expenditure, the *contra fiscum* rule would not apply because an interpretation which would include interest in section 36(11)(*a*) cannot arise on the plain reading of the definition.

An amendment to section 36(11)(*a*) to remove the exclusion of interest or finance charges relating to shaft-sinking and mining equipment is recommended. The amendment would bring about certainty and equality of treatment for all forms of mining capital expenditure. Disappointingly, the recommendations of the Davis Tax Committee Report on Hard Rock Mining does not propose the amendment of section 36(11) (*a*) as suggested. On the contrary, it proposes that the existing mining tax regime for redemption of capital expenditure be scrapped and replaced with capital expenditure redemption in the ratio of 40:20:20:20 over four years. This will result in mine operators paying more tax on mining income because 60 per cent in year one, 80 per cent in years two, three and four of that income will be taxable.

The interest contemplated in section 24(J)(1) includes finance-related charges such as raising fees, default interest, administration costs, and service fees. Interestingly, there is no requirement that the interest must be non-capital in nature provided that it was incurred in the production of income and there is a loan agreement (oral or in writing) between a debtor and a creditor, the requirements of section 24(J)(2) will have been met. It is therefore recommended that persons conducting mining operations should structure loans around the provisions of section 24(J)(2) to allow the deduction of interest incurred to finance shaft-sinking and mining equipment. Mine operators who subscribe to Islamic law can use section 24JA's diminishing *musharaka* and *murabaha* arrangements to secure a deduction under section 24J(2).

4.3 Closing remarks

The existing mining tax regime for redemption of mining capital expenditure has a substantial gap, as discussed above in my recommendations. This has the effect of increasing mining taxable income in that it does not qualify as capital expenditure for the purposes of sections 15(*a*) and 36(11). Additionally, the legislation is confusing as it requires taxpayers to rely on provisions outside of the mining tax regime – ie, sections 11(*a*) or 24J read with section 24JA.

In my view, the foregoing reveals a breach of the tax canons of inconvenience and certainty in the following respects. Taxpayers are not able to rely on section 15(*a*) to deduct all expenditure relating to mining income and with ease obtain upfront deduction of capital. This is an inconvenience to investors and the Income Tax Act offers no certainty as to whether mining interest paid will indeed be permitted as a deduction under non-mining income.

In the event that the reforms to the mining tax regime as suggested by the Davis Tax Committee Report on Hard Rock Mining are implemented in their present form or amended, a further study will be necessary. Such a study would investigate whether interest incurred in financing shaft-sinking and mining equipment is included in the capital expenditure deductible as per the proposed 40:20:20:20 formula.

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