Mining tax changes must not scare off investors

By Owen Murphy, Africa Desk Leader at BDO

The Davis Tax Committee issued its second and final report on Hard-Rock Mining in late 2016, which has generated much debate in the industry. The report is advisory, and was submitted to the Finance Minister for consideration during law-making, subject to the normal consultative process.

The committee's recommendations around how the mining industry should be taxed are informed by the principal of sectoral neutrality and aim to remove the favourable mining tax capital deduction regime that has been in place since the 1940s.

The goal of the deduction regime was to encourage investment in new mining ventures, reduce the cost of extraction and to obviate the administrative difficulties involved in distinguishing between capital expenditure and working costs.

The system was restricted to some extent in 1984 with the introduction of a system of ring-fencing that restricts the deduction of capital expenditure to mining income on a mine-by-mine basis.

The Davis Committee's sectoral neutrality approach would see the immediate 100 percent deduction of mining capital expenditure from income for tax purposes being replaced.

Currently, 100% of capital expenditure can be written off against taxable income from mining operations in the year it is incurred, (subject to the ring-fencing requirements). In other industries, such as manufacturing, companies can deduct 40% of the cap-ex in year one, 20% in year two, 20% in year three and 20% in year four.

The report introduces uncertainty into the industry. While it expresses the view that tax design has little impact on investor sentiment, it represents another straw on the camel's back for an industry facing shrinking margins, a high legislative burden and a reduction in investment despite the thousands it employs.

If implemented, the recommendations mean tax payments on profitable mines will be accelerated, which means less cash available for new capital expenditure.

If mines become less profitable, and there are fewer dividends on the table, the return on equity for mining becomes less attractive. Investors who would have invested in mines will invest elsewhere.

A counterargument to this, put to the Davis committee, was that the 100% allowance is generous by international norms. This is true, but the rationale is that it attracts investors.

With the proposed new regime, there are definitions that need to be clarified. There may be a debate around "stay in business" capital expenditure or repairs, which may occur in year three, for instance, and genuine capital expenditure.

Current ring-fencing policy means what is spent on one mine can't be used as a tax deduction against another mine. The report proposes doing away with ring-fencing, to compensate for the removal of the 100% tax deduction. However, the days of one company having more than one large mining operation are becoming less prevalent. The lack of ring-fencing may become relevant in empowerment deals, but only if these are shareholding based.

The proposals will introduce a lot of administrative complexity. It will also require some detailed legal drafting to ensure there aren't disputes down the line.

It's possible that the new regime, if implemented, may threaten the viability of future projects.

Mining projects that run for five to 10 years rely to a great extent on being able to use free cash for investment. With less cash available, these companies will then have to borrow locally, or from an overseas parent, where currency risk becomes an issue.

This is a policy decision that will have a short-term negative impact on current projects and a long-term negative impact on future projects.

South Africa continues to sit on trillions of rands in mineral resources. As a country, we will only be able to benefit from these assets while it is more viable to invest our mines than in opportunities elsewhere on the planet.

The Davis Committee has made their recommendation, and it seems the principle of sectoral neutrality has held sway. However, before implementing these recommendations, and changing the fundamental tenets of the mining capex deduction system, we should consider all the implications.

South Africa's mineral bounty is a golden goose. While the proposed new mining tax regime might not kill that goose, we need to ask ourselves, do we want that goose to lay ten eggs, or just two?