SOUTH AFRICA - MINING AND PETROLEUM ROYALTIES - THE IMPOSITION AND CALCULATION

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The imposition of mineral and petroleum royalties ("mining royalties") in South Africa commenced on 1 March 2010[1] The Mineral and Petroleum Resources Royalty Act 28 of 2008 (the "Royalty Act") regulates the imposition and calculation of mining royalties. Mining royalties are deductible for income tax purposes.

Basic Structure of Royalty Regime

In South Africa the liability to pay mining royalties arises when mineral resources which have been *extracted* from within the Republic, are *transferred.* The *'transfer'* of the mineral resources is the trigger for the imposition of the royalty.

'Transfer' is defined as the disposal of a mineral resource, or the consumption, theft, destruction, or loss of a mineral resource (other than by way of flaring or other liberation into the atmosphere during exploration or production) if that mineral resource has not previously been disposed of, consumed, stolen, destroyed or lost. Because mineral resources are often temporarily exported for refining, the temporary export of mineral resources is not regarded as a *transfer*.

The term "*mineral resource"* includes prospecting rights for minerals, exploration rights for petroleum, mining permits, retention permits or mining rights for minerals, and production rights for petroleum issued under the MPRD Act. The Royalty Act distinguishes between a 'refined mineral resource' and 'unrefined mineral resource':

- A <u>refined</u> mineral resource is a mineral resource which is solely listed in Schedule 1 of the Royalty Act; or a dual listed resource, which is listed in Schedule 1 and Schedule 2, and has been refined to or beyond the condition specified in Schedule 1 for that mineral

[1] The Mineral and Petroleum Resources Development Act 28 of 2002 ('the MPRD Act') allows the State, as custodian of South Africa's mineral and petroleum resources, to impose royalties on the transfer of mineral resources.

resource. Examples of refined minerals are gold (processed to at least 99.5% purity), platinum group metals (processed to at least 99.9% purity), copper (processed to at least 99% purity) and oil and gas resources at the inlet of the refinery.

- An unrefined mineral resource is a mineral resource which is listed solely in Schedule 2 of the Royalty Act; or a dual listed mineral resource (ie a mineral resource listed in Schedule 1 and Schedule 2) that fails to meet the condition specified in Schedule 1 for that mineral resource. Examples of what constitutes unrefined minerals include coal of specified grades, rough diamonds, 80% uranium oxide in the uranium concentrate sold, concentrates and bulk.

Calculation of the royalty

The formulae which have to be applied to perform the royalty calculation distinguish between refined and unrefined mineral resources and use two variables to calculate the royalty liability:

- the value of the minerals (the tax base) and
- a royalty percentage rate (calculated in a prescribed manner) which is applied to the base.

Royalties are capped and cannot exceed 5% for refined mineral resources and 7% for unrefined mineral resources.

The royalty payable in relation to a *refined* mineral resource is determined by multiplying the gross sales of the extractor (of that mineral resource) by a percentage/rate which is calculated by applying a formula specified in section 4(1) of the Royalty Act.

Similarly the royalty payable in respect of *unrefined* mineral resources is calculated by multiplying the extractor's gross sales (of that mineral resource) by the percentage or rate which is calculated by applying the formula in section 4(2) of the Royalty Act.

These formulae described below, contain four parameters:

- the intercept term, 0.5 (%), which acts as a minimum charge to ensure that the Government (as custodian) always receives some level of royalty payments for the permanent loss of non-renewable resources;

- earnings before interest and taxes ("EBIT") (a concept which is prescribed in detail in s 5 of the Royalty Act);
- gross sales;
- constants of either 9 or 12.5, depending on whether the mineral resource is refunded or unrefined (these constants are aimed at neutralising the differences between refined and unrefined mineral resources. Refined mineral resources have higher gross sales and therefore a higher tax base than unrefined minerals because more value addition occurs as minerals are refined. The higher 12.5 constant which applies to refined mineral resources, seeks to offset this higher base).

The effect of the formulae is that the royalty percentage rate (which has to be applied to the tax base) varies according to the profitability of a mine.

For *refined* mineral resources the formula to determine the percentage or rate (which has to be applied to the tax base) is:

0.5 + [EBIT / (gross sales in respect of refined mineral resources x **12.5**)] x 100.

For *unrefined* mineral resources the formula to determine the percentage or rate (which has to be applied to the tax base) is:

0.5 + [EBIT / (gross sales in respect of unrefined mineral resources x **9**)] x 100.

The Royalty Act prescribes what EBIT may include and what EBIT has to exclude, when applying the formula.

Earnings Before Interest and Taxes

Earnings before interest and taxes ('EBIT') is one of the key components (the numerator) of the rate formula presented for the calculation of the royalty. Section 5 of the Royalty Act prescribes what constitutes EBIT - the intention of this provision is to identify the earnings attributable to the winning and recovery of mineral resources up to its first saleable point. EBIT measures an extractor's net operating profits from mining and does not include taxes and other charges.

The Explanatory Memorandum to the Royalty Act confirms that –

- EBIT is meant to measure an extractor's net operating mining profits in relation to mineral resources extracted and transferred;
- EBIT contains three elements: (a) gross sales, (b) recoupments; and (c) deductions (expenses);
- EBIT is the aggregate of -

  (a) Gross sales for all transferred mineral resources,

  Plus

  (b) Recoupments from the disposal of assets used to develop mineral resources, to the extent the depreciation of those assets offset EBIT, or taken into account as capital expenditure.

  Less

  (c) Operating expenditure incurred and depreciation allowances claimed on capital expenditure, relating to the extraction and development of mineral resources, if the expenditure is deductible under the ITA and brings the mineral resources to a Schedule 1 (or Schedule 2 if applicable) condition.

Operating expenditure and capital expenditure are potentially deductible in the year incurred, even if the gross sales in respect of the mineral resources are only received or accrued in a subsequent year. Deductions are only permitted if they contribute towards bringing the mineral resources to their Schedule 1 and Schedule 2 conditions.

Capital expenditure which falls *within t*he scope of EBIT includes:

(a) depreciation allowances as provided for in s 36 (fixed mining capital expenditure);

(b) capital expenditure in terms of the Tenth Schedule (fixed oil and gas capital expenditure); and

(c) depreciation allowances in terms of ss 11(e) and 12C of the Income Tax Act ("ITA) (for general equipment, plant and machinery expenditure).

The following amounts are *excluded* from the determination of EBIT:

(a) Any deduction in respect of financial instruments as defined in the ITA (other than option contracts, forward contracts or other instruments, the value of which is derived directly or indirectly with reference to mineral resources). Interest deductions from debt and the cost of carrying derivatives are not deductible, but the costs from mineral resource hedges (forward contracts) are deductible, because these hedges act as an economic offset against mineral resource gross sales;

(b) Deductions allowed in terms of section 11(a) of the Income Tax Act in respect of the royalty. As stated, the royalty is deductible for income tax purposes, but the royalty is not allowed to be deducted from EBIT.

(c) Transport, insurance and handling costs of mineral resources incurred after refinement to the condition or stated in Schedule 1 or 2 and for purposes of disposal.

(d) Any balance of assessed loss mentioned in sec 20 of the Income Tax Act, unless the balance of the assessed loss arose in respect of capital expenditure taken into account for purposes of determining the taxable income of an oil and gas company in terms of para 5 of the Tenth Schedule in respect of exploration or production.

(e) Deductions allowed in terms of section 24I of the Income Tax Act, on foreign exchange transactions.

(f) Any determination in respect of an impermissible tax avoidance arrangement contemplated in Part IIA of the Income Tax Act.

(g) Any deductions for capital expenditure incurred in the exploration for, and production of, an oil and gas right (ie cost uplifts).

If EBIT is negative, it is deemed to be nil.

Gross Sales: The royalty base

The royalty formulae also require gross sales to be taken into account. Separate gross sales calculations for refined and unrefined mineral resources have to be performed[2]. Gross sales calculations are not performed mineral by mineral or category by category. All refined mineral resources transferred by an extractor have to be aggregated for purposes of the gross sales calculation, and similarly all unrefined mineral resources have to be aggregated.

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[2] Section 6 of the Royalty Act.

When determining the gross sales value, the condition in which the mineral resource is transferred is relevant.

Where a *refined* mineral resource is disposed of (para *(a)* of the definition of transfer):

- ***in*** the specified condition, the gross sales value is the amount received or accrued during the year of assessment in respect of the transfer of that mineral resource;
- in a condition ***different to*** the specified condition, the amount that would have been received or accrued during the year of assessment in terms of a transaction entered into at arm's length, had the mineral resource been transferred at the specified condition, constitutes the gross sales.

Where a *refined* mineral resource is consumed, stolen or destroyed, (para *(c)* of the definition of 'transfer') the gross sales value is the amount that would have been received or accrued during the year of assessment had that mineral resource been transferred in the condition specified in Schedule 1 for that mineral resource in terms of an arm's length transaction.

Where an *unrefined* mineral resource is disposed of (para *(a)* of the definition of transfer):

- ***in*** the condition specified for that mineral resource in Schedule 2, the gross sales value is the amount received or accrued during the year of assessment in respect of the transfer of that mineral resource;
- in a condition ***different to*** the condition specified in Schedule 2, the gross sales value is the amount that would have been received or accrued during the year of assessment in terms of a transaction entered into at arm's length, if the mineral resource had been transferred at the condition specified in Schedule 2.

Where an *unrefined* mineral resource is consumed, stolen or destroyed, (para *(c)* of the definition of 'transfer'), the gross sales value is the amount that would have been received for that transfer in a comparable arms length transaction, had that mineral resource been transferred in the condition specified in Schedule 2.

The gross sales value does not take into account:

- any amount received or accrued in respect of transport, insurance and handling costs of a mineral resource after that mineral resource was refined to the condition specified for that mineral resource; or

- any amount received or accrued for the disposal of that mineral resource.

Where the amount in respect of the transfer of a refined or an unrefined mineral resource cannot be quantified, the amount that would have been received for that transfer in a comparable arms length transaction will constitute the gross sales value.

The legislation also allows for the adjustment of the gross sales value, where the amount accrued differs from the amount received.

Generally, the Royalty Act seeks to ensure a minimum level of beneficiation for refined and unrefined mineral resources. It does this by specifying the condition at which mineral resources should be transferred. Where a mineral resource is transferred outside the condition stated the legislation makes provision for a rational adjustment (up or down). Where a mineral resource is transferred *above* the specified condition, both gross sales and expenditure are notionally reduced in line with the notionally specified condition. Where a mineral resource is transferred *below* the specified condition, the legislation now provides for the notional upliftment of the expenditure. This upliftment of expenditure will apply even where the mineral has a range of specified conditions. In such a case, the expenditure is adjusted upwards to reflect the specified condition at the bottom of the range.

Unrefined mineral resources that fall outside the specified range should be treated as follows:

(a) If the unrefined mineral resource is developed to a level falling within the specified condition, the actual value upon transfer of the mineral resource can be used;

(b) If the unrefined mineral resource is developed to a level falling above the specified condition, the mineral resource must be treated as having been transferred at the higher of the minimum condition specified for that mineral resource;

(c) If the unrefined mineral resource is developed to a level falling below the range, the mineral resource must be treated as having been brought up to the minimum condition specified and a notional adjustment up to the bottom end of the range has to be made.

Unrefined mineral resources are sometimes transferred with ancillary mineral resource by-products, which in terms of the current provisions of the Royalty Act, must be treated separately for purposes of the Royalty Act. Although Platinum Group Metals (PGM's) are listed as an unrefined mineral resource, the group consists of several mineral resource by-products which are all treated as part of the PGMs for purposes of the unrefined (Schedule 2) mineral resources calculation. The separation of by-products creates a significant compliance burden, as the actual value of the by-products is difficult to quantify. Where unrefined mineral resources are transferred with by-products, the specified condition will only apply to the main mineral resource and the by-products will be viewed as part and parcel of the dominant mineral resource transferred. However, practical difficulties are encountered regarding the distinction between the respective concentrate conditions specified and the provision dealing with this aspect, is considered to be of limited application in its current form.

Exemptions

Extractors who win or recover mineral resources for testing, identification, analysis and sampling are exempt from paying royalties, provided that the gross sales in respect of the mineral resources do not exceed R100 000 during a year of assessment.

An exemption for domestic refining has the effect of granting rollover relief to registered extractors. Many small and medium-sized extractors cannot refine a mineral resource to completion, and they often sell their mineral resources to other extractors to refine. To benefit from the relief offered, the transfer of the mineral resource must be done via a written agreement concluded between the transferor and transferee, in which the parties agree that rollover relief applies to the transaction. The transferee is then treated as the person who had won or recovered the mineral resource. In effect the royalty obligation is deferred and 'rolls over' to the transferee.

Fiscal Stability Agreements

Extractors can obtain long term fiscal stability in respect of royalty liability calculations for the duration of their mining rights. The Minister of Finance can conclude binding fiscal stability agreements with an extractor in respect of an extractor's mineral resource right or in anticipation of the extractor acquiring a mineral resource right.

These fiscal stability agreements guarantee that certain terms and conditions apply in respect of the right, as long as the extractor holds the rights. Fiscal stability agreements stabilise the rate formulae and if legislative amendments occur that result in a higher royalty becoming payable, such legislative amendments will have no force and effect in cases if a fiscal stability agreement already exists. If the State breaches the terms of the fiscal stability agreement, and the failure has an adverse economic effect on the determination of the royalty payable by the extractor who is a party to the fiscal stability agreement, the extractor is entitled to compensation or to an alternative remedy that eliminates the impact of the State's failure. An extractor is also entitled to unilaterally terminate a fiscal stability agreement at any time.

Fiscal stability agreements are limited to certain mineral resource rights, eg prospecting rights, exploration rights, mining rights and production rights granted in terms of the MPRD Act and also exploration and production for petroleum.

Binding fiscal stability agreements may be assigned by the extractor to another person who is acquiring the prospecting right or exploration right from the extractor. The right to assign prospecting or exploration rights is open ended and fiscal stability agreement relating to *prospecting or exploration rights* can be freely assigned.

However, fiscal stability protection for MPRD Act *mining or production rights* can only be assigned in limited circumstances, ie if both the extractor and the other person form part of the same group of companies as defined in the Income Tax Act on the date of disposal.

A binding fiscal stability agreement relating to the anticipated acquisition of a mineral resource right has no force and effect unless that mineral resource right is granted within one year after date of conclusion of the fiscal stability agreement.