

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

**THE TAXATION OF OIL AND GAS EXPLORATION AND  
PRODUCTION IN SOUTH AFRICA**  
**A CRITICAL COMPARISON OF THE OP26 AND TENTH SCHEDULE TAX REGIMES**

**ALISON JANE FUTTER**

**SMTALI008**

A full dissertation submitted in fulfilment of the requirements for the degree of Master of Commerce: Taxation in the Department of Accounting, University of Cape Town.

Supervisor: Dr Craig West

Co- Supervisor: Adv David Clegg

August 2010

## ACKNOWLEDGEMENTS

This dissertation would not have been possible without the guidance of my supervisor, Dr Craig West. Craig your encouragement and positive criticism of each revision proved invaluable. You challenged me to improve not only style, presentation, grammar and spelling, but my entire approach to the dissertation. You were brave enough to suggest rewriting more than once, which is exactly what was needed. Your meticulous review of my work, your academic artistry and astuteness were just the inspiration that I needed to complete this dissertation. Thank you.

I would also like to express my gratitude to my co-supervisor, Adv David Clegg. David you prompted me in the right direction with your commentary and suggestions. And whilst our interpretation of the legislation might differ in relation to the continuance of “unredeemed capital expenditure” under the Tenth Schedule, your review of my work provides the calming assurance of its technical accuracy. In my books you are and always will be the “guru” on OP26 and the Tenth Schedule. It was always a rewarding learning experience to work under your mentorship. Thank you.

I am indebted to my employer, the Petroleum Oil and Gas Corporation of South Africa (Pty) Ltd for financing my research, and providing unhindered access to the information resources including the OP26 leases.

Finally, I wish to thank my husband, Denis for his support and the time that he afforded me to work on this dissertation. Denis only you truly understand me and the madness of a woman possessed by her dissertation.

## **KEYWORDS**

South Africa

Income Tax

Corporate Tax

Mining company

Exploration and production

Prospecting and mining

Hydrocarbons

Oil and Gas

OP26

Tenth Schedule

University of Cape Town

## ABSTRACT

As a consequence of the secrecy surrounding South African oil exploration during the apartheid era, and the highly specialised nature of the industry, the specifics of the special OP26 rules were largely unknown to the revenue authorities and tax practitioners, other than those closely involved in the industry (Clegg & Steenkamp, 2007: 1).

This dissertation provides a clear exposition of difficult legal tracts of the Income Tax Act, OP26 prospecting leases, OP26 mining leases and OP26 prospecting sub-lease agreements and the Tenth Schedule of the Income Tax Act. A study of the interpretational rules applicable to fiscal legislation and the surrounding literature, analysis and interpretation of the commentary, case law, tracts of the legislation and OP26 lease agreements provide a clear understanding of the historical and current corporate taxation of the exploration for and production of oil and gas in South Africa.

The dissertation evaluates whether the Tenth Schedule achieves the aim of greater transparency and standardization and tests the hypothesis that companies engaged in the exploration and production of oil and gas enjoy the same, if not more favourable, tax dispensation under the Tenth Schedule than under the OP26 regime.

Following the introductory chapter, the remainder of the dissertation is set out below. Chapter 2 explains the OP26 and the Tenth Schedule regimes. The chapter further considers transparency and standardisation in relation to the OP26 regime compared with the Tenth Schedule regime. The dissertation tests the purpose of transparency and standardisation against anti-avoidance and consistent interpretation. Chapter 2 concludes that the Tenth Schedule does not in all circumstances afford greater transparency and standardisation particularly in relation to fiscal stability agreements. Chapter 3 provides the comparison of the original OP26 prospecting lease, OP26 mining lease and OP26 prospecting sub-lease agreements and the tax treatment under these lease agreements (referred to generically as the OP26 regime), to the tax

treatment under the Tenth Schedule to identify their similarities. The conclusion drawn is that the Tenth Schedule offers tax benefits to oil and gas companies that are comparable to the OP26 regime. Chapter 4 examines the primary concerns of existing investors in the upstream oil and gas sector in relation to the taxation of the exploration for and production of oil and gas in South Africa. The interpretational issues are discussed and possible amendments to the Tenth Schedule that may be required are identified. The finding is that not all of the core aspects of the OP26 regime have been fully preserved by the Tenth Schedule, specifically Fiscal Stability.

The dissertation concludes in chapter 5 with a summary of the findings from the preceding chapters, postulates the interventions and corrective action that the revenue authorities may take and makes suggestions for future research topics.

August 2010

## DECLARATION

I, Alison Jane Futter, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole or any part of it has been, is being, or is to be submitted for another degree in this or any other university.

I authorise the University to reproduce for the purpose of research either the whole or any portion of the contents in any manner whatsoever.

Signature: .....

Date: 13 August 2010

University of Cape Town

## CONTENTS

ACKNOWLEDGEMENTS .....	ii
KEYWORDS .....	iii
ABSTRACT .....	iv
DECLARATION.....	vi
CONTENTS .....	vii
ABBREVIATIONS .....	xi
GLOSSARY .....	xii
CHAPTER 1 – INTRODUCTION.....	1
1.1 Background .....	1
1.2 Research Hypothesis .....	3
1.3 Research Methodology.....	3
1.4 Scope of the Dissertation.....	3
1.5 Dissertation structure.....	4
CHAPTER 2 – TRANSPARENCY AND STANDARDIZATION.....	6
2.1 Introduction .....	6
2.2 Understanding the OP26 regime.....	6
2.3 Understanding the Tenth Schedule regime.....	8
2.4 Transparency .....	8
2.4.1 Lack of Transparency under the OP26 regime.....	8
2.4.2 Transparency under the Tenth Schedule regime .....	8
2.4.3 Purpose of Transparency .....	9
2.5 Standardization .....	12
2.5.1 Lack of Standardization under the OP26 regime .....	12
2.5.2 Standardization under the Tenth Schedule regime.....	13
2.5.3 Purpose of standardization .....	15
2.6 Conclusion .....	18
CHAPTER 3 – SIMILARITIES BETWEEN THE OP26 REGIME AND THE TENTH SCHEDULE REGIME.....	19
3.1 Introduction .....	19
3.2 Tax rates .....	20
3.2.1 Introduction.....	20

3.2.2 Tax rates under OP26 regime.....	21
3.2.3 Tax rates under the Tenth Schedule regime.....	21
3.3 Secondary Tax on Companies (“STC”).....	22
3.3.1 STC under the OP26 regime.....	22
3.3.2 STC under the Tenth Schedule regime.....	23
3.3.3 Legislative changes with regard to the taxation of dividends.....	24
3.4 Capital Gains Tax (“CGT”).....	24
3.4.1 CGT under the OP26 regime.....	25
3.4.2 CGT under the Tenth Schedule regime.....	25
3.5 Ring-fencing.....	26
3.5.1 Ring-fencing under the OP26 regime.....	26
3.5.1.1 <i>Ring-fencing by industry</i> .....	26
3.5.1.2 <i>Ring-fencing by mine</i> .....	27
3.5.2 Ring-fencing under the Tenth Schedule regime.....	27
3.6 Foreign Exchange Gains and Losses.....	28
3.6.1 Foreign Exchange Gains and Losses under the OP26 regime.....	28
3.6.2 Foreign Exchange Gains and Losses under the Tenth Schedule regime.....	29
3.7 Customs Duties.....	30
3.7.1 Customs duties under the OP26 regime.....	30
3.7.2 Customs duties under the Customs and Excise Act.....	31
3.8 Value Added Tax (“VAT”).....	31
3.8.1 VAT under the OP26 regime.....	31
3.8.2 VAT under the Tenth Schedule regime.....	32
3.9 Deductions.....	32
3.9.1 Deductions under the OP26 regime.....	33
3.9.1.1 <i>Operating expenses</i> .....	33
3.9.1.2 <i>Prospecting capital expenditure</i> .....	34
3.9.1.3 <i>Mining capital expenditure</i> .....	38
3.9.1.4 <i>Refining capital expenditure</i> .....	41
3.9.2 Deductions under the Tenth Schedule Regime.....	42
3.9.2.1 <i>Operating expenses</i> .....	42
3.9.2.2 <i>Exploration and Production capital expenditure</i> .....	42
3.9.2.3 <i>Refining capital expenditure</i> .....	43
3.9.2.4 <i>Operator cost recoveries</i> .....	45
3.10 Thin Capitalisation and Transfer Pricing.....	47
3.10.1 Introduction.....	47

3.10.2 Transfer Pricing and Thin Capitalisation under the OP26 regime .....	48
3.10.3 Transfer Pricing under the Tenth Schedule regime .....	48
3.10.4 Thin Capitalisation under the Tenth Schedule regime .....	50
3.11 Conclusion .....	52
CHAPTER 4 – SIGNIFICANT DISTINCTIONS BETWEEN THE OP26 REGIME AND THE TENTH SCHEDULE REGIME .....	54
4.1 Introduction .....	54
4.2 Fiscal Stability .....	55
4.2.1 Introduction .....	55
4.2.2 Fiscal stability under the OP26 regime .....	56
4.2.3 Fiscal stability under the Tenth Schedule regime .....	57
4.3 Ring-fencing .....	62
4.3.1 Introduction .....	62
4.3.2 The meaning of oil and gas income .....	64
4.3.3 Investment income .....	65
4.4 Additional deductions for capital expenditure.....	68
4.4.1 Introduction .....	68
4.4.2 Unredeemed capital expenditure.....	69
4.4.3 Tenth Schedule additional capital allowances.....	69
4.4.4 The treatment of pre Tenth Schedule capital expenditure.....	70
4.5 Disposal of oil and gas rights .....	77
4.5.1 Introduction .....	77
4.5.2 Taxation of farm-in/farm-out proceeds/expense under the OP26 regime .....	78
4.5.2.1 <i>OP26 regime</i> .....	78
4.5.2.2 <i>Current Income Tax Act</i> .....	79
4.5.3 Taxation of the disposal of an oil and gas right under the Tenth Schedule regime .....	79
4.5.4 Interpretational issues.....	81
4.6 Conclusion .....	84
CHAPTER 5 – CONCLUSION .....	86
5.1 Context .....	86
5.2 Summary of findings .....	87
5.3 Envisaged interventions by the revenue authorities .....	88

5.4 The benefit of this research .....	90
5.5 Suggestions for future research .....	90
ANNEXURES .....	92
ANNEXURE A Tables.....	92
Table 1. OP26 Prospecting Lease v OP26 Mining Lease .....	92
Table 2. Similarities between the OP26 regime and the Tenth Schedule regime .....	94
Table 3. Petroleum Contracts: Fiscal Stability Clauses.....	95
ANNEXURE B Memorandum of Agreement.....	96
ANNEXURE C Illustration of the impact of the Tenth Schedule elections.....	100
ANNEXURE D Example of the application of the unredeemed capital expenditure allowance .....	107
BIBLIOGRAPHY.....	112
PUBLISHED REFERENCES .....	112
UNPUBLISHED REFERENCES .....	115
LEGISLATION .....	116
EXPLANATORY MEMORANDUMS .....	117
SARS PUBLICATIONS .....	117
PROPOSALS TO NATIONAL TREASURY .....	119
COURT CASES .....	119

## **ABBREVIATIONS**

CFC	Controlled foreign corporation
CGT	Capital gains tax
CIPRO	The Company and Intellectual Property Registrar's Office of South Africa
DTA	Double Taxation Agreement
GAAR	General anti-avoidance rule
ITA	The Income Tax Act, No 58 of 1962 as amended
JOA	Joint Operating Agreement
JV	Joint venture partnership
MPRDA	The Minerals and Petroleum Resources Development Act, No 28 of 2002
MOA	The Memorandum of Agreement guaranteeing the provisions of the 10 <sup>th</sup> Schedule
OECD	Organisation for Economic Cooperation and Development
OP26	A prospecting lease (or sublease) issued in terms of section 14(1)(b) of the Mining Rights Act, 1967 (no. OP26)
OPASA	The Offshore Petroleum Association of South Africa
POEM	Place of effective management
PSLA	OP26 Prospecting Sub-Lease Agreement
RLA Act	Revenue Laws Amendment Act, No 20 of 2006
SARS	The South African Revenue Service
STC	Secondary tax on companies
VAT	Value added tax
WHT	Withholding Tax

## **GLOSSARY**

Act	The Income Tax Act, No 58 of 1962 as amended
Commissioner	The Commissioner for the South African Revenue Service
Dry hole	An exploratory or development well found to be incapable of producing either oil or gas in sufficient quantities to justify completion as an oil or gas well.
Explanatory Memorandum	Explanatory Memorandum to the Revenue Laws Amendment Bill, 2006
Gas	Any subsoil combustible gas, consisting primarily of hydrocarbons, other than hydrocarbons converted from bituminous shales or other stratified deposits of solid hydrocarbons (such as coal)
Hydrocarbons	An organic compound consisting entirely of hydrogen and carbon
Mining block	A lease or a number of leases of adjoining tracts of land that constitute a unit of acreage sufficient to justify the expense of drilling an exploration or development well.
Mining Rights Act	The Mining Rights Act, No 20 of 1967
Minister	The Minister of Minerals and Energy Affairs
National Treasury	The National Treasury's legislative mandate is described in the Public Finance Management Act (Chapter 2). The National Treasury is mandated to promote government's fiscal policy framework; to coordinate macroeconomic policy and intergovernmental financial relations; to manage the budget preparation process; to facilitate the Division of Revenue Act, which provides for an equitable distribution of nationally raised revenue between national, provincial and local government; and to monitor the implementation of provincial budgets.

Offshore	The sea-bed and soil within the territorial waters and on the continental shelf of the Republic of South Africa
Oil	Any subsoil combustible liquid consisting primarily of hydrocarbons, other than hydrocarbons converted from bituminous shales or other stratified deposits of solid hydrocarbons (such as coal).
OP26 regime	The original OP26 prospecting lease, OP26 mining lease and OP26 prospecting sub-lease agreements, and the tax treatment under these lease agreements
SOEKOR	Suidelike Olie-Eksplorاسie Korporاسie (Eiendoms) Beperk.
Tenth Schedule	The Tenth Schedule to the Income Tax Act, No 58 of 1962
10 <sup>th</sup> Schedule	The Tenth Schedule to the Income Tax Act, No 58 of 1962

## **CHAPTER 1 – INTRODUCTION**

### **1.1 Background**

The hydrocarbon minerals industry (such as oil, gas and coal) has a number of special features which make it quite distinct from most other industries and other forms of economic activity. These differences relate to: size of investment, timescale, location, risk, cost of failure, size of reward, share of gross domestic product, level of employment, role of international markets and the non-renewable nature of hydrocarbon mineral resources.

Because of the distinctive features of the hydrocarbon mineral extraction industry a government is likely to formulate a specific tax policy (Andrews-Speed, 2000:1.5). Correspondingly, the taxation of revenues from crude oil and natural gas reserves in South Africa has been subject to rules that are significantly different from those applicable to other operations (including other resource operations such as mining). South Africa's investment regime for oil and gas exploration and production (prior to years of assessment commencing on or after 2 November 2006) was governed by the OP26 prospecting lease, OP26 mining lease and OP26 mining subleases, collectively known as "OP26". OP26 contained tax incentives that overrode the Income Tax Act, No 58 of 1962 (the "ITA" or the "Act"), including a tax stabilisation regime that "froze" the provisions of the Income Tax as at 1977 (Mitchell, 2007:228).

Clegg & Steenkamp (2007: 1) indicate that the reason for the special treatment of oil and gas exploration and production (in South Africa) is rather obvious. First of all, the discovery and production of oil and gas within a specific country's territory is usually of great strategic significance, since it may lead to the generation of substantial foreign revenue for the country, and also decrease the dependency of a country on external sources to satisfy its energy needs. Since the exploration for oil and gas is an extremely costly and a medium to long term exercise, governments have identified the need to make it attractive for local and global companies to invest in oil and gas exploration and production in their countries.

The most popular method to do this has consistently been to reward such companies with a beneficial tax regime. Countries with less favourable geological conditions normally offer better fiscal terms, while those perceived to have more potential offer tougher terms. Investment in hydrocarbon exploration will only occur if a combination of the fiscal terms, geological reality and the oil (or gas or mineral) price make it worthwhile to invest (Omar, 1998: 2).

The Explanatory Memorandum to the Revenue Laws Amendment Bill, 2006<sup>1</sup> states that despite being rich in many hard minerals, South Africa has not shared the same success in oil and gas reserves. Exploration over the past thirty years has revealed only small deposits offshore in the South and in the West. A few companies do, however, remain interested in the region, especially given recent oil prices.

In 2002, the new Minerals and Petroleum Resources Development Act, 28 of 2002 was promulgated. This Act proposes a departure from the existing oil and gas prospecting and mineral rights as contained in OP26.<sup>2</sup> OP26 leases that were in existence prior to the promulgation of this Act were to continue in force until terminated or expired or until June 2007, whichever occurred first.

In order to fill the vacuum created by the demise of the OP26, the National Treasury has negotiated and finalised a new tax regime, partially based on that of OP26. This new tax regime is known as the “Tenth Schedule regime”. Mitchell (2007: 228) notes that given the high risks and historically low rewards (in South Africa), if the key features of the OP26 regime were not renewed, few of the active companies would remain invested.

In addition to filling the void created by the demise of OP26, the Tenth Schedule to the Income Tax Act should ensure greater transparency and standardization of the beneficial tax incentives applicable to the upstream oil and gas industry (in South Africa) (Clegg and Steenkamp, 2007: 2).

---

<sup>1</sup> At 15.

<sup>2</sup> See chapter 6 of the Minerals and Petroleum Resources Development Act.

## **1.2 Research Hypothesis**

This dissertation evaluates whether or not: (a) the Tenth Schedule achieves the aim of greater transparency and standardization and (b) tests the hypothesis that companies engaged in the exploration and production of oil and gas enjoy the same, if not more favourable, tax dispensation under the Tenth Schedule than under the OP26 regime.

## **1.3 Research Methodology**

The research is qualitative in nature and follows the process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary, typical of doctoral research (McKerchar, 2008:18).

In this dissertation analysis is achieved through examination of the legal tracts of the Income Tax Act, OP26 prospecting leases, OP26 mining leases and OP26 prospecting sub-lease agreements (collectively known as “OP26”) and the Tenth Schedule of the Income Tax Act and the application of the interpretational rules applicable to fiscal legislation to identify the interpretational difficulties and the practical shortcomings of the OP26 and Tenth Schedule regimes. Furthermore the OP26 and Tenth Schedule regimes are compared to evaluate the impact of their similarities and differences on existing Oil and Gas Companies decisions to remain invested in South Africa. The dissertation also provides analysis and interpretation of the literature, commentary and case law to provide a clear understanding of the historical and current corporate taxation of the exploration for and production of oil and gas in South Africa for the benefit of possible new investors.

## **1.4 Scope of the Dissertation**

The scope of this dissertation is confined to the corporate income tax implications of the exploration for and production of oil and gas under a prospecting or mining lease to be converted from OP26, or granted under the MPRDA (namely South African oil and gas rights). In addition, the dissertation is restricted to the corporate income tax

implications of offshore exploration for and production of oil and gas as conducted within South Africa's territorial waters and on the continental shelf. The dissertation does not address the taxation of midstream and downstream oil and gas activities (such as refining and marketing, distribution and sales of petroleum products).

The dissertation is further limited to legal entities such a South African incorporated company (namely a South African tax resident) or the branch of a foreign company registered with CIPRO in South Africa (namely a non-resident for tax purposes) carrying out exploration for and production of oil and gas. The dissertation examines the South African corporate income taxation of such companies and branches. Other taxes, such as employees' tax and state royalties that are administrated by the Commissioner for the South African Revenue Service, are not dealt within the ambit of the dissertation. International tax considerations in relation to corporate income taxation; such as place of effective management ("POEM"), Transfer Pricing, Thin Capitalisation, Controlled Foreign Corporations ("CFC") and Double Taxation Agreements ("DTAs") including the definition of Permanent Establishment ("PE"), for the purpose of attribution of business profits are only considered where such aspects inform the South African tax considerations.

Finally the dissertation considers only those items of revenue and expenditure that are directly associated with the prospecting for and mining of oil and gas as dealt with in the OP26 regime and the Tenth Schedule. This examination of revenue and expenditure is limited to the corporate income taxation of these items in relation to the tax year of assessment ending in 2010/11.

### **1.5 Dissertation structure**

Following the introductory chapter, the remainder of the dissertation is as set out below. Chapter 2 explains the OP26 and the Tenth Schedule regimes. The chapter further considers transparency and standardisation in relation to the OP26 regime compared with the Tenth Schedule regime. The dissertation tests the purpose of transparency and standardisation in relation to anti-avoidance and consistent interpretation. Chapter 2 concludes that the Tenth Schedule does not in all

circumstances afford greater transparency and standardisation particularly in relation to fiscal stability agreements.

Chapter 3 provides the comparison of the original OP26 prospecting lease, OP26 mining lease and OP26 prospecting sub-lease agreements and the tax treatment under these lease agreements (referred to generically as the OP26 regime), to the tax treatment under the Tenth Schedule to identify their similarities. The conclusion drawn is that the Tenth Schedule offers tax benefits to oil and gas companies that are comparable to the OP26 regime.

Chapter 4 examines the primary concerns of existing investors in the upstream oil and gas sector in relation to the taxation of the exploration for and production of oil and gas in South Africa. The interpretational issues are discussed and possible amendments to the Tenth Schedule that may be required are identified. The finding is that not all of the core aspects of the OP26 regime have been fully preserved by the Tenth Schedule, specifically Fiscal Stability.

Chapter 5 summarises the findings from the preceding chapters, postulates the interventions and corrective action that the revenue authorities may take and makes suggestions for future research topics.

## **CHAPTER 2 – TRANSPARENCY AND STANDARDIZATION**

### **2.1 Introduction**

Research conducted in Ghana, Zambia, Tanzania, Sierra Leone, Malawi, DRC and South Africa shows that African governments are foregoing millions of dollars in tax revenue from the mining industry. This is largely because of overly generous tax concessions, usually granted discretionarily in secret mining contracts, as well as tax avoidance and illegal tax evasion practices by multinational mining companies. These losses are fuelled by a lack of transparency (Lambrechts et al., 2009:14).

Lambrechts et al. (2009:14) argues that transparent and balanced mining tax regimes, as opposed to secret tax deals with individual companies, are the best way to avoid corruption and assure citizens and investors that the rents from mining are being shared fairly.

Manuel (2006: 1) states that South Africa has a long history of tax incentives to attract oil and gas exploration/extraction via private leasing agreements. These incentives (known as OP 26 agreements) have assisted in attracting oil and gas investment to the South African west and southern coast lines. The Tenth Schedule developed in the wake of the expiry of these agreements renews and modernises key features of the OP 26 regime in a more transparent and user-friendly form (Manuel, 2006:1).

In this chapter the author evaluates whether the Tenth Schedule results in greater transparency and standardization.

### **2.2 Understanding the OP26 regime**

SOEKOR (Pty) Limited (the state owned “Exploration and Production Company”) was granted, in 1967, the right in terms of Prospecting Lease OP26 (“OP26 prospecting lease”) to prospect for natural hydrocarbons in the sea-bed and soil within

the territorial waters<sup>3</sup> and on the continental shelf<sup>4</sup> of the Republic of South Africa, and, if a commercially viable discovery was made, to enter into a mining lease.

The OP26 prospecting lease grants SOEKOR the right to sub-let portions of the prospecting area (clause 15.1) and to enter into joint ventures (“JV”), partnerships and other forms of co-operation agreements in any portion of the prospecting area (clause 15.2), on such terms and conditions as the Minister of Minerals and Energy Affairs (“the Minister”) may approve. The OP26 prospecting lease provides that any sub-lease, JV arrangement, etc. will be subject to the same tax dispensation in relation to prospecting operations (clause 33) as well as in relation to any OP26 mining lease granted pursuant thereto (clause 23).

Transactions in connection with the OP26 prospecting lease and the OP26 prospecting sub-leases are taxed, based on the Income Tax Act as at 1977 (clause 33). Transactions in terms of the OP26 mining leases are taxable in accordance with the current provisions of Income Tax Act, subject to the following:

- in respect of deductions, the provisions of the Income Tax Act as at 1977 shall apply if they are more favourable than those of the current provisions; and
- certain other special tax consequences are also prescribed by the OP26 mining lease (clause 23).

The Prospecting Lease OP29 (“OP29 prospecting lease”), was also granted to SOEKOR in 1967. In terms of the OP29 prospecting lease, SOEKOR was granted the right to prospect for and develop commercially viable onshore discoveries. The OP29 prospecting lease was relinquished by SOEKOR in 1992. As a result, the taxation of income from onshore exploration and production is taxed in accordance with the current provisions of the Income Tax Act.

---

<sup>3</sup> “Territorial waters” means the territorial waters as defined in section 2 of the Territorial Waters Act, 1963 (Act No 87 of 1963).

<sup>4</sup> “Continental shelf” means the continental shelf referred to in section 7 of the Territorial Waters Act, 1963 (Act No. 87 of 1963).

### **2.3 Understanding the Tenth Schedule regime**

The Tenth Schedule regime came into operation on 2 November 2006 and applies to tax years of assessment commencing on or after 2 November 2006. Under the Tenth Schedule regime the taxation of oil **and** gas companies is no longer governed by the terms of the oil and gas right, but rather an oil and gas company is taxed in accordance with section 26B, the Tenth Schedule to the Income Tax Act and fiscal stability agreements.

### **2.4 Transparency**

#### **2.4.1 Lack of Transparency under the OP26 regime**

It was only the OP26 lease holders (“OP26 taxpayers”), their tax advisors, their SARS assessor and the Department of Minerals and Energy who had intimate knowledge of the OP26 regime. The OP26 lease agreements are still not publically available or published by the Department of Minerals and Energy. Accordingly, it may be said that the OP26 regime lacks transparency.

#### **2.4.2 Transparency under the Tenth Schedule regime**

The Tenth Schedule is a schedule to the body of the Income Tax Act and as such is part of the formal legislative framework. Its provisions were enacted by parliament (namely statute), gazetted in the Government Gazette and published by the government printers as part and parcel of the Income Tax Act. It can therefore be said that the provisions of the Tenth Schedule are available to the public and are publicly known amongst taxpayers, tax practitioners and the revenue authorities (National Treasury and the SARS).

This transparency however does not extend to the fiscal stability agreements concluded between the taxpayer and Minister of Finance as provided for in the Tenth

Schedule<sup>5</sup> (refer to 2.5.2 below). To date<sup>6</sup> the Minister of Finance has signed two fiscal stability agreements. Although there is a standard form of the Memorandum of Agreement (“MOA”) proposed by National Treasury,<sup>7</sup> the terms and wording of the fiscal stability agreements with Forest Oil<sup>8</sup> and BHP<sup>9</sup> differ from each other. Furthermore, these agreements are not publicized and therefore it is only the specific taxpayers concerned, National Treasury (who facilitated the signing of the MOA), the Minister of Finance and the taxpayer’s SARS assessor that are privy to the content of these fiscal stability agreements.

### 2.4.3 Purpose of Transparency

The purpose of transparency is to ensure the successful administration of tax anti-avoidance by the revenue authorities.

Huxham & Haupt (2010:450) indicate that it is crucial to distinguish between “tax avoidance” and “tax evasion”. Tax evasion, an illegal offence resulting in severe penalties and possible imprisonment, involves the usage of fraud or deceit to reduce a tax liability through the non-disclosure of income and overstating deductions. Conversely, tax avoidance is the manner whereby a taxpayer would legitimately organise his affairs in such way that would result in the minimum tax liability imposed by the Income Tax Act.

Taxpayers, as often cited, are entitled to arrange their affairs in such manner with the result that the tax payable is less than it otherwise would have been, provided there is no provision in the law designed to prevent or counter the avoidance of tax by means of that specific scheme.<sup>10</sup>

---

<sup>5</sup> Paragraph 8 of the Tenth Schedule.

<sup>6</sup> As at 13 October 2008, being the date of the last MOA signed by the Minister of Finance.

<sup>7</sup> See Annexure B of this dissertation

<sup>8</sup> Forest Exploration International (South Africa) (Pty) Ltd

<sup>9</sup> BHP Billiton Petroleum Great Britain Limited

<sup>10</sup> Lord Tomlin stated (at 520) in *IRC v Duke of Westminster*, 1936, 19 TC 490:

*“Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”*

Under the OP26 regime, tax anti-avoidance was enforced by means of a “General Anti-Avoidance Rule” (“GAAR”) as contained in section 103 of the Income Tax Act. According to Louw (2007:10) the GAAR provided that the Commissioner could *only* apply section 103(1) of the Income Tax Act when satisfied that all of the following four criteria existed:<sup>11</sup>

- (a) A transaction, operation, or scheme had to exist;
- (b) which resulted in the avoidance, reduction or postponement of a tax liability levied in terms of the Income Tax Act;
- (c) the “abnormality requirement” must be present having regard to the transaction, operation, or scheme, either, in relation to a manner not normally employed for *bona fide* business purposes other than obtaining a tax benefit, or the transaction, operation, or scheme created abnormal rights and obligations; and
- (d) the transaction, operation, or scheme must have been entered into solely or mainly to obtain a “tax benefit”.

Such tax benefit would incorporate “any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the Income Tax Act or by any other law administered by the Commissioner”.<sup>12</sup> Once established, the onus rests with the taxpayer<sup>13</sup> to prove that the sole or main purpose of the transaction was other than to avoid tax.

Section 103 of the Income Tax Act was replaced by section 80A to 80L of the Income Tax Act in 2006. In terms of section 26B(3) the general anti-avoidance rules apply to the Tenth Schedule. The general anti-avoidance rules applicable to the Tenth Schedule are contained in sections 80A to 80L of the Income Tax Act (Part IIA of the Income Tax Act<sup>14</sup>).

Clegg, 2010 at 23.6 indicates that in accordance with sections 80A to 80L of the Income Tax Act, the GAAR (as applicable to the Tenth Schedule) requires the

---

<sup>11</sup> *SIR v Geustyn, Forsyth and Joubert* 1971 (3) SA 567 (A) (33 SATC 113)

<sup>12</sup> Section 103(7) of the ITA

<sup>13</sup> Section 82 of the ITA and *ITC 1636* (60 SATC 267)

<sup>14</sup> Part IIA come into effect for tax “avoidance” arrangements entered into on or after 2 November 2006 and replaced section 103(1).

following three elements to be present before it can be applied successfully. Firstly, an “avoidance arrangement” must be present. Secondly, the sole or main purpose of such avoidance arrangement must have been to *obtain* a “tax benefit”. And finally, in addition to obtaining a tax benefit, one of the tainted elements must be present, which are – the “abnormality” element, or, “lack of commercial substance” element, or, “misuse or abuse of the provisions of the Act” element (Louw, 2007:19).

The three elements of the new GAAR are largely reminiscent of the old GAAR under section 103(1), however the “lack of commercial substance” tainted element and “misuse or abuse of the provisions of the Act” tainted element are “new” requirements.

An avoidance arrangement is presumed to lack commercial substance if it would result in a significant tax benefit for a taxpayer but has no significant effect upon either business risks or net cash flows of that taxpayer (aside from the purported tax effects). The application of this presumptive test is problematic since there is no indication of what would constitute a “significant” tax benefit. Presumably the benefit must be significant in the context of the particular taxpayer’s financial affairs in general. The same difficulty applies to determining whether there is a “significant effect” on business risk or net cashflow<sup>15</sup>.

Van Schalkwyk & Geldenhuys (2009: 168) indicate that the concept of a “misuse or abuse” is new to the South African income tax environment. According to the Revised Proposals on Tax Avoidance and Section 103 of the Income Tax Act, the rationale behind the insertion of the “misuse or abuse” element was to reinforce the modern approach to the interpretation of tax statutes “in order to find the meaning that harmonizes the wording, object, spirit and purpose of the provisions of the Income Tax Act” (SARS 2006:16). The quoted part of the rationale was borrowed from the judgment of the Supreme Court of Canada in *Canada Trustco Mortgage Company v Canada* 2005 SCC 54 (at paragraph 54).

---

<sup>15</sup> Clegg (2010) at paragraph 26.3.

*Canada Trustco Mortgage Company* (supra) is regarded as the leading case relating to the Canadian GAAR as contained in section 245 of the Canadian Federal Income Tax Act (Meyerowitz et al., 2007:147). According to Olivier & Honiball (2008: 405), the meaning of the words “misuse or abuse” in Canadian case law are exactly what was intended by the South African Legislature with the phrase “a misuse or abuse of the provisions”.

In *Canada Trustco Mortgage Company*, the Supreme Court of Canada indicated that the words “misuse or abuse” imply “frustrating” or “defeating” the purpose of the provisions relied on by the taxpayer. It is submitted that a “misuse or abuse of the provisions” implies violating the purpose of a provision.

In the absence of transparency, it would be difficult for SARS to determine whether or not there has been “misuse or abuse of the provisions of the Act” when it is unclear which version of the Income Tax Act to apply, namely the Income Tax Act as at a specified date in relation to the OP26 leases or a fiscal stability agreement concluded in terms of the Tenth Schedule. Furthermore in the absence of transparency, it would be difficult to ascertain whether the “abnormality” element is present, when the terms of the OP26 lease or fiscal stability agreement are unknown to the assessor. To conclude, the OP26 regime lacked transparency because it was not available in the public domain. The Tenth Schedule regime is an improvement but lacks “sufficient” transparency. This lack of transparency creates the opportunity for tax avoidance to exist that may not be circumvented by South Africa’s GAAR.

## **2.5 Standardization**

### **2.5.1 Lack of Standardization under the OP26 regime**

Even though there was a standard form<sup>16</sup> for the OP26 prospecting lease and OP26 mining lease, each OP26 lease is unique. There are subtle differences between the tax

---

<sup>16</sup> The standard form of the mining lease is included as Addendum A to the OP26 prospecting lease. Clause 23 of the OP26 prospecting lease:

“The terms and conditions of any Mining Lease to which SOEKOR shall become entitled [...] shall be prescribed in Addendum “A” hereto, which forms an integral part of this Prospecting Lease, and shall, notwithstanding anything in the law contained, be binding upon the State”.

treatment under the original OP26 lease and the sub-leases by virtue of inconsistent terminology used<sup>17</sup> as between leases entered into at different points in time (Clegg, 2006:6). These differences relate primarily to special incentives with regard to water depth, a discretionary power given to the Minister of Mineral and Energy Affairs (in consultation with the Minister of Finance) to reduce the tax charge and the tax rate for oil and gas mining companies under the OP26 regime.

Furthermore, the version of the Income Tax Act to be applied in the computation of taxable income under the OP26 regime also differed from OP26 leaseholder to leaseholder based on the type of OP26 lease held and the discretionary elections available to certain lease holders. The OP26 prospecting lease holders and OP26 prospecting sub-lease holders are taxed in terms of the provisions of the Income Tax Act as at 1977. OP26 mining leaseholders are taxed in terms of the current Income Tax Act and could elect to claim a favourable tax deduction under the Income Tax Act as at 1977. Accordingly, it may be said that the tax treatment under the OP26 regime lacked standardisation.

Refer to Annexure A, Table 1, the prominent differences between the OP26 lease agreements.

### **2.5.2 Standardization under the Tenth Schedule regime**

Whilst the provisions of the Tenth Schedule are transparent (in that they are publically available and published as part of the Income Tax Act), the Tenth Schedule does not fully standardize the corporate income taxation of oil and gas companies because of the ability to freeze provisions under a fiscal stability agreement.

---

<sup>17</sup> For example the original OP26 mining lease provides that “*SOEKOR shall throughout the terms of this Mining Lease be liable for income tax payments to the State on the annual taxable income derived by it from the mining of natural oil [...]*”, whereas the OP26 mining sub-leases refer to the Lessee being “*liable for income tax payments to the State on annual taxable income derived by it from mining for natural oil*”. The difference in emphasis raises the issue whether there should be a different interpretative result (in the case for instance of a “farm out” where the proceeds may be said to result from the mining for natural oil, but not from the mining of natural oil which would seem to imply a closer nexus between the mining activities and the proceeds derived).

In recognition of the need for oil and gas companies to have certainty as to the tax treatment of future revenues and in conformity with international practice, the Minister of Finance may enter into a fiscal stabilization contract with an oil and gas company. Such a contract binds the state and guarantees that the provisions of the Tenth Schedule at the date that a particular oil and gas right is acquired, apply and that the contract may not be amended for the duration of the oil and gas company's right (or any renewals thereof and conversions from the time of exploration to the initial production rights) (Clegg, 2010:350).<sup>18</sup>

The fiscal stability agreement will remain in place over the full life of the oil and gas right and also if exploration rights are renewed or converted to production rights.<sup>19</sup>

An oil and gas company may at any time, unilaterally rescind the agreements if so desired (that is, if subsequent tax law becomes even more favourable than this regime).<sup>20</sup>

The ability to “freeze” the taxation of an oil and gas company through use of a fiscal stability agreement creates the situation that the tax treatment will differ by virtue of changes in the provisions of the Tenth Schedule between fiscal stability agreements entered into at different points in time for each oil and gas right. There were as many as four fiscal amendment Acts<sup>21</sup> in South Africa per annum. The impact is that the revenue authorities will still need to be cognisant of the terms of the Tenth Schedule as at a specified date in relation to each oil and gas right in respect which a taxpayer has obtained a fiscal stability agreement. On a practical level this may require separate tax calculations per oil and gas right that will be consolidated to provide the final taxable income of an oil and gas company. Accordingly, it may be said that the tax treatment under the Tenth Schedule to the Income Tax Act lacks standardisation.

---

<sup>18</sup> Paragraph 8(1) of the Tenth Schedule

<sup>19</sup> Paragraph 8(2) of the Tenth Schedule

<sup>20</sup> Paragraph 8(3) of the Tenth Schedule.

<sup>21</sup> Although in recent years the number of fiscal amendment Acts has reduced to two.

### 2.5.3 Purpose of standardization

The purpose of standardization is twofold. Standardization makes the administration of tax compliance easier for the taxpayer (and the SARS). Standardization also allows for consistent interpretation and therefore application of the provisions of the tax legislation.

The OP26 regime is contract based. Accordingly, the general principles for the interpretation of contracts are applied. These principles are summarised as follows in *Coopers v Lybrand & Bryant* 1995(3) SA761(A) at 767E-768E:

*“According to the ‘golden rule’ of interpretation the language in the document is to be given it’s grammatical and ordinary meaning, unless this would result in some absurdity or some repugnancy or inconsistency with the rest of the instrument [...] The mode of construction should never be to interpret the particular word or phrase in isolation (in vacuo) by itself [...] The correct approach to the application of the ‘golden rule’ of interpretation after having ascertained the literal meaning of the word or phrase in question is, broadly speaking, to have regard:*

- (1) To the context in which the word or phrase is used within its inter relation to the contract as a whole, including the nature and purpose of the contract [...];*
- (2) To the background circumstances which explain the genesis and purpose of the contract, i.e. to matters probably present to the minds of the parties when they contracted [...];*
- (3) To apply extrinsic evidence regarding the surrounding circumstances when the language of the document is on the face of it ambiguous, by considering previous negotiations and correspondence between the parties, subsequent conduct of the parties showing the sense in which they acted on the document, save direct evidence of their own intentions.”*

The Tenth Schedule is regimented within the legal framework of the Income Tax Act. The interpretation of the Tenth Schedule therefore follows the principles of interpretation as applied to the interpretation of statutes.<sup>22</sup>

Van Schalkwyk & Geldenhuys (2009:169) indicate that in common law tradition, there are two broad approaches to the interpretation of statutes (which includes tax statutes),<sup>23</sup> namely the traditional and the modern approach. Each of these approaches consists of two general theories to interpretation, that is, literalism and intentionalism in the case of the traditional approach, and purposivism and contextualism in the case of the modern approach (Du Plessis 2002:93-98). These theories are not mutually exclusive, because in many instances their application is intertwined. According to literalism, the true meaning of a statutory provision is to be sought virtually exclusively in the very words used by the Legislature (Devenish 1992:26).<sup>24</sup> The words of the provision must be adhered to, regardless of manifestly unjust or even absurd consequences (Joubert & Faris 2001:282). Intentionalism (also referred to as the subjective theory) holds that the meaning of a statutory provision is governed by what the Legislature intended as disclosed by the wording of the provision (Kellaway 1995:63). This implies that the real intention of the Legislature, once discerned, should be given effect to (Du Plessis 2002:94). Purposivism attributes meaning to a

---

<sup>22</sup> Van Schalkwyk & Geldenhuys (2009:19) state that with regard to constitutional and statutory interpretation, section 39(1) and (2) of the Constitution of the Republic of South Africa, 1996 states the following:

“39. Interpretation of Bill of Rights.

(1) When interpreting the Bill of Rights, a court, tribunal or forum –

- (a) must promote the values that underlie an open and democratic society based on human dignity, equality and freedom;
- (b) must consider international law; and
- (c) may consider foreign law.

(2) When interpreting any legislation, and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights.”

Section 39(1) of the Constitution gives specific instructions on how to interpret the Bill of Rights. Section 39(2) deals with the interpretation of any other legislation. These sections command a similar interpretative approach to both the Constitution and statutes. Thus, in effect, constitutional interpretation determines and shapes statutory interpretation (Du Plessis 2002:133).

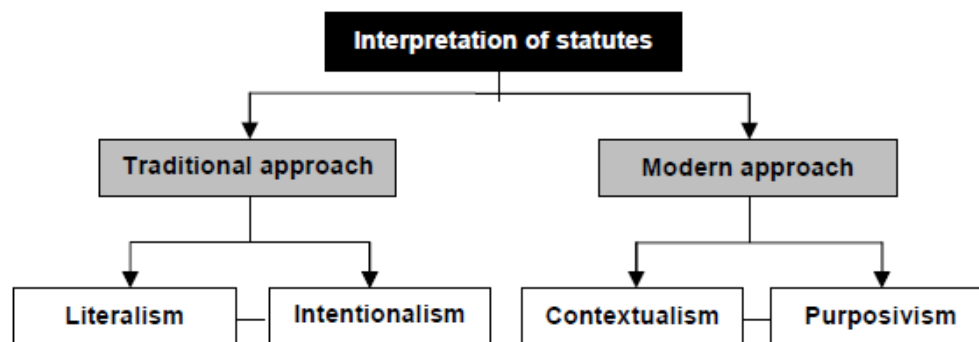
<sup>23</sup> Botha JA in *Glen Anil Development Corporation Ltd v SIR 1975 (4) SA 715 (A)* at page 727: “there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation”

<sup>24</sup> The spirit of the law cannot operate beyond the limits of its language. This principle was laid down by Innes CJ in *Dadoo Ltd v Krugersdorp Municipal Council 1920 AD 530* at page 544. It implies that a court cannot do violence to the language of the lawgiver by placing upon it a meaning of which it is not reasonably capable, in order to give effect to what he or she may think to be the policy or object of the particular measure (*Dadoo Ltd v Krugersdorp Municipal Council [supra] at page 543*).

statutory provision in the light of the purpose it seeks to achieve<sup>25</sup> (Joubert & Faris 2001:285). Legislative purpose is a more general and far more an objective concept than that of legislative intent (Devenish 1992:35). Contextualism is often advanced as the interpretive twin of purposivism, the argument being that the purpose of a provision can only be ascertained by looking at it in context<sup>26</sup> (Du Plessis 2002:97). The meaning of a provision is often said to be determinable by reading its words in context or reading the language in context or reading the provision itself in context (Joubert & Faris 2001:297).

The two broad approaches to the interpretation of statutes, in common law tradition, are summarised in figure 1<sup>27</sup>:

**Figure 1: The broad approaches to the interpretation of statutes**



The principles for interpretation in relation to contracts and statutes have the following in common:

- 1) Emphasis on the words used; and
- 2) The use of the words in a particular context.

Therefore, where standardisation provides for use of consistent terminology within the framework of the Tenth Schedule, standardisation should ensure that the Tenth Schedule regime is interpreted on a similar basis by oil and gas companies and SARS.

<sup>25</sup> The “context” of a statute refers not only to the language of the rest of the statute, but also to the “matter of the statute, its apparent scope and purpose, and, within limits, its background”. This principle was laid down by Schreiner JA in *Jaga v Dönges, N.O. and Another; Bhana v Dönges, N.O. and Another 1950(4) SA 653* at page 662

<sup>26</sup> In *De Beers Marine (Pty) Ltd v CSARS (2002) 3 All SA 181 (A)*, Nienaber JA emphasised the cardinal importance of the context in which the words or phrases are used when interpreting tax statutes. He stated, at paragraph 7, that the language of a provision must “take its colour, like a chameleon, from its setting and surrounds in the Act”.

<sup>27</sup> Van Schalkwyk & Geldenhuys (2009:170)

Under the OP26 regime the terminology used in the lease agreements would differ from the terminology used in the Income Tax Act as at 1977. Accordingly there are likely to be differences in interpretation.

## **2.6 Conclusion**

The aim of the Tenth Schedule to the Income Tax Act is to incorporate the taxation of oil and gas companies into a formal legislative framework ensuring greater transparency and standardization (Clegg and Steenkamp, 2007: 2).

The author submits<sup>28</sup> that the insertion of the taxation of companies engaged in the exploration for and production of oil and gas into the legislative framework (via section 26B and the Tenth Schedule to the Income Tax Act) provides for greater transparency, in that the tax treatment is not hidden in a myriad of OP26 prospecting leases, OP26 mining leases, OP26 sub-leases, the Income Tax Act as at 1977 and the current Income Tax Act. The author furthermore submits that, in the absence of the oil and gas company concluding a fiscal stability agreement, the Tenth Schedule also provides for greater standardization, given that the oil and gas company is taxed under the provisions of the Tenth Schedule and the current Income Tax Act.<sup>29</sup>

However where the oil and gas company has concluded a fiscal stability agreement with the Minister of Finance, both transparency and standardization will be compromised. Accordingly, the Tenth Schedule regime under such circumstances fails to achieve its stated aim.

---

<sup>28</sup> Clegg & Steenkamp (2007: 5) and The Explanatory Memorandum to the Revenue Laws Amendment Bill, 2006 supports this submission.

<sup>29</sup> Section 26B(1) of the ITA provides that the taxable income of any oil and gas company will be determined in accordance with the provisions of the Income Tax Act, subject to the specific provisions contained in the Tenth Schedule to the Income Tax Act.

## **CHAPTER 3 – SIMILARITIES BETWEEN THE OP26 REGIME AND THE TENTH SCHEDULE REGIME**

### **3.1 Introduction**

The fiscal terms accepted by a country reflect the negotiating strength and experience of the country, geological prospects, and the track record of previous projects. A country with large proven reserves and low exploration and development costs will be able to negotiate a higher revenue share than a country that has a short, and perhaps somewhat uneven, track record, particularly if there is uncertainty regarding the size, quality and extraction costs of its petroleum reserves.

South Africa has low prospects for oil and gas reserves. This has prompted tax rules that are largely different from those applicable to other operations (including other hydrocarbon mining operations such as coal) for companies engaged in the exploration for and production of oil and gas.

Mitchell (2007: 228) notes that given the high risks and historically low rewards (in South Africa), if the key features of the OP26 regime were not renewed, few of the active companies would remain invested. According to the Explanatory Memorandum (2006:16) the government intended that core aspects of the OP26 regime should be renewed under the Tenth Schedule, whilst the lesser aspects would fall away.

This Chapter tests the hypothesis that companies engaged in the exploration and production of oil and gas enjoy the same, if not more favourable, tax benefits under the Tenth Schedule to those received under the OP26 regime.

## **3.2 Tax rates**

### **3.2.1 Introduction**

Omar (1998:2) states that the income tax rate is one of the most important factors determining investment in hydrocarbon production and should be appropriately set to attract the necessary foreign investment. According to Omar (1998:2) South Africa is faced with relatively unfavourable geological realities and enormous international competition with regard to investment in petroleum exploration. The major shortcoming of the South African fiscal policy on hydrocarbon production is the fact that it is insensitive to changes in the oil price and the geological realities in the country. The legislator has preserved the tax rates under the OP26 regime in the Tenth Schedule regime for OP26 leaseholders, based on the assumption that, given South Africa's geology, these rates proved attractive to investors under the OP26 regime and such investors would remain invested under the Tenth Schedule by maintaining the tax rate at 28%.

Garnaut & Ross (1983:18) indicate that where there is a concentration of income from mineral production in large, often foreign, corporations are involved in equity for high taxation. Although South Africa taxes foreign companies at a higher tax rate under the Tenth Schedule regime, the Legislature has not followed the policy proposed by Garnaut & Ross by imposing low tax rates. It is South Africa's fiscal policy to tax foreign (non-resident) and local companies on an equitable basis. The difference between the tax rate applied to foreign companies and local companies is in recognition that local companies pay STC on dividends declared to their shareholders. The effective tax rate for a local company is accordingly under the Tenth Schedule regime comparable to higher rate paid by foreign companies of 31%.

It is often argued that the oil industry requires higher than average rates of return on capital because of its inherent risk (Rutledge & Wright, 1998:803). But, the tax rates under the Tenth Schedule and OP26 regime are capped at the current corporate rate of tax, namely 28% as applicable to all companies in South Africa. Therefore, it may be concluded that the tax rates levied on oil and gas companies in South Africa are not aimed at attracting investors.

### 3.2.2 Tax rates under OP26 regime

The current income tax rate is applicable to oil and gas companies irrespective of whether a particular company is engaged in prospecting for and/or mining of oil and gas (clause 23.1, read together with clause 23.4.4), namely 28%, but this rate is capped at a specified maximum rate of tax in relation to the OP26 prospecting lease and the OP26 prospecting sub-lease holders.<sup>30</sup>

### 3.2.3 Tax rates under the Tenth Schedule regime

The Tenth Schedule caps the corporate rate at 28% for residents and at 31% for foreign companies<sup>31</sup> that trade in South Africa through a branch.<sup>32</sup>

---

<sup>30</sup> Clauses 23.1 and 23.2 of OP26 sub-lease agreements provide that SOEKOR was liable for income tax payments on the disposal of crude oil and gas at a rate equal to the lesser of that prescribed in the Income Tax Act, or:

- (a) 38% of taxable income if disposed crude oil < 2million tons per annum;
- (b) 44% of taxable income if disposed crude oil > 2million tons and <4 million tons per annum;
- (c) 48% of taxable income if disposed crude oil > 4million tons and <10million tons per annum;
- (d) 50% of taxable income if disposed crude oil > 10million tons; and
- (e) 40% of taxable income in respect of gas disposed.

However, certain limitations were also placed on the above provisions. If the tax calculated in terms of these provisions were less than 3.5% of the gross income derived by SOEKOR from the disposal of crude oil and gas during the year of assessment, tax payable could be increased to:

- (a) 3.5% of gross income; or
- (b) 50% of taxable income whichever was the lesser.

The 1977 Amendment to the Income Tax Act introduced an additional normal tax over and above the normal tax rate. The amendment provided for the payment of tax at the same rate as applicable to ordinary companies (normal tax) plus an additional normal tax, equal to 40% of taxable income after the payment of the said normal tax. In 1977, the original conditions of OP26 were still in place, and in terms of clause 23.3 of this lease, the amendments to the Income Tax Act would only have been applicable to SOEKOR in so far as it did not prejudice SOEKOR's rights in terms of the OP26.

OP26 was amended in 1981 to include the provision of normal and additional normal tax and determined that tax payable is limited to the minimum of the amount determined in terms of the Income Tax Act, or:

- a) Normal tax plus an additional normal tax calculated at 20% of remaining taxable income while cumulative taxable income is less than total direct capital development costs giving an effective rate of 48% presently;
- b) Normal tax plus an additional normal tax calculated at 30% of remaining taxable income while cumulative taxable income is greater than total direct capital development costs but less than twice the total direct capital development costs giving an effective rate of 54.5% presently; or
- c) Normal tax plus an additional normal tax calculated at 40% of remaining taxable income while cumulative taxable income is greater than two times total direct capital development costs giving an effective rate of 61% presently.

No distinction is made between tax on oil and gas in terms of the amended OP26 of 1981.

<sup>31</sup> Under this basis of taxation, resident oil and gas companies are subject to tax on their world wide income, while non-resident oil and gas companies are subject to tax only on their South African source income. A resident in relation to "a person (other than a natural person) is an entity incorporated,

If a foreign company that carries on trade in South Africa previously derived its exploration and production rights from an earlier OP26 lease agreement (which is now converted to a MPRDA right), the rate of tax may not exceed 28%. This distinction arises from the fiscal stabilisation clause to which OP26 lessees were entitled and which resulted in favourable treatment in the Tenth Schedule<sup>33</sup> (Clegg, 2010:349).

The capping of the corporate income tax rate at 28% under the Tenth Schedule is more favourable than the cap for the corporate income tax rate as provided for under the OP26 regime (refer to 3.2.2 of this dissertation).

### **3.3 Secondary Tax on Companies (“STC”)**

In 1993 section 64B of the Income Tax Act was inserted in terms of which a secondary tax on companies (“STC”) is imposed. STC is currently levied at the rate of 10% on the net dividends (dividends declared less certain dividends received) distributed by a resident company, whether to residents or to foreign companies.

#### **3.3.1 STC under the OP26 regime**

The OP26 mining sub-leases specifically exempt the lessee from Secondary Tax on Companies (“STC”) (clause 23.4.4 of the Mining Lease<sup>34</sup>), the OP26 prospecting lease does not contain an express exemption (the terms being drafted prior to the introduction of STC). The OP26 prospecting lease imposes liability for corporate

---

*established or formed in the Republic or which has its place of effective management in the Republic*”. Furthermore, a person defined as a resident of any other country in terms of a Double Taxation Agreement with that country is excluded from being a resident of South Africa for Income Tax purposes.

<sup>32</sup> Paragraph 2(1) of the Tenth Schedule

<sup>33</sup> Paragraph 2(2) of the Tenth Schedule

<sup>34</sup> Clause 23.4.4 of the OP26 mining lease provides that the “Lessee shall not be liable to the State for distributed or undistributed profits tax, including the Secondary Tax on Companies imposed under Part VII, Section 64B, et. Seq. of the Income Tax Act, in respect of profits derived from mining for Natural Oil”.

income tax under the Income Tax Act as at 1977, but the relief provided by clause 33<sup>35</sup> is arguably too narrow<sup>36</sup> to preclude a tax in the nature of STC.

Accordingly, where there has been a farm-out or disposal of a participation in an OP26 prospecting lease and the taxpayer records an income or capital gain, and thereafter declares a dividend to its shareholder, the dividend declaration will attract STC.

Arguably in the context of a dividend remittance to a foreign company, there may be relief under the OP26 regime from STC on remittances outside the Republic (Arthur Anderson, 1993:18). The OP26 mining lease exempts the lessee from, inter alia, “any tax on the remittance outside the Republic of South Africa of profits derived from the mining of natural oil<sup>37</sup>”. It is submitted that this interpretation is incorrect as STC is based on the declaration of a dividend to a foreign company and not the physical export of funds (i.e. the remittance of the dividend).

### **3.3.2 STC under the Tenth Schedule regime**

In terms of section 26B(2) of the Income Tax Act any tax payable on the net amount of any dividend declared by an oil and gas company as derived from profits attributable to its oil and gas income (namely STC), must be determined in terms of the Income Tax Act, but also subject to the provisions of the Tenth Schedule.

---

<sup>35</sup> Clause 33 of the OP26 prospecting lease secured that throughout the period of the prospecting lease’s validity it would be governed by and interpreted in accordance with the laws of the Republic of South Africa, in force from a specified date, namely the promulgation date of the specified Income Tax Act amendments (“1977”), and by such further laws as may be passed in addition to or in substitution of them, provided such further laws shall not adversely affect the contractual rights and obligations of the lessee under the prospecting lease without its consent.

<sup>36</sup> Whilst at first sight this clause 33 precludes the application of legislation subsequent to 1977, it is submitted that this clause is not relevant in respect of tax, which is referred to in clause 28, with the result that this clause does not prevent the levying of STC. In terms of clause 28, the OP26 prospecting leaseholder is “liable for income tax payments to the state on the annual taxable income derived by it from the prospecting for Natural Oil and transactions in connection therewith in accordance with the Income Tax Act as of the date the 1977 amendments thereto were promulgated. As STC is not levied on “taxable income”, but on distributed profits, the current Income Tax Act arguably applies to a dividend declaration during the prospecting phase.

<sup>37</sup> Clause 23.6.3 of the OP26 mining lease

STC is limited to 5% on the net amount of the dividend declared by an oil and gas company derived from profits of its oil and gas income. This rate is reduced to 0% in the case of dividends declared by an oil and gas company if all its oil and gas rights are solely derived by virtue of a previous OP26 right.<sup>38</sup> The 5% and 0% rates will however not apply to an oil and gas company engaged in refining.<sup>39</sup>

Foreign companies that are subject to the 31% corporate tax rate are exempted from STC, as would be the case for any non-resident.

The STC provisions under the Tenth Schedule are similar to those of the OP26 regime. Particularly in relation to an oil and gas company that held an OP26 mining sub-lease agreement (which provides for an exemption from STC) that is now taxed under the Tenth Schedule at 0%.

### **3.3.3 Legislative changes with regard to the taxation of dividends**

Clegg (2010: 349) states that the STC is in the process of being replaced by a dividend withholding tax (“WHT”). The dividend WHT will no longer be a tax on the company declaring the dividends but, rather, on the shareholder. When the dividend WHT is introduced it is expected that the specific rate provisions relating to the STC will generally apply to the dividend WHT.

### **3.4 Capital Gains Tax (“CGT”)**

Capital Gains Tax (“CGT”) was introduced from 1 October 2001. As set out in the Eighth Schedule to the Income Tax Act, any capital gain made from the disposal of any “asset” (which is widely defined and would include the disposal of shares in an oil and gas company or mining rights) would be subject to CGT at an effective rate of 14% for companies.

---

<sup>38</sup> Paragraph 3(1) and 3(2) of the Tenth Schedule

<sup>39</sup> Paragraph 3(3) of the Tenth Schedule

### 3.4.1 CGT under the OP26 regime

The OP26 prospecting lease states that the OP26 leaseholder is “liable for income tax payments to the State on the annual taxable income derived by it from the prospecting for natural oil<sup>40</sup> and transactions in connection therewith in accordance with the Income Tax Act as of the date the 1977 amendments thereto were promulgated” (clause 28).

Thus, according to Clegg (2006: 11), where the OP26 leaseholder has derived capital gains in the case of a disposal of its oil and gas right, such a capital gain would likely be considered to be “in connection” with prospecting operations and would therefore not be subject to CGT (case law<sup>41</sup> seems to support that conclusion, though there are arguments to the contrary), as CGT was not part of the Income Tax Act as at 1977.

### 3.4.2 CGT under the Tenth Schedule regime

“Oil and gas income” means the receipts, accruals or gains derived by an oil and gas company in respect of any oil and gas right, including leasing or disposing of that right, thereby including commercial royalty income and capital gains (Clegg, 2010:348) (refer to 4.3.2 of this dissertation).

The Tenth Schedule (excluding the roll over election in relation to the disposal of an oil and gas right) does not exempt the taxpayer from CGT on the disposal of assets.

Therefore, there would be CGT in relation to the disposal of shares in an oil and gas company. The CGT implications of the disposal of the shares depend on the makeup of the company and the tax residency of the shareholders. South African tax residents are subject to CGT on any capital gain realised on the disposal of shares held on capital account.<sup>42</sup> Shareholders that are not tax resident in South Africa, however, are

---

<sup>40</sup> Definition of “natural oil”, in Section 1 of the ITA: “means any liquid or solid hydrocarbon or combustible gas existing in a natural condition in the earth’s crust, but does not include coal or bituminous shales or other stratified deposits from which oil can be obtained by destructive distillation (such as coal-to-liquids technology), or gas arising from marsh or other surface deposits.”

<sup>41</sup> *Minister of Finance v De Beers (Pty) Ltd* 2006 (69 SATC 105)

<sup>42</sup> Assuming they are companies and not natural persons.

only subject to CGT on any capital gain realized on the disposal of shares if 80% or more of the market value of the shares is attributable directly or indirectly to immovable property situated in South Africa. Oil and gas rights are considered to be immovable property<sup>43</sup> for this purpose (Clegg, 2010:353).

Accordingly, the OP26 regime is more favourable than the Tenth Schedule in relation to capital gains tax.

### **3.5 Ring-fencing**

#### **3.5.1 Ring-fencing under the OP26 regime**

The Income Tax Act provides for several measures to ring-fence the deductibility of mining capital expenditure.

##### ***3.5.1.1 Ring-fencing by industry***

The deduction for capital expenditure in relation to any mine or mines is limited to the taxable income derived from mining. Any excess of accumulated capital expenditure which is not deductible (“unredeemed capital expenditure”) is carried forward and deducted in succeeding years against the taxpayer’s taxable income from mining. This is known as the mining ring-fence. The effect of this limitation is to prevent the deduction of capital expenditure resulting in a tax loss which could be set-off against other, non-mining income.<sup>44</sup>

The mining ring-fence did not apply in 1977. A company which earned other income (for example income from manufacturing) could, therefore, deduct mining capital expenditure from such income and thereby reduce its overall tax burden.

---

<sup>43</sup> The application of CGT to non-residents in terms of paragraph 2(b)(i) of the Eighth Schedule , specifically includes immovable property situated in the Republic held by the non-resident or any interest or right of whatever nature of that non-resident to or in immovable property situated in the Republic.

<sup>44</sup> Section 36(7E) of the ITA.

It is submitted that this means that the deduction under the current Income Tax Act is less favourable than the deduction available under the Income Tax Act as at 1977. Therefore, the mining ring-fence will not apply under OP26 if so elected by the OP26 leaseholder.

### ***3.5.1.2 Ring-fencing by mine***

Until 1984, a company which operated more than one mine could set off its unredeemed capital expenditure on one of its mines against mining income of another mine where both mines had already commenced production. However, a limitation was then introduced in terms of which the deduction is limited, in relation to any one mine, to the amount of taxable income derived by the taxpayer from mining that particular mine (subject to certain exceptions).<sup>45</sup> This is known as the capital expenditure per mine ring-fence.

The expenditure per mine ring-fence did not yet apply in 1977 and should not affect an OP26 Mining Lease granted pursuant to OP26, if so elected by the OP26 leaseholder.

Accordingly, under the OP26 mining lease, the more beneficial 1977 dispensation would be adopted to ensure that ring-fencing does not apply.

### **3.5.2 Ring-fencing under the Tenth Schedule regime**

There is ring-fencing under the Tenth Schedule by industry to a limited extent in that, any assessed losses<sup>46</sup> from exploration or production may only be set-off against oil and gas income, and income derived from the refining of gas. If any amount remains after setting-off the assessed loss against such income, an amount equal to 10% of the remaining assessed loss may be set-off against any other income<sup>47</sup> derived by that

---

<sup>45</sup> Section 36(7F) of the ITA.

<sup>46</sup> Paragraph 5(3) of the Tenth Schedule

<sup>47</sup> For example income derived from ancillary trades such as the leasing of excess building space, the purchase and sale of oil to cover contractual short-falls and management fees from managing oil and gas joint ventures (Explanatory Memorandum, 2009:70).

company.<sup>48</sup> Any losses remaining after off-set against any other income may be carried forward to the succeeding year of assessment.<sup>49</sup>

No restrictions are imposed under the Tenth Schedule which ring-fence the losses of a particular well against the income from another well (namely there is no ring-fencing by mine).<sup>50</sup>

The ring-fencing provisions under the Tenth Schedule are accordingly not as favourable as the dispensation enjoyed by oil and gas companies under the OP26 regime (refer to 3.5.2 of this dissertation).

### **3.6 Foreign Exchange Gains and Losses**

#### **3.6.1 Foreign Exchange Gains and Losses under the OP26 regime**

Special rules for the taxation of foreign exchange gains and losses were first introduced in the Income Tax Act in 1978 with the introduction of section 24B. Subsequently, the provisions of section 24B were replaced in their entirety by the provisions of section 24I of the Income Tax Act.

The Income Tax Act as at 1977 did not contain specific legislation governing the taxation of the foreign exchange gains and losses. Accordingly, foreign exchange gains and losses were taxed in terms of the general capital/ revenue and accrual/ incurral provisions. Thus, where an OP26 lessee borrowed funds in order to undertake prospecting/mining operations, any realised foreign exchange gain arising would be taxable, and any realised foreign exchange loss arising would be tax deductible, depending on whether the borrowing was more closely linked to the financing of a capital or operating expense.<sup>51</sup>

---

<sup>48</sup> Paragraph 5(4) of the Tenth Schedule

<sup>49</sup> Paragraph 5(5) of the Tenth Schedule

<sup>50</sup> Section 36(7E), (7F) and (7G) of the ITA.

<sup>51</sup> *CIR v G Brollo Properties (Pty) Ltd* 56 SATC 47(A); *ITC 1643* (61 SATC 12)

In contrast under the current Income Tax Act, a taxpayer is liable to account for both realised and unrealised foreign exchange gains in terms of the provisions of section 24I. Foreign exchange gains and losses only arise where the OP26 lessee has not transacted in its “local currency”. “Local currency” is defined (inter alia) as the currency of the Republic or the currency used by a foreign company with a permanent establishment for purposes of its financial reporting.<sup>52</sup> Where a taxpayer undertakes its financial reporting in South African Rands and borrows funds in a foreign currency (such as United States Dollars) to undertake its exploration/production activities from an offshore rig/production platform in South Africa (defined as a “permanent establishment”)<sup>53</sup> then foreign exchange gains and losses, be it realised or unrealised (unrealised gains and losses being accounted for at the end of each financial year), are taxable or deductible, as the case may be.<sup>54</sup>

### **3.6.2 Foreign Exchange Gains and Losses under the Tenth Schedule regime**

In terms of paragraph 4 of the Tenth Schedule, currency gains and losses of a company must be determined solely with reference to the currency and translation method used by that company for financial reporting purposes. As a result, United States Dollar-based oil and gas companies can use the Dollar as their base currency for determining currency gains and losses for tax purposes. Notwithstanding this, all taxes due to South African Revenue Service (“SARS”) must be translated to South African Rands at the “average exchange rate” for the year and must be paid to SARS in Rands.<sup>55</sup> An oil and gas company may change the currency used for financial reporting with approval of SARS, only if SARS is satisfied that the company is not changing the currency solely or mainly to reduce its tax liability.

---

<sup>52</sup> Definition of “local currency” paragraph (a), section 24I of the ITA

<sup>53</sup> Definition of “permanent establishment”, section 1 of the ITA: “permanent establishment” means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organization for Economic Co-operation and Development.

Article 5 of the OECD model tax convention provides that for the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term “permanent establishment” includes especially at sub-paragraph (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

<sup>54</sup> Section 24I of the ITA. Refer to 3.6.2 of this dissertation for the tax treatment under the Tenth Schedule.

<sup>55</sup> This is consistent with the translation of foreign currency provided for under section 25D(2) of the ITA.

Paragraph 4 of the Tenth Schedule attempts to maintain the relief provision provided by OP26, of companies not being taxed on foreign currency gains or losses, as a consequence of the fact that section 24I of the current Income Tax Act did not exist in the Income Tax Act as at 1977.

The Tenth Schedule falls short of this aim in that it provides that foreign currency gains and losses are determined with reference to the currency and translation method used by that company for financial reporting purposes. For example, for financial reporting purposes unrealised foreign currency gains and losses are recognised on translation (namely financial year-end). The OP26 prospecting and OP26 prospecting sub-lease lessees were taxed in accordance with the Income Tax Act as at 1977 and accordingly would not recognise unrealised foreign exchange gains or losses for tax purposes.

### **3.7 Customs Duties**

#### **3.7.1 Customs duties under the OP26 regime**

There are generous exemptions in the OP26 mining lease from Customs and Excise. Clause 10.1 of the OP26 mining lease provides that:

*“SOEKOR and its contractors may during the continuance of this Mining Lease and subject to the provisions of international trade agreements which may be in force, import into the Republic of South Africa or clear from any customs and excise warehouse under rebate of full customs duty (as defined in the Customs and Excise Act, 1964) such equipment, machinery, materials, instruments, supplies and accessories (excluding refined petroleum products for use in road vehicles and any goods imported by SOEKOR and any of its contractors for the personal use of its personnel) as are required for use in its mining operations under this Mining Lease [...].”*

A similar clause is found in the OP26 prospecting sub-leases, clause 25.5.3. Accordingly, an OP26 leaseholder will not suffer customs and excise duties on equipment and machinery used in the exploration for, or production of oil and gas.

### **3.7.2 Customs duties under the Customs and Excise Act**

Under the Customs and Excise Act, 1964, equipment, machinery, materials, instruments, supplies and accessories utilised in the exploration of oil and gas imported under rebate item 460.23 are exempt from customs and excise duty.

The current tax dispensation for customs duties is accordingly not dissimilar to the dispensation under the OP26 regime.

## **3.8 Value Added Tax (“VAT”)**

### **3.8.1 VAT under the OP26 regime**

Value Added Tax (“VAT”) is levied at the rate of 14%. It is levied on supplies by a vendor of goods or services and on the importation of any goods or services into South Africa. Exports are zero-rated.

VAT would apply<sup>56</sup> to prospecting and mining operations. The limitation to the Income Tax Act as at 1977 is limited to income tax. The OP26 Mining Lease precludes other taxes on the income of miners, or taxes of a similar nature, calculated in relation to taxable income, profits or turnover from mining operations. It is submitted that VAT is not a tax on income, or a similar tax. Therefore, VAT would apply to mining operations (Arthur Anderson, 1993:18).

---

<sup>56</sup> SARS VAT ruling 64 (28/3/1-5 May 1992) states that input VAT may be claimed in respect of prospecting expenses, if these expenses were incurred in the course or furtherance of an “enterprise”. Section 23(3)(d) of the VAT Act allows a company to register for VAT in circumstances where the company is continuously and regularly carrying on an activity which, in consequence of the nature of that activity, can reasonably be expected to result in taxable supplies being made for a consideration only after a period of time and where the total value of taxable supplies to be made can reasonably be expected to exceed R50 000 in a period of 12 months.

The applicability of VAT is likely to benefit a prospector or miner, at least during the investment phase of the project, since it entitles the oil and gas company to receive a refund of the VAT element of purchases (in the form of an input tax credit).

Some commentators have suggested that VAT is a tax on turnover<sup>57</sup> and hence is specifically excluded under the OP26 mining lease and that OP26 leaseholders would be exempt from VAT. It is submitted that this interpretation is incorrect as VAT is levied at “Vatable transaction” level and not on the turnover of a taxpayer.

### 3.8.2 VAT under the Tenth Schedule regime

Clegg (2010:354) states that the normal VAT rules apply to oil and gas companies. Briefly, VAT liability enables rand-based expenditures to qualify for VAT credit as input VAT. Sales of crude oil are zero-rated (no VAT charge applies). Gas does not qualify for zero rating.

### 3.9 Deductions

The distinction between capital and revenue expenses is important in South African tax law, since capital expenditure may usually not be deducted for tax purposes unless specifically allowed. Capital expenses<sup>58</sup> can generally be regarded as those expenses

---

<sup>57</sup> The OP26 mining lease (clause 23.6) provides the following in relation to mining operations:  
“Any payments to the State in terms of clause 23 hereof, shall constitute SOEKOR’s (which includes sub-lessees, joint venturers, etc in terms of clause 1(n) of the Mining Lease) *only commitment to the State, or any political sub-division thereof, for taxes or levies on the income derived by SOEKOR from the mining of natural oil [...]*”

The clause further provides the lessee, its sub-lessees and its joint venturers shall not be liable for:

- Any further taxes on income derived from mining;
- Any similar taxes calculated with reference to taxable income, profits or turnover;
- Any profit-sharing, royalty or lease consideration;
- Non-resident shareholders’ tax (NRST) (which was abolished from 1 October 1995), dividend withholding tax or tax on profits remitted to non-residents;
- Undistributed profits tax (which was abolished on 31 March 1990).

<sup>58</sup> An expense is considered to be of a capital nature if, for example:

- It adds to the taxpayer’s income-earning structure (*New State Areas Ltd v CIR* (1946 AD 610) (14 SATC 155))
- It is a once-off expense from which future benefits (income) will flow (*CIR v George Forest Timber Co Ltd* (1924 AD))

incurred to set up the structure of a business (cost of the mine, cost of equipment, etc), while revenue expenses would be those expenses required for the day-to-day running of the business (salaries, rent, interest, etc). Capital expenses in relation to mining companies are categorised as:

- Prospecting (or exploration) capital expenditure;<sup>59</sup> and
- Mining (or production)<sup>60</sup> capital expenditure.<sup>61</sup>

### 3.9.1 Deductions under the OP26 regime

#### 3.9.1.1 Operating expenses

Operating expenses were tax deductible under the general deduction formula as contained in section 11(b) of the Income Tax Act as at 1977 or they may be deductible under section 11(a) of the current Income Tax Act. The most relevant requirements for deductibility are that the expenses must be:

- Actually incurred;<sup>62</sup>

---

• It creates an enduring benefit or advantage for the taxpayer (*Atherton v British Insulated and Helsby Cables Ltd* (1926 AC 205) (10 SATC 155))  
(Huxham & Haupt, 2009: 99)

<sup>59</sup> “Prospecting expenditure” is not defined in the Income Tax Act. The meaning of prospecting expenses is inferred from section 15(b) of the Income Tax Act as including expenses arising from surveys, wells and other exploration work preliminary to the establishment of a mine and expenses incidental to such prospecting operations.

<sup>60</sup> The definition of “Production” in paragraph 1 of the Tenth Schedule includes –

- “(a) the separation of oil and gas condensates;
  - (b) the drying of gas; and
  - (c) the removal of non-hydrocarbon constituents,
- to the extent that these process are preliminary to refining;”

<sup>61</sup> In the context of mining taxation, “mining expenditure” is interpreted as being synonymous with the defined term “capital expenditure”, in section 36(11) of the ITA. “Capital Expenditure” is defined as *expenditure (other than interest or finance charges) on shaft sinking and mine equipment[ ...] and, in the case of a natural oil mine, the cost of laying pipelines from the mining block to the marine terminal or the local refinery, as the case may be.* Interest and finance charges are specifically excluded from the determination of “capital expenditure” in the ITA.

<sup>62</sup> *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936 CPD 241) (8 SATC 13):

at page 15. – “[. . .] the words of the statute [i.e. section 11(a) are ‘actually incurred’ not ‘necessarily’ incurred. The use of the word ‘actually’ as contrasted with the word ‘necessarily’ may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses, therefore, are not ‘necessary’ but they are actually incurred and therefore deductible.”

In *CIR v Golden Dumps (Pty) Ltd* 1993 (4) SA 110 (A) (55 SATC 198) (in the Court a quo *ITC 1499* (53 SATC 266)) it was held that when an expenditure is the subject of a bona fide dispute, it lacks the degree of finality to render it actually incurred. In *KBI v Nasionale Pers Bpk* 1984 (4) SA 551 (C) (46

- In the production of the income;<sup>63</sup>
- In the course and for the purpose of furtherance of the specific trade of the taxpayer;<sup>64</sup> and
- Not be of a capital nature.

Operating expenses incurred whilst still in the prospecting stage (namely pre-trade revenue expenses) are accumulated until the mining stage (namely trade commences), and then the total is claimed as single deduction<sup>65</sup>.

### 3.9.1.2 Prospecting capital expenditure

Prospecting expenses under the OP26 regime would be deductible under section 15(b)<sup>66</sup> of the Income Tax Act as at 1977, provided that such expenditure was incurred in the Republic.

---

SATC 83) (on appeal as *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A) (48 SATC 55) the taxpayer, a company, claimed a deduction for the portion of annual bonuses it considered to be appropriate to the period ending on the last day of each year of assessment. Its employees, however, could at those dates make no claim for bonuses, becoming eligible for them some months later. It was held that no liability existed at the relevant dates and that there was no expenditure actually incurred.

In *Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A) (50 SATC 81 at 90) (on appeal from *CIR v Edgars Stores Ltd* 1986 (4) SA 312 (T) (48 SATC 89)), it was held that only expenditure in respect of which the taxpayer had incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of section 11(a) from income returned for the year. Where the existence of a liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately determined at the tax year-end, in which event the liability is nevertheless regarded as having been incurred in the tax year in question.

<sup>63</sup> In *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936 CPD) a broad test as to whether an expense is incurred in the production of income was laid down. An expense is in the production of income in a business operation if any *one* of the following requirements are met-

- The expense is *necessary* for the performance of the business operation
- The expense is attached to the business operation by *chance*
- The expense is genuinely incurred for the purpose of carrying on the business operation more *efficiently*.

(Huxham & Haupt, 2009: 97)

This test was slightly modified in *CIR v Genn & Co (Pty)* 1955 AD (20 SATC 113), and approved in *CIR v African Oxygen Ltd* 1963 (1) SA 681 (AD) at 688, and in *CIR v Allied Building Society*, 1963 (4) SA 1 (AD) at 13 (25 SATC 343).

<sup>64</sup> The application of section 23(g) is the *ratio decidendi* in case of *Joffe & Co (Pty) Ltd v CIR* (1946). *Joffe & Co. (Pty) Ltd v CIR* (1946 AD 157) (13 SATC 354) provides at page 357 (quoted with approval from the English case of *Strong & Co. Ltd v Woodfield* (1906) AC): “It is not enough that the disbursement is made in the course of, or arises out of, or is connected with the trade or is made out of the profits of the trade. It must be made for the purpose of earning the profits.”

And at page 359. “[. . .] the Court is not concerned with deductions which may be considered proper from an accountant’s point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the statute.”

<sup>65</sup> Section 11A of the ITA.

<sup>66</sup> Section 15(b) of the ITA as at 1977:

Under the OP26 regime, OP26 prospecting lease and OP26 prospecting sub-lease holders are taxed under the source basis of taxation (as was the basis of taxation in South Africa prior to 1 January 2001). The “Republic” is not defined under the OP26 lease. For purpose of the OP26 regime, the Republic is accepted in common law as extending only 12 nautical miles from the coastline. The mining and prospecting lease area under the OP26 regime covers the territorial waters and the continental shelf of the Republic. The lease areas therefore extend beyond the Republic. Accordingly, OP26 prospecting lease holders may not receive a tax deduction under section 15(b) until such time as they enter into an OP26 mining lease. Under the OP26 mining lease all offshore mining income is deemed to be from a source in the Republic.<sup>67</sup>

The question arises as to whether the prospecting expenditure incurred under an OP26 prospecting lease or OP26 prospecting sub-lease outside the Republic could be regarded as deductible capital expenditure as envisaged in section 36(11) of the Income Tax Act. Section 15(b)(iii) of the Income Tax Act provides that “*any expenditure which has been allowed in terms of this paragraph (section 15(b)) shall not be included in such person’s capital expenditure as defined in subsection (11) of*

---

(b) Any expenditure incurred by the taxpayer during the year of assessment on prospecting operations (including surveys, boreholes, trenches, pits and other exploratory work preliminary to establishment of a mine) in respect of any area within the Republic in respect of which a mining lease has been granted by the State, together with any other expenditure which in the opinion of the Secretary is incidental to such operations: Provided that-

- (i) [...]
- (ii) In the case of any company that derives income from different classes of mining operations, the deduction under this paragraph shall be made from the income derived from such class or classes of mining operations and in such proportions as the Secretary may determine;
- (iii) Any expenditure which has been allowed to be deducted from the income of any person in terms of this paragraph shall not be included in such person’s capital expenditure as defined in sub-section (11) of section *thirty-six*.

<sup>67</sup> Section 9(1)(cA) of the ITA deems any amount derived under a contract for the disposal of any mineral, including natural oil, by the taxpayer in the course of mining operations carried on by him under the mining authorisation granted under the Minerals Act, 1991 (Act No. 50 of 1991) or prospecting right, mining right, exploration right or production right or mining permit issued in terms of the Mineral and Petroleum Resources Development Act, 2002 (Act No. 28 of 2002), to be from a South African source, irrespective of where the contract was made or where the mining operations are carried on. Furthermore, the OP26 mining lease at clause 23.5 provides that:

*“SOEKOR (includes any sub-lessee, joint venturer, etc) shall maintain a permanent establishment in the Republic of South Africa and arrange its affairs in such a manner that all the profits from mining for natural oil under this Mining lease will be attributable to that establishment.”*

Accordingly, offshore mining income within the Republic (as then defined) derived under an OP26 mining lease will always be subject to taxation in South Africa.

*section thirty six*". Thus, where expenditure is denied under section 15(b), it may apparently be claimed under section 36(11) of the Income Tax Act.

Meyerowitz (2006: 23) states that: "*Prospecting expenditure in an area where a mining lease has been granted by the State is not allowable under section 15(b) and will only be allowable if it is of a nature falling within the meaning of capital expenditure under section 36(11).*"

Whilst Silke (1978, para 669) states to the contrary, that "*where prospecting operations are conducted in any area in the Republic in which a mining lease has been granted, or in other appropriate circumstances, prospecting expenses must be included with capital expenditure deductible from the income of the particular mine in the same manner and to the same extent as is all other capital expenditure*". Similarly in the current service edition (De Koker (ed), 2009: para 16.8), the author notes as follows: "*Any expenditure deductible deducted under s15(b) may not be included in the taxpayer's 'capital expenditure' as defined in s36(11) (s15(b)(iii)). Were it not for this prohibition, prospecting expenses would be included with capital expenditure deductible in the same manner and to the same extent as is all other capital expenditure*".

"Capital expenditure" does not, it is submitted include all expenditure which is of a "capital nature" but only the particular expenditure as defined in section 36(11) of the Income Tax Act, which cannot be construed to include "prospecting expenditure". As such the denial of the prospecting deduction under section 15(b) of the Income Tax Act would result in the taxpayer being unable to claim any tax deduction for prospecting expenditure until the OP26 prospecting lease or OP26 prospecting sub-lease holder has entered an OP26 mining lease.

Clause 23.5.1 and 23.5.2 of the OP26 mining lease provide that:

*"In calculating the taxable income referred to in this clause 23, the deductions from income shall be granted in the Income Tax Act as at the date on which the 1977 amendments thereto were promulgated, and shall in any event include:*

- *the costs expended by the Lessee itself on prospecting operations within the area covered by the Prospecting Lease in any tax year or part thereof, and*

- *the costs expended by the Lessee itself on the prospecting operations within the area covered by the Mining Block in any tax year or part thereof.”*

Therefore prospecting expenses incurred by a taxpayer who has been granted an OP26 mining lease are deductible under the provisions of the OP26 mining lease. However at the time that the prospecting expenditure is incurred, the taxpayer’s tax liability should be governed by the terms of the OP26 prospecting lease and not the OP26 mining lease. Thus all prospecting expenditure should be deducted only in the year in which mining operations commence. Such a result would however be contrary to a fundamental principle of tax, that the “tax is an annual event”<sup>68</sup> and as such expenditure must be deducted in the year of incurral (Clegg, 2006:9). It is submitted that prospecting expenditure is deductible as incurred<sup>69</sup> and will create an assessed loss to be set off against future income.

It should be noted that clause 23.8 of the OP26 mining lease provides that *“in determining the taxable income or profits in respect of the Mining Block, the phrase mining for ‘Natural Oil’ shall be interpreted as including all prospecting, development and exploitation activities and such taxable income or profits shall be taxed as set out in this clause 23.”* Accordingly, prospecting expenditure is deductible in terms of the OP26 mining lease as and when incurred, and will accordingly result in the taxpayer creating an assessed loss, to be offset against future mining income. This provision however is limited to determining the *“taxable income or profits in respect of the Mining Block”* and thus would not apply in determining the taxable

<sup>68</sup> In *Sub Nigel Ltd v CIR* (1948 AD) it was said:

“For the whole scheme of the Act shows that, as the taxpayer is assessed for income tax for a period of one year no expenditure incurred in a year previous to the particular year can be deducted.”

In *Concentra (Pty) Ltd v CIR* (1942 CPD), the company claimed as a deduction certain expenditure relating to directors’ expenses which had arisen in earlier years. The court held that the expenditure should have been claimed in the years in which it arose, and that, by not doing so, the company had forfeited its right to claim a deduction in terms of s11(a).

In the *Caltex Oil (SA) Ltd v SIR* (1975 AD), Botha JA in his judgement made the following statement:

“It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure incurred on the other during the year of assessment.”

<sup>69</sup> Expenses that are incurred prior to and in preparation for the carrying on a trade are typically not deductible (*CSARS v Contour Engineering (Pty) Ltd 1999 (61 SATC 447)*). However certain provisions of the ITA such as section 15(b) specifically provide for the deduction of such pre-trade capital expenditure.

income or profits from areas in the OP26 prospecting lease which fall outside the area of the OP26 mining lease (Clegg, 2006:9).

The Commissioner for the South African Revenue Service (“the Commissioner”) may direct that expenses under section 15(b) of the Income Tax Act must be deducted in a series of annual instalments. This discretion is not subject to objection and appeal, but in practise this discretion is rarely exercised by the Commissioner.

The sub-section also provides for a potential “matching” (at the Commissioner’s discretion) of deductions where different classes of mining<sup>70</sup> are involved. This discretion although rarely used in practice, is not subject to objection and appeal

In the Income Tax Act as at 1977, the Commissioner did not have the discretion to direct the deduction of prospecting expenses over a series of annual instalments, nor to direct the matching of deductions with different classes of mining. It is construed therefore that in relation to OP26 mining leases, the taxpayer is likely to elect the treatment of a deduction under the provisions of section 15(b) as at 1977.

### **3.9.1.3 Mining capital expenditure**

Deductions from income derived from mining<sup>71</sup> activities are regulated by section 15(a) of the Income Tax Act, which states that these deductions should be determined in accordance with section 36.

The mining expenditure that is deductible in terms of section 15(a) and section 36<sup>72</sup> of the Income Tax Act includes, inter alia, expenses on:

---

<sup>70</sup> For example, the Commissioner may direct that prospecting expenses from natural oil mining may not be set off against income arising from diamond mining.

<sup>71</sup> Definition of “mining operations” and “mining” in section 1 of the ITA, “includes every method or process by which any mineral is won from the soil or any substance or constituent thereof.”

<sup>72</sup> Section 36(11) of the ITA as at 1977:

(11) For the purposes of this section-

(a) expenditure on shaft sinking and mine equipment and, in the case of a natural oil mine, the cost of laying pipelines from the mining block to the marine terminal or the local refinery, as the case may be; and

*(Paragraph (a) substituted by s28(1)(b), Act 85, 1974, in terms of s70 of that Act first effective as from the commencement of years of assessment ending on or after 1 January 1974)*

- 
- (b) expenditure on development, general administration and management (including any interest and other charges payable after the thirty first day of December, 1950, on loans utilised for mining purposes) prior to the commencement of production or during any period of non-production; and
  - (c) in the case of any [...] natural oil mine, an amount calculated [...] in the manner prescribed for the calculation of the capital allowance provided for in section 26(2) of the Mining Rights Act, 1967 (Act No.20 of 1967), at the rate of [...] six per cent per annum in the case of [...] any natural oil mine [...] on the amount of the unredeemed balance of the aggregate of-
    - (i) the expenditure referred to in paragraphs (a) and (b), excluding any interest and other charges on loans referred to in paragraph (b), if the mine is [...] a natural oil mine [...];
    - (ii) the amount (if any) allowed to rank as capital expenditure in terms of section 37;
    - (iii) any expenditure incurred during any period of production of development on any reef on which at the date of such development stopping has not yet commenced; and
    - (iv) the amount calculated in terms of this paragraph up to the end of year of assessment immediately preceding the year of assessment under charge, if the mine is [...] a natural oil mine, for the period from the end of the month in which the expenditure is actually incurred or is in terms of proviso (dd) to this paragraph deemed to be incurred, up to the end of the year of assessment immediately preceding the first year of assessment in respect of which the determination of the taxable income derived from the working of such mine does not result in an assessed loss, [...]; Provided that-
      - (aa) the amount under this paragraph shall not be calculated for any period during which mining operations are not carried on in accordance with the terms of the relevant lease;
      - (bb) notwithstanding anything to the contrary in an law contained, the amount under this paragraph shall not be taken into account for the purpose of calculating the capital allowance as provided for in section 26(2) of the Mining Rights Act,1967, or for the purpose of determining the profits of which a share is payable to the State in terms of any mining lease;
      - (cc) the provisions of section 26(3) and (4) of the Mining Rights Act, 1967, shall, in so far as they can be applied, apply *mutates mutandis* for the purpose of determining the unredeemed balance of the aggregate of the amounts referred to in subparagraphs (i) to (iv), inclusive, of this paragraph;
      - (dd) for the purpose of subsections (3) and (3)*bis* of this section any amount calculated under this paragraph in respect of any year of assessment shall be deemed to be capital expenditure incurred on the last day of such year of assessment;
      - (ee) [...]
      - (ff) [...]

**‘capital expenditure incurred’**, for the purpose of determining the amount of capital expenditure incurred during any period of in respect of any mine, means the amount (if any) by which the expenditure that is incurred during such period in respect of such mine and is capital expenditure, exceeds the sum of the amounts received or accrued during the said period from disposals of assets the cost of which has in whole or in part been included in capital expenditure taken into account (whether under this Act or any previous Income Tax Act or any Income Tax Ordinance of the territory) for the purpose of any deduction in respect of such mine under section 15(a) of this Act or the corresponding provisions of any previous Income Tax Act, or in the case of a company, under the said section or section 11(2)(i) of the Income Tax Ordinance, 1961 (Ordinance No.10 of 1961), of the territory, or the corresponding provisions of any previous Income Tax Ordinance of the territory;

(Definition inserted by sec.21(c), Act 65, 1973)

- (a) Shaft sinking and mine equipment;<sup>73</sup>
- (b) Cost of laying pipelines from the mining block to the marine terminal or local refinery or to the onshore processing facility;<sup>74</sup>
- (c) Expenditure on development, general administration and management (including any interest and other charges on loans utilised for mining purposes) prior to the commencement of production, or during any period of non-production;<sup>75</sup>
- (d) Costs<sup>76</sup> incurred in connection with:
- Viability studies;
  - The design, procurement, management (including project management), transport and construction of the constituent parts (from after raw material stage and including the piles and other foundations) of any marine or onshore receiving installations erected or to be erected on the mining block or onshore with a view to exploration of the natural oil;
  - Costs of training of personnel for any purpose in connection with the abovementioned installations, at any time prior to the successful commissioning of such installations but excluding any assets belonging to another taxpayer;
- (e) A capital allowance of 12% per annum on the unredeemed portion (namely the portion not yet recovered through the earning of mining revenues) of virtually all the expenditure referred to above, excluding interest and other charges on loans, calculated from the end of the year before the mine becomes taxpaying (as opposed to being in a loss position);<sup>77</sup> and
- (f) Expenditure on various qualifying assets such as mine housing, mine hospitals, schools, and other facilities owned and operated by the taxpayer for the benefit of its employees.<sup>78</sup> The current Income Tax Act requires deduction of this expenditure to be spread in equal instalments over ten years (five years

---

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

*(Definition inserted by sec.21(d), Act 65, 1973)*

<sup>73</sup> Section 36(11)(a) of the ITA.

<sup>74</sup> Section 15(a) of the ITA as at 1977.

<sup>75</sup> Section 36(11)(b) of the ITA.

<sup>76</sup> Clause 23.7.2(c) of the OP26 Mining Lease

<sup>77</sup> Section 36(11)(c) of the ITA as at 1977.

<sup>78</sup> Section 36(11)(d) of the ITA.

in the case of motor vehicles), the Income Tax Act as at 1977 did not include such a limitation. Therefore, these costs are deductible in full when incurred under the OP26 regime.

Some of the above categories are interpreted widely, and include items that may not appear to be included at first glance. For instance according to Van Blerck (1990:12-7), shaft sinking costs can include expenditure incurred on mining access, equipping the shaft, handling of materials, sub-surface equipment, treatment and utility plant, civil engineering services, architectural services, mechanical and electrical services, refrigeration and financial costs.

Although mining equipment is not defined in the Income Tax Act, the South African Revenue Service has allowed a broad interpretation to include all surface equipment, administrative buildings, processing plants and storage buildings owned by the taxpayer (Van Blerck, 1990:12-11).

It is also important to note that the equipment should consist of tangible assets and that intangible assets would not qualify for deduction (Van Blerck, 1990: 12-11). In terms of the International Accounting Standard 38 (2004: 1571), an intangible asset is defined as an “identifiable non-monetary asset without physical substance”. In the mining context, intangible assets may include items like patents, goodwill and mining licences (Ramboll, 2009: 11).

#### ***3.9.1.4 Refining capital expenditure***

The definition of “oil and gas company” includes a company that is engaged in the refining of gas derived from an “oil and gas right”.<sup>79</sup> Refining capital expenditure is depreciated over a 4 year period on the basis of 40:20:20:20.<sup>80</sup> The balance of capital equipment is depreciated over the expected useful life of the asset<sup>81</sup>. Industrial

---

<sup>79</sup> Definition of “Oil and Gas Company” as contained in paragraph 1 of the Tenth Schedule to the ITA prior to 30 September 2009.

<sup>80</sup> Section 12C of the ITA

<sup>81</sup> Section 11(e) of the ITA and practise note 19.

buildings<sup>82</sup> and commercial buildings<sup>83</sup> are depreciated at 5% per annum. Pipelines<sup>84</sup> and ports assets<sup>85</sup> are depreciated over 10years and 20years respectively.

### **3.9.2 Deductions under the Tenth Schedule Regime**

#### ***3.9.2.1 Operating expenses***

Paragraph 5(1) of the Tenth Schedule provides that for the purposes of determining the taxable income of an oil and gas company during a year of assessment, there will be allowed as deductions from its oil and gas income all expenditure and losses actually incurred (other than any expenditure or loss actually incurred on the acquisition of an oil and gas right, except as allowed in paragraph 7(3)) in that year of exploration or production.

#### ***3.9.2.2 Exploration<sup>86</sup> and Production capital expenditure***

Capital expenditure on exploration or production is fully deductible, in terms of paragraph 5(1), but also qualifies for a percentage “uplift” in terms of paragraph 5(2).

Paragraph 5(2) of the Tenth Schedule allows for the deduction of 100% of the expenditure of a capital nature actually incurred in a year in respect of exploration and it allows for the deduction of 50% of capital expenditure incurred in respect of production. Essentially, capital expenditure in respect of exploration<sup>87</sup> receives a

---

<sup>82</sup> Section 13 of the ITA

<sup>83</sup> Section 13quin of the ITA

<sup>84</sup> Section 12D of the ITA

<sup>85</sup> Section 12F of the ITA

<sup>86</sup> Definition of “Exploration” as contained in paragraph 1 of the Tenth Schedule; means the acquisition, processing and analysis of geological and geophysical data or other related activity for the purpose of defining a trap to be tested by drilling together with well drilling, logging and testing (including extended well testing) up to and including the field appraisal stage.

<sup>87</sup> In the context of exploration expenditure, it is understood that SARS accepts that all expenditure incurred by a company during its exploration phase, will be deductible unless it is overhead expenditure of a corporate (as opposed to operational) nature.

The cut-off between expenditures incurred in respect of exploration and production respectively, must be determined in relation to those terms as defined in the Tenth Schedule and not necessarily by reference to whether the company holds an exploration right or a production right under the minerals

200% super deduction and capital expenditure in respect of production receives a 150% super deduction. No deduction may be claimed in terms of paragraph 5(2) in respect of expenditure incurred for the acquisition of an oil and gas right.

Mitchell (2007:82) states that the “uplift” acts as an incentive to invest in high-risk, high-cost capital expenditure that probably represents long-term sunken capital. Exploration is given a higher uplift due to the higher nature of the risk (and to compensate for the fact these losses will probably not be useable against income for a longer period than production expenses).

Prospecting (“Exploration”) and Mining (“Production”) capital expenditure is deductible in full under both the Tenth Schedule and OP26 regime. Accordingly, this core aspect of the OP26 regime has been retained. (Refer to 4.4 of this dissertation in which the additional tax deductions in relation to capital expenditure are examined).

### ***3.9.2.3 Refining capital expenditure***

The Tenth Schedule applies only to an “oil and gas company”. The Tenth Schedule, when first added by section 63(1) of the Revenue Laws Amendment Act, 2006 defined an oil and gas company as any company that:

- “(a) (i) holds any oil and gas right;<sup>88</sup> or*  
*(ii) engages in exploration or production in terms of any oil and gas right; or*  
*(iii) engages in refining of gas<sup>89</sup> derived in respect of any oil and gas right held by that company; and*  
*(b) engages in no trade other than any of the activities contemplated in item (a)”*

---

legislation. A production licence may be granted at a point in time which does not align with the termination of ‘exploration’ from a taxation perspective (Clegg, 2010 at 20.9).

<sup>88</sup> Definition of “oil and gas right” as contained in paragraph 1 of the Tenth Schedule; means any reconnaissance permit, technical co-operation permit, exploration rights or production right as contemplated in Section 1 of the Mineral and Petroleum Resources Development Act, 2002 (Act No 28 of 2002), or any right or interest therein.

<sup>89</sup> Definition of “Gas” as contained in paragraph 1 of the Tenth Schedule; means any subsoil combustible gas, consisting primarily of hydrocarbons, other than hydrocarbons converted from bituminous shales or other stratified deposits of solid hydrocarbons.

It is apparent from the above definition of “oil and gas company”, that any exploration or production which takes place in a company conducting other activities, would be taxable (with the income from those other activities) in terms of the general provisions of the Income Tax Act, without having regard to the provisions of the Tenth Schedule.

The narrow scope of the definition of “oil and gas company” was aimed at preventing taxpayers engaged in any trade<sup>90</sup> other than the specified activities in the definition from accessing the enhanced capital allowances (and certain other favourable tax treatments) for “oil and gas companies”, as well as the possibility of entering into a “fiscal stability agreement” which will preserve those advantages for a regulated period of time.

Clegg (2008: A-1) states that subsequent to the promulgation of the Tenth Schedule in 2006, it becomes apparent that the normal commercial activities of a company prospecting for/or producing oil and gas, or refining gas results in the derivation of revenues from incidental activities outside of those specified in the definition. Although it may be argued on the basis of case law<sup>91</sup> that such activities do not constitute separate trades, a negative interpretation by SARS would be destructive to the financial viability of most participants in the industry. Accordingly, a submission was made to National Treasury for an amendment to the Tenth Schedule. This proposal was adopted by National Treasury.

The Explanatory Memorandum, 2009 at 70, indicates that the “oil and gas company” definition was too narrowly defined and takes an all-or-nothing approach. A company engaging in any trade that is not stipulated in the oil and gas company definition prevents the benefits of the Tenth Schedule. This prohibition applies even to ancillary trades normally associated with oil and gas exploration and production. These ancillary trades include the leasing of excess building space, the purchase and sale of

---

<sup>90</sup> Definition of “trade” in section 1 of the ITA, “includes every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use of or the grant of permission to use any patent, or any design, or any trademark or any copyright, or any other property of a similar nature.

<sup>91</sup> *ITC 1503* (53 SATC 342)(T); *ITC1753* (65 SATC 310)

oil to cover contractual short-falls and management fees from managing oil and gas joint ventures. No reason, according to the Legislature, exists to prevent the application of the Tenth Schedule merely because a company engages in ancillary trades normally associated with oil and gas exploration and production.

Accordingly, the definition of “oil and gas company” was amended on 30 September 2009 so as to eliminate the all-or-nothing approach.<sup>92</sup> The prohibition against impermissible trades was dropped. This amendment was not made retrospective as its purpose was to clarify the intention of the Legislature, namely that the Tenth Schedule applies to companies that hold a South African oil and gas right.

In the absence of the retrospective amendment the question arises whether in lieu of the allowances provided for refining capital expenses (as documented in 3.9.1.4 of this dissertation), a company engaged in the refining of gas<sup>93</sup> could have claimed refining capital expenses in full under paragraph 5(1). Paragraph 5(1) of the Tenth Schedule allows the deduction of expenditure and losses actually incurred by an oil and gas company. The author submits that such a deduction would not be allowed under paragraph 5(1) as the nature of expenditure envisaged is expenditure “in respect of exploration or production”.

#### **3.9.2.4 Operator cost recoveries**

When there is more than one participant in a mining block, a joint operating agreement (“JOA”) is executed. The JOA governs how the mining block is to be operated and how costs are to be shared between the participants. In addition, one of the participants is designated in the JOA as the operator of the mining block and the other participants as non-operators. The operator is responsible for the day-to-day operations of the mining block.

---

<sup>92</sup> An oil and gas company is defined in paragraph 1 of the Tenth Schedule as any company that;  
“ (i) holds any oil and gas right; or  
 (ii) engages in exploration or production in terms of any oil and gas right”

<sup>93</sup> The definition of oil and gas company as contained in paragraph 1 of the Tenth Schedule, prior to 30 September 2009, specifically included any company that “engages in refining of gas derived in respect of any oil and gas right held by that company”.

A practical difficulty that arises in relation to the JOA is that the agreed costs sharing may be different to the participation percentage. Accordingly, there will be a mismatch between the proportionate income and the proportionate expenditure incurred. This creates the opportunity for possible tax avoidance.

For example, South Africa does not have a system of Group Taxation. Each corporate entity is treated as a separate tax payer. There is a tax advantage to be gained where one participant from the same group of companies is in a tax assessed loss position (typical of a new entrant) and the other in a tax paying position (typical of an oil and gas company with a producing asset). A lower proportionate share income is received by and a higher proportion of expenses is incurred by, the participant in the taxpaying position.

Costs are typically incurred by the operator in carrying out the day-to-day operations of the mining block. The operator then invoices its fellow participants in the mining block for a reimbursement of their agreed sharing of the costs. The timing of cost reimbursements at tax year-end can often result in a mismatch of the tax treatment of the costs in the tax calculation of the operator and the tax calculations of the non-operators.

For example, the operator has paid all the expenses and is able to claim a deduction of the expenses paid, but unless the operator has invoiced for the recovery of a portion of the expenses, typically it will not set off the re-imburements or recognise them as income until the next tax year. The non-operators are obligated to reimburse the operator as agreed in the JOA and according might claim a deduction in respect of such amounts payable even before an invoice is received or a payment made.

It is submitted that the JOA creates an immediate shared incurral of expenditures and that invoicing by the operator does no more than notifying the non-operators, accordingly there is no tax advantage to be gained in the timing of the re-imburement of costs.

## 3.10 Thin Capitalisation and Transfer Pricing

### 3.10.1 Introduction

Sunley et al. (2002:4) cautions governments in relation to the dangers of transfer pricing in relation to erosion of the government take of profits from oil and gas mining.

Sunley et al. (2002:4) states that:

“Through transfer pricing, a taxpayer seeks to minimize income and maximize deductible expenditures in high-tax jurisdictions and vice versa in low-tax jurisdictions.

A transfer pricing mechanism that could affect revenue in the oil and gas sector is the creative use by firms of price hedging mechanisms, perhaps involving transactions between related parties, causing great difficulty in assessing whether hedging instruments are used for transfer pricing purposes rather than to reduce risk.

More common measures to maximize expenditure deductions include:

- The provision by related parties of highly leveraged debt finance at above-market interest rates.
- Claiming excessive management fees, deductions for headquarter costs, or consultancy charges paid to related parties.
- The provision of capital goods and machinery in leasing arrangements at above-market costs charged by a related-party lessee.
- If the petroleum tax rate is above the standard tax rate, there may be an incentive to establish a domestic shell firm that will on-lend financing capital from related parties to the oil company, giving rise to an interest deduction at a higher tax rate than is charged on the interest earnings in the shell company.

Abusive transfer pricing can be very difficult to detect and prevent. Properly designing the tax code, though, is an important first step. At a minimum, the tax legislation should include safeguards requiring that transactions between related parties be assessed on an arms-length basis, or perhaps that certain deductions be capped as a share of total costs. Some countries also impose a limit on the allowable (for tax purposes) debt-leverage of a project.”

### **3.10.2 Transfer Pricing and Thin Capitalisation under the OP26 regime**

The thin capitalisation and transfer pricing provisions for goods and services supplied between connected persons were introduced in the Income Tax Act in 1995. As these restrictions on the deductibility of expenses and interest were promulgated post 1977, it is anticipated that the taxpayer would elect under the OP26 regime (at clause 26 of the OP26 mining lease and similarly at clause 28 of the OP26 prospecting sublease agreement) that the Income Tax Act as at 1977 should apply.<sup>94</sup> Accordingly the taxpayer under OP26 is not subject to either the thin capitalisation or transfer pricing provisions.

### **3.10.3 Transfer Pricing under the Tenth Schedule regime**

Transfer pricing is not specifically mentioned in the Tenth Schedule and the provisions of section 31(2) of the Income Tax Act will therefore apply (Clegg and Steenkamp, 2007:3).

---

<sup>94</sup> Clause 26 of the OP26 mining lease provides that “*Except to the extent exempted in terms of Clause 23, Lessee shall, throughout the term of this Mining Lease, be liable for income tax payments to the State on the annual taxable income derived by it from prospecting and mining for Natural Oil and transactions in connection therewith in accordance with Income Tax Act as of the date the 1977 amendments thereto were promulgated*”.

Similarly clause 28 of the OP26 prospecting sub-lease provides that: “*Except to the extent exempted, Lessee shall throughout the terms of this Sub-Lease, be liable for income tax payments to the State on the annual taxable income derived by it from prospecting for Natural Oil and transactions in connection therewith in accordance with the Income Tax Act as of the date the 1977 amendments thereto were promulgated*”.

The provisions of section 31(2) of the Income Tax Act provide as follows:

- where goods or services
- are supplied or acquired
- in terms of an *international agreement*
- *and* the acquirer is a *connected person* in relation to the supplier
- *and* the price of the goods or services is not an *arm's length price* (i.e. market value<sup>95</sup> in circumstances)
- the Commissioner may adjust the price to an arm's length price in calculating the taxable income of the acquirer or supplier. The adjustment may further be subject to STC (as if the value were distributed from a subsidiary company).
- The exercise by the Commissioner of his discretionary powers is subject to objection and appeal (Huxham & Haupt, 2009: 423).

An "international agreement" is defined in section 31 of the Income Tax Act as a transaction, operation, or scheme entered into between

- A resident and any other person who is not a resident; or
- A person who is not a resident and any other person who is not a resident for the supply of goods or services to or by a permanent establishment of either of such persons in the Republic; or
- A person who is a resident and any other person who is a resident for the supply of goods or services to or by a permanent establishment of either of such persons outside the Republic.

The participants in a mining block are typically companies from groups of companies that are independent / un-associated to each other. The section 1 definition of "connected person" in the Income Tax Act does not specifically address participants in a joint venture, but it is construed that for income tax purposes that the joint venture<sup>96</sup> may be seen as a "partnership" on the basis that it's "members share in

---

<sup>95</sup> *True Motives 84 (Pty) Ltd v Mahdi and another* 2009 (4) SA 153 (SCA):

"Market value is the price that an informed willing buyer would pay to an informed willing seller for the property having regard to all its potential at the time of sale"

<sup>96</sup> A distinction is often drawn between the term "partnership" and the term "joint venture". Although joint venture agreements may contain a statement that they are not to be construed as a partnership, joint ventures generally meet all the requirements of a partnership and may, where appropriate, be treated as a form of partnership. The term "joint venture" is usually used where the

profits and losses according to their members share in the partnership”.<sup>97</sup> The impact of this interpretation is that all transactions between participants in the mining block are seen to be transactions with connected persons and accordingly participants may be called to justify the arm’s length price of their activities in the joint venture where one (or more) of the participants is a non-resident for tax purposes.

It is not uncommon for foreign incorporated companies to carry out their oil and gas activities through a registered<sup>98</sup> branch in South Africa. Transfer pricing legislation does not apply to the dealings between a company and its own branch because a company and a branch are the same entity, and a branch is not defined as a “connected person”.<sup>99</sup> However, this does not mean that companies can ignore the arm’s length principle when interacting with their branch.

In SARS Practise Note 7 at paragraph 6, SARS indicates that it will apply the principles of section 31 to the dealings between a company and its own branch in the application of the DTA’s entered into by South Africa. Tax treaties address the concept of transfer pricing so that profit can be properly allocated between tax treaty partners. Under the tax treaties (typically Article 9), transfer pricing adjustments arise if the terms and conditions of transactions between associated companies differ from the terms and conditions that would have occurred between independent companies. Once triggered, the tax treaty allows for profits to be adjusted to reflect the profits that would have arisen had arm’s length terms and conditions been initially applied (Explanatory Memorandum in respect of the draft Taxation Amendment Bill, 2010:96).

#### **3.10.4 Thin Capitalisation under the Tenth Schedule regime**

Paragraph 6 of the Tenth Schedule provides a “safe harbour” against the thin capitalisation rules found elsewhere in the Income Tax Act.

---

parties concerned intend to pursue a single venture only, for example, in the mining industry joint ventures are often formed for the purpose of prospecting for mineral deposits (Pedregal, 2009:18).

<sup>97</sup> *ITC 1794* (2005) (67 SATC 262)

<sup>98</sup> Registered with CIPRO

<sup>99</sup> Section 1 of the ITA, definition of “connected person”

Paragraph 6(1) of the Tenth Schedule provides that for purposes of determining the taxable income of an oil and gas company during a year of assessment, the Commissioner may not disallow a deduction of expenditure for loans, advances and debts (or for any other financial assistance<sup>100</sup>) on the grounds that these loans, advances and debts are excessive in relation to its fixed capital (as determined on the last day of its year of assessment), unless

- An interest-bearing loan, advance or debt was owed during that year by it to a person who is its connected person, and
- All interest-bearing loans, debts and advances contemplated above in the aggregate exceed an amount equal to three times its total fixed capital (being its share capital, share premium and accumulated net realised and unrealised profits) as calculated on the last day of the company's year of assessment.

This paragraph has the purpose of fixing a 3:1 ratio rule for thin capitalisation rather than leaving it to negotiation and the practise note<sup>101</sup> as is the case with other taxpayers<sup>102</sup> under section 31(3) of the Income Tax Act.

The thin capitalisation “safe harbour” involves two basic steps:

- First, the oil and gas company determines whether it owes interest-bearing loans, advances or debts to its connected person. In terms of paragraph 6(3), loans, advances or debts are interest bearing for a particular year only if they bear interest during that year.
- Secondly, the loans, advances or debts are measured against the total fixed capital of the company.

The Commissioner may, in terms of paragraph 6(2) of the Tenth Schedule, disregard excessive levels of debt if that excess occurs only for a temporary duration<sup>103</sup>.

---

<sup>100</sup> The author submits that “indirect financial assistance” as contemplated in section 31(3) of the Income Tax Act will enjoy the “safe harbour” under paragraph 6(1). The ambit of paragraph 6(1) is wide, specifically including “any other financial assistance”.

<sup>101</sup> To date the 3:1 ratio has only been contained in the SARS Practice Note 2 – 14 May 1996, paragraph 4.1.

<sup>102</sup> In accordance with SARS Practice Note 2, the Commissioner in general accepts a 3:1 debt:equity ratio. However, on application the Commissioner may exercise his discretion and accept a different ratio. In practice it is understood that an 8:1 ratio has been accepted in the case of branches of foreign banks but generally, the 3:1 ratio is not departed from (Clegg, 2010 at 24.12).

### 3.11 Conclusion

The Tenth Schedule does not preserve the tax treatment under OP26 in its entirety. It satisfies existing investors, even if only on a “swings and roundabouts” basis.

Refer to Annexure A for a table of the similarities between the OP26 regime and the Tenth Schedule regime.

The Tenth Schedule affords similar tax benefits to the OP26 regime in relation to tax rates, STC, VAT, customs duties, the deduction of operating expenses, the deduction of exploration and production expenses. The Tenth Schedule provides for comparable (but not equally favourable) tax benefits in relation to the tax treatment of foreign exchange gains/ losses and the ring-fencing of mining assessed losses (dealt with in further detail at 4.3 of this dissertation). Furthermore, there are short-comings in relation to Capital Gains Tax. The Tenth Schedule affords relief from CGT limited only to the rollover election available on the disposal of oil and gas rights<sup>104</sup> (dealt with in further detail at 4.5 of this dissertation). The Tenth Schedule offers very limited relief from thin capitalisation in the form of a “safe harbour” rule and no exemption from transfer pricing. Under the OP26 regime, the OP26 lessee could opt that neither thin capitalisation, nor transfer pricing provisions should apply.

Whilst there are similarities between the tax benefits offered to oil and gas companies under the OP26 regime and the Tenth Schedule, it cannot unequivocally be stated that companies engaged in the exploration for and production of oil and gas enjoy the same, if not more favourable, tax dispensation under the Tenth Schedule than under the OP26 regime. In fact, provisions such as thin capitalisation and transfer pricing

---

<sup>103</sup> This is in alignment with SARS Practise Note 2 at 6.2. “Where a taxpayer, therefore, can justify a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate under particular or special circumstances, he may approach the Commissioner, to exercise his discretion in terms of section 31. This will, generally be of a temporary nature and a period may be specified within which the 3:1 ratio should be restored or the interest rate be reduced”.

<sup>104</sup> See Annexure A of this dissertation.

are unfavourable in comparison to the OP26 regime. In chapter 4, the significant distinctions between the OP26 regime and the Tenth Schedule regime are examined.

## **CHAPTER 4 – SIGNIFICANT DISTINCTIONS BETWEEN THE OP26 REGIME AND THE TENTH SCHEDULE REGIME**

### **4.1 Introduction**

Sunley et al. (2001:1) states that oil and gas extraction plays a dominant role as a source of export earnings and, to a lesser extent, employment in many developing countries. But the most important benefit for a country from the development of the oil and gas sector is likely to be its fiscal role in generating tax and other revenue for the government. To ensure that the state as resource-owner receives an appropriate share of the economic rent generated from extraction of oil and gas, the fiscal regime must be appropriately designed.

The government, as resource owner, has a valuable asset in the ground. This asset (a crude oil or natural gas deposit) can only be exploited once. In order to convert this asset into financial resources, the government must attract capital on terms that ensure it gets the greatest possible value for its resources under uncertainty about what the value of the resources will turn out to be.

There is a fundamental conflict between oil and gas companies and the government over the division of risk and reward from a petroleum project. Both want to maximize rewards and shift as much risk as possible to the other party. Oil and gas agreements and the associated fiscal rules establish the “price” of the resource in terms of the bonuses, royalties, taxes or other payments the investor will make to the government over the life of the project. Designing fiscal arrangements that encourage a stable fiscal environment and efficient resource development maximize the magnitude of the revenues to be divided.

In designing fiscal instruments, the government will need to weigh its desire to maximize short-term revenue against any deterrent effects this may have on investment. This will require a balanced sharing of risk and reward between the investor and the government (Tordo, 2007:13):

- Governments typically aim to obtain the maximum value (not volume) for their countries over time in terms of net receipts for treasury. Their goal is to

maximize the wealth from their natural resources and, at the same time, attract foreign investment. Governments also have development and socio-economic objectives, such as job creation, transfer of technology, and development of local infrastructure.

- Oil and gas companies aim to ensure that the return on capital is consistent with the risk associated with the project and with the strategic objectives of the corporation.

Sunley et al. (2001:1) advises that governments should aim for a fair and rising government share of the resource rent, without scaring off potential investors.

This chapter examines the primary concerns of existing investors in the upstream oil and gas sector in relation to the taxation of the exploration for and production of oil and gas in South Africa and makes recommendations for probable solutions.

## **4.2 Fiscal Stability**

### **4.2.1 Introduction**

Sunley et al.(2002:8) indicates that given the nature of investment in oil and gas extraction (namely: long term, large-scale and up-front) a particular concern for investors is to guard themselves against unforeseen changes to the financial premises of the project. One safeguard mechanism that is often sought by investors is the inclusion of a fiscal stability clause in the project agreement. While this to the government can seem an attractive and, in the short run, inexpensive way of minimizing investor risk, it does limit the government's flexibility to set tax policy, potentially resulting in a revenue loss and increased administrative costs.

Fiscal stability clauses come in different forms. One approach is to “freeze” the tax system at the time of the project agreement. If the tax system is later changed, this will imply a special treatment of a particular taxpayer, adding to the administrative burden, especially if several projects are operating under different tax systems. Another approach is to guarantee the total investor take. If one tax is increased, this

will be offset by a reduction in another tax (or in principle by paying a compensatory subsidy), which perhaps better preserves the integrity of the tax system. Still, it may be quite difficult in practice to agree on compensatory measures that can satisfy both government and investor. There are also some stability clauses that are asymmetric: protecting the investor from adverse changes to the fiscal terms but passing on benefits of economy-wide reductions in tax rates.

Fiscal stability clauses are widespread in the oil and gas sector. Of 109 countries surveyed in 1997 by Barrows, a majority (63 percent) provided fiscal stability clauses for all fiscal terms (see Annexure A of this dissertation). A small group (14 percent) had partial fiscal stability clauses excluding income tax. Finally, a minority (23 percent) did not provide any fiscal stability clauses, in project agreements (at least up until 1997). However, this does not prevent an investor from seeking to renegotiate fiscal terms in response to policy changes. A recent example of a country, which repealed its tax stability clause for contracts signed from 2002 onwards, is that of Kazakhstan. Tax conditions set in contracts may now be adjusted in compliance with amendments to tax laws, by the mutual consent of the government and the contractor.

#### **4.2.2 Fiscal stability under the OP26 regime**

Under the OP26 regime all the taxes were guaranteed within the lease agreement, granting definitive assurance to the OP26 leaseholder of fiscal stability. There was no need for an investor to search exhaustively for all the fiscal legislation and then seek guarantee agreements in respect of each separate tax.

In general under the OP26 mining lease, the taxpayer is taxed in terms of the Income Tax Act as at 1977. Furthermore, the taxpayer may claim tax deductions that are more favourable, as between the Income Tax Act as at 1977 and the current Income Tax Act.

The OP26 mining lease restricted the taxpayer's tax burden to income tax only. Furthermore, it prevented the introduction of new unfavourable legislation, such as CGT promulgated after 1977 and provided for the exemption of all taxes based on turnover.

### 4.2.3 Fiscal stability under the Tenth Schedule regime

Paragraph 8(1) of the Tenth Schedule provides that the Minister of Finance, after consultation with the Minister of Energy, may enter into agreements that contractually bind the State with an oil and gas company guaranteeing that the provisions of the Tenth Schedule, as at the date that the agreement was entered into, will continue to apply for the duration of that company's oil and gas right.

Paragraph 8(2) ensures that fiscal stability will remain if exploration rights are renewed or are converted into production right.

Paragraph 8(6) of the Tenth Schedule provides that: *“If the State fails to comply with the terms of the fiscal stability agreement and that failure has a material adverse economic impact<sup>105</sup> on the taxation of income or profits of the oil and gas company that is party to the fiscal stability agreement, the oil and gas company is entitled to compensation for the loss of market value caused by that failure (and interest at the prescribed rate) or to an alternative remedy that otherwise eliminates the full impact of that failure.”*

A copy of the standard memorandum of agreement for fiscal stability is attached as Annexure B of this dissertation.

The short-comings of the fiscal stability agreement envisaged in the Tenth Schedule are:

1. The agreement does not encompass all taxes levied on an oil and gas company. The approach taken by National Treasury in replacement of the fiscal stability available under the OP26 regime appears to be the insertion of a fiscal stability clause for each tax impacting on the oil and gas sector (for example, the Mineral and Petroleum Resources Royalty Act, No 28 of 2008).

---

<sup>105</sup> Paragraph 8(6) is problematic since there is no indication of what would constitute a “material adverse economic impact”. Presumably a “material adverse economic impact” would have an after tax effect of greater than 10% of taxable income for an “oil and gas company”, before triggering compensation from the state.

2. The agreement does not prevent the introduction of new taxes in relation to an oil and gas company. For example a windfall profits tax or export duties on crude oil.
3. The agreement does not allow for the transfer of fiscal stability to third parties once the taxpayer has entered into production. In terms of clause 24.1 of the OP26 prospecting sub-lease agreement, the principle was established that an oil and gas company may transfer all or part of its rights, duties and obligations under the sub-lease to any other oil and gas company, this includes fiscal stability in relation to the OP26 mining lease.

The Tenth Schedule at paragraph 8 provides for the transfer of the fiscal stability agreement rights in relation to:

- Disposals of exploration rights (paragraph 8(2)(a))
- Disposals within the same group (paragraph 8(2)(b))
- Changes in participating interest percentage (paragraph 8(3))

A concern of existing investors in the upstream oil and gas sector in relation to fiscal stability is that, in relation to the disposal of a production right, the Tenth Schedule at paragraph 8(2)(b) limits the transfer of fiscal stability agreement rights to any other oil and gas company. This concern is articulated in a submission to National Treasury on behalf of OPASA for a proposed amendment to the Tenth Schedule (Futter, 2010: A-3).

South Africa competes with other destinations for new entrants. South Africa's poor geological attractiveness of producing assets may deter a new entrant. This coupled with the fact that the new entrant does not enter on a level playing field to existing participants, may further deter new entrants. True fiscal stability is assurance that the legislative treatment is stable, predictable and uniform to all participants.

Changes to the participants in an oil and gas right are internationally not uncommon at the production stage. These changes are driven by:

1. A participant's intention to refocus its activities and resources to better producing opportunities (often outside South Africa),
2. Increases in operating costs that can no longer be afforded,
3. Decisions to invest in further capital to enhance recovery that cannot be afforded by all participants.
4. A participant choosing to reduce the investment risk where the economic returns do not warrant further expenditure.
5. A participant's realignment of its core business (typical for companies focused on exploration and not production). In such instances, participation in a producing asset will be sold out to a company specialising in production.

The transferability of fiscal stability agreement rights impacts on the marketability of a production right. Any new participant to a production right will not share the fiscal stability enjoyed by original participants. Accordingly, the new participant will not operate on an equal footing to its partners.

This inequity can also influence the decision making of the joint venture after a new participant's entry, for example where the economics of further investment to enhance recovery proves to be unviable for one of the participants because of a difference in fiscal treatment.

OPASA has requested that in the spirit of alignment with the OP26 regime, the assignment of fiscal stability agreement rights on disposal of an oil and gas right to any other oil and gas company should be extended to production rights. Their proposed amendment to the Tenth Schedule was as follows (Futter, 2010:A3-4):

*“Sub-paragraph (2)(a) and paragraph (2)(b) of paragraph 8 of the Tenth Schedule should be substituted with the following sub-paragraph:*

*8(2) In the case of a disposal of an oil and gas right as defined in sub-paragraph (7) an oil and gas company that has concluded an*

*agreement as contemplated in subparagraph (1) in respect of that right may, as part of that disposal assign all of its fiscal stability rights in terms of that agreement relating to the oil and gas right disposed of, to any acquiring gas company.”*

The suggested wording consolidates exploration and production rights to the defined term “oil and gas right” in sub-paragraph 8(7) of the Tenth Schedule and correspondingly eliminates the distinction in relation to the assignment of fiscal stability agreement rights on disposal to an acquiring company.<sup>106</sup>

The author proposes an alternative solution for existing investors in the oil and gas sector where there is no amendment to the legislation. The disposal of an investment in an oil and gas block is typically either by disposal of a participation in the mining block (or part thereof) or shares in a company that holds the mining block. The restriction on the disposal of fiscal stability agreement rights whilst in production does not extend to a change in shareholding in the oil and gas company.

If it is the intention of the legislature to prevent the transfer of fiscal stability in relation to a producing asset, anti-avoidance measures would need to be introduced to prevent taxpayers from registering multiple companies for the purpose of holding their participation in each mining block, where the taxpayer wants to preserve the ability to dispose of an investment in a producing asset with the fiscal stability.

The secondary concern of existing investors in relation to paragraph 8(2)(b) of the Tenth Schedule is that it allows for the transfer of the fiscal stability agreement within the same group of companies, as opposed to affiliates as defined in the MPRDA.

Section 1 of the Income Tax Act, defines “group of companies” as two or more companies of which one company (namely the controlling group company) directly or

---

<sup>106</sup> The term “acquiring company” has been used in the proposed wording in substitution for “other oil and gas company”. An oil and gas company is defined in paragraph 1 of the Tenth Schedule as a company that holds any oil and gas right. This definition prejudices new entrants that do not hold an existing oil and gas right. Although, it may be argued that upon acquiring a participation in a production right the new entrant simultaneously becomes an oil and gas company as defined and accordingly becomes a company to which the rights under a fiscal stability agreement may be transferred.

indirectly holds shares in at least one other company (namely the controlled group company), to the extent that at least 70% of the equity shares of each controlled group company are held directly by the controlling group company, one or more other controlled companies or any combination thereof.

The Mineral Petroleum and Resources Development Act, 2002 (“MPRDA”) provides for the transfer of a mining or production right to an “affiliate”. An “affiliate” is defined for MPRDA purposes as a company that owns, or is owned by the MPRDA mining or production rights holder. “Owns” and “owned” mean ownership directly or indirectly of more than 50% (fifty percent) of the voting shares or member’s interests.

With effect from 1 Jan 2009, section 41 of the Income Tax Act provides that “group of companies” means a group of companies as defined in Section 1, but specifically excludes from the “group of companies” definition any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law.

The concern of existing investors in relation to the above definitions is that there is inconsistency between the MPRDA and the Income Tax Act. An oil and gas company may seek the transfer of a mining or production right to an affiliate in terms of the MPRDA, but a corresponding transfer of the fiscal stability agreement is not possible where the equity holding is less than 70%.

A transfer of a mining or production right to another group company takes place simultaneously with the transfer of the fiscal stability agreement. However, the group rules in the Income Tax Act which provide relief in relation to income tax recoupments, CGT roll-overs, non-supplies for VAT purposes, exemptions from stamp duties and transfer duties do not apply in relation to foreign companies. This is a problem when the bulk of upstream oil and gas exploration in Southern African territorial waters is undertaken by, or jointly with, the subsidiaries or branches of foreign companies.

Accordingly, OPASA has requested that paragraph 8(2)(b) should accommodate the transfer of the fiscal stability agreements between affiliates as defined in the MPRDA.

Furthermore, OPASA has requested that the definition of group of companies in Section 41 of the Income Tax Act must be refined to specifically include affiliates, as defined in the MPRDA, in relation to the transfer of exploration and production rights.

### **4.3 Ring-fencing**

#### **4.3.1 Introduction**

In terms of paragraph 5(3) of the Tenth Schedule, when determining the taxable income of an oil and gas company, *“any assessed losses (as defined in section 20) in respect of exploration or production may only be set-off against the oil and gas income, and income derived from the refining of gas by that company to the extent those losses do not exceed that income”*.

To the extent that any assessed loss remains after the set-off as set out above, paragraph 5(4) provides that 10% of the remaining assessed loss may be set off against any other income, which does not constitute oil and gas income.

The expression “oil and gas income” means the receipts, accruals or gains derived by an oil and gas company in respect of any oil and gas right, including the leasing or disposal of that right,

The intention of the Legislature at paragraph 5(3) of the Tenth Schedule is to preclude the taxpayer from setting off assessed losses in respect of oil and gas exploration or production against income other than oil and gas income, and income derived from refining<sup>107</sup> of gas (i.e. ring-fence oil and gas mining losses).

---

<sup>107</sup> The term “refining” is important in relation to consideration of what constitutes “income derived from the refining of gas” as envisaged in paragraph 5(3) of the Tenth Schedule.

Whilst the Tenth Schedule no longer contains a definition of refining (it was removed 30 September 2009), the author has based the definition of refining on the definition provided in the Revenue Laws Amendment Act, 2006. Gas refining activities is defined as those activities necessary to convert the gas to a finished refined product such as diesel, petrol (“mogas”), kerosene (“illuminating paraffin”), liquid petroleum gas (“LPG”), naphtha, alcohols, ethanol, distillates and propane. These processes are described as:

- a) The fractional distillation,
- b) Chemical processing,
- c) Conversion treatment

It is not uncommon for companies engaged in the exploration for oil and gas to hold large cash deposits. Because of the high risk nature of exploration activities external funding of such activities by financial institutions are rare, accordingly companies typically fund these activities using their own cash resources. Existing investors in the oil and gas sector are concerned that interest income derived from these cash balances would be construed as non-oil and gas income and subject to the 10% ring-fencing.

Their concern stems from the example provided in the Explanatory Memorandum to the Revenue Laws Amendment Act, 2006<sup>108</sup> in which “bond interest”<sup>109</sup> on working capital is provided as an example of the functioning of the ring-fencing provided for in paragraph 5(4) of the Tenth Schedule. The revenue authorities may interpret this example to imply that all investment income received by an oil and gas company is to be treated as income other than oil and gas income.

The example furnished in the Explanatory Memorandum (2006:19) is as follows:

<p><b>Facts.</b></p> <p>Oil and Gas Company generates 192 million U.S. dollars in oil production receipts plus another 25 million in U.S. dollars from bond interest on working capital. Oil and Gas Company incurs 80 million U.S. dollars in oil operating expenditures as well as 60 million U.S. dollars for oil capital expenditures (i.e. for a new oil rig).</p> <p><b>Result.</b></p> <p>Oil and Gas Company has total oil losses of 200 million U.S. dollar (\$80 million plus \$120 million (i.e. \$60 million times 2)). This \$200 million amount completely offsets the \$192 million amount, leaving an \$8 million excess. Of this \$8 million excess, \$800 000 can be used to offset the \$25 million in U.S. dollar working capital income. At the end of the day, Oil and Gas Company is taxed on the \$24.2 million of interest income (\$25 million – \$800 000) and has \$7.2 million of excess oil and gas loss (\$8 million – \$800 000) as a carry forward into the following year.</p>
--

- 
- d) Product blending to meet fuel specification or
  - e) Any combination thereof.

<sup>108</sup> At 19

<sup>109</sup> Bond interest envisages a longer term investment than mere interest on current accounts.

### 4.3.2 The meaning of oil and gas income

An oil and gas mining assessed loss may be offset against oil and gas income, and against income derived from the refining of gas. Oil and gas income is income derived by an oil and gas company “in respect of” an oil and gas right. The question that therefore needs to be answered, is whether investment income could be regarded as income derived in respect of an oil and gas right or income “derived from” refining.

The term “in respect of” has been interpreted by the courts in a number of cases, in the context of different statutes, and has not been given a consistent meaning. It seems clear that the particular meaning to be ascribed to the term depends upon the context in which it is used.<sup>110</sup> While it seems clear that the phrase requires a causal connection, the context in which it is used dictates whether it is to be given a wider<sup>111</sup> or a narrower meaning<sup>112</sup> and whether or not it requires a direct relationship.<sup>113</sup> Unfortunately, it is not absolutely clear what meaning should be given to the words “in respect of” in the context of the definition of “oil and gas income”.

The term “derived from” is understood to generate a direct causal link between the income and the source from which it arises. This implies that the income derived must be directly connected to the oil and gas mining operations.<sup>114</sup>

---

<sup>110</sup> In *CIR v Crown Mines Ltd* 1923 AD 121, Solomon JA, said a p.128, ‘Now the words in respect of may be used in various senses, and in each case it is essential to examine the context in order to ascertain the sense in which it is used’.

<sup>111</sup> In *Sekretaris van Binnelandse Inkomste v Raubenheimer* 31 SATC 209, it was concluded that “if the phrase and consequently the subsection is reasonably capable of two constructions, that the construction should be placed on it which favours the taxpayer”.

<sup>112</sup> In *Ernst v Commissioner for Inland Revenue* 1954 (1) SA318 (A) at 323 C-E it was held that one should adopt a strict construction of the empowering legislation where a class of taxpayers is privileged. The Tenth Schedule provides class privileges to oil and gas companies and hence the definition of oil and gas income should have a narrow interpretation.

<sup>113</sup> In *Rabinowitz & Anor v De Beers Consolidated Mines Ltd* 1958 (3) SA 619 (A), Schreiner JA said the following at 631: “But expressions like ‘in respect of’ and ‘in connection with’ , though they may sometimes be used to cover a wide range of association, must in other cases be limited to the closer or more direct forms of association indicated by the context”.

<sup>114</sup> In *CIR v D & N Promotions (Pty) Ltd* 1995 (2) SA 296 (A) the court considered two amounts of interest received by a farming company engaged in sugar cane farming. The first amount of interest arose as a result of a compensation amount for the loss of certain rights, while the second amount of

### 4.3.3 Investment income

To understand the meaning of oil and gas income, from a case law prospective in relation to interest income, the oil and gas industry should consider the case of *Western Platinum Ltd v C:SARS* (2004) 4 All SA 611 (SCA). In this decision, the court had to determine in what circumstances interest may be characterised as “income derived by the taxpayer from mining operations” in order to determine the applicability of section 15(a), read with section 36(7C) of the Act, where certain capital expenditure is allowed to be deducted from the “income derived by the taxpayer from mining operations”.

The court held that section 36(7C) did not refer to “mining” or “mining operations”, but referred specifically to “income derived from the working of any producing mine”. It found that this expression (which appears to be more focused than the expressions “mining” and “mining operations”) leaves no doubt that to constitute mining income, the source of the income must be minerals taken from the earth.<sup>115</sup>

The conclusion was that in order to be mining income (i.e. income derived from mining operations) as contemplated in section 36(7C) of the Income Tax Act, the income must be derived from the business of extracting minerals from the earth.

---

interest was paid to the taxpayer by a sugar mill on the retention of a portion of the purchase price of sugar cane supplied to it.

In this case, the counsel for the Commissioner of Inland Revenue argued that the moneys retained by the miller were a form of investment which carried interest and that the interest did not, thus, constitute income derived from farming operations. The court disagreed with this argument and stated:

*“I find this argument far-fetched. It is true that if a farmer invests surplus funds, even funds derived from farming operations, then interest paid on the investment would not normally be regarded as income derived from farming operations, but the present case is a far cry from that. The interest receipt does not derive from an investment of surplus funds: it is part and parcel of a scheme devised for the remuneration of the farmer for the sugar cane delivered by him to the miller.”*

Further the court held that for income to have been derived from farming operations, it is necessary for that income to be derived directly from farming operations. *En casu*, it was found that the interest paid on the amount due in respect of the delivery of the sugar cane was paid as part of the purchase price and was therefore farming income.

<sup>115</sup> At 7D-E

Conradie JA accepted, in paragraph (7), that in order to qualify as mining income, the income had to be directly connected to the mining source and said the following in paragraph (8):

*“(8) [...] income which is directly connected to a mining source qualifies as mining income; an intermediate investment of such income, putting it to work as capital, generally breaks the direct connection”*

The legislation relating to mining income, however, is narrower in definition than that referring to oil and gas income. If the relevant specific phrases (namely “derived [...] from” when considering mining income, and “in respect of” when defining oil and gas income) are considered, the phrase “in respect of” requires a connection that may be broader between the oil and gas activity and oil and gas income, as opposed to mining income, which is required to be directly derived from a mining source. Nonetheless, the use of the phrase “in respect of” still requires a close connection, but not necessarily as close as is required in *Western Platinum Ltd* (supra). The case however provides valuable guidance and authority for the interpretation of oil and gas income in the Tenth Schedule.

With regard to interest earned on money held in a banking account, Conradie JA said in *Western Platinum Ltd*, the following in paragraph (15):

*“If the current accounts had simply been repositories of the proceeds of metal sales and interest were earned on credit balances so that such interest was the result of an (inevitable) disequilibrium from time to time between outgoings from that account and mining income paid into it, the connection between the interest and the mining source would be direct. Interest so earned could therefore be regarded as a necessary concomitant of the mining operations”.*

Accordingly, interest on a bank account in the absence of a cash management arrangement with the banks,<sup>116</sup> and where there are no separate investment decisions

---

<sup>116</sup> The court in *Western Platinum Ltd v Commissioner for South African Revenue Service* found that the interest on Western Platinum Mine’s current accounts was not mining income, because it had operated a cash management system by arrangement with its bankers. The cash management system compromised twenty six companies and the intervention of a management company. This meant that Western Platinum Mine received a rate of interest that it would not have received had it not used the cash management system and the management company. The court held that the arrangement was in

or actions which break the link with the oil and gas revenues, may be construed as oil and gas income.

With regard to interest earned on amounts placed by the appellant in certain escrow accounts, Conradie JA said the following in paragraph (20):

*“In regard to interest on so-called escrow accounts, since this interest arose from receipts held by the two foreign banks as part of the security for loans to enable the taxpayer to mine, there was a direct connection between the interest earned and the operation of mining. The interest was the unavoidable result of the way in which the scheme for the remuneration of the appellant had been devised. It was not entitled to be paid the price for its metals except in accordance with its financing arrangement with the banks. Accordingly, the interest earned on the escrow accounts was part and parcel of its mining operations as it exhibited the direct connection with those operations that qualified it as mining income”.*

This implies that, even with the narrow definition of “mining income”, a close enough connection may exist to recognise investment income as being derived from oil and gas mining and refining. For instance where funds are earmarked by the taxpayer for a specific purpose such as the funding of exploration activities it may be said that the interest in respect of these funds follows as an automatic consequence of the investment. The dominant purpose of the investment itself is decisive.

Our courts have considered the dominant purpose<sup>117</sup> approach and identified various principles in this regard. One such principle is that when there is any indication that the intention or purpose of the taxpayer is mixed, the main or dominant purpose is

---

essence an investment scheme and that the decision to manipulate the accounts broke any direct connection that the interest may have had with the mining income.

<sup>117</sup> In *Commissioner of Taxes Southern Rhodesia v Levy*,<sup>117</sup> the court, while ruling on whether the dominant purpose of the taxpayer in acquiring certain shares was to obtain an income-bearing investment, and whether the profit made by him on the sale of such shares would accordingly be capital in nature, found that the determining factors in resolving the question of capital or income accrual must be the main and dominant purpose with which the asset sold was acquired.

A similar conclusion may be drawn in relation to the income generating activity, namely an enquiry in respect of the main or dominant purpose of such activity.

considered.<sup>118</sup> Case law also indicates that whether an intention is dominant is a matter of degree.<sup>119</sup>

In conclusion, investment income is not to be dogmatically treated as income other than oil and gas income, the circumstances of each type of interest income derived by the taxpayer should be examined to ascertain whether or not such interest income may be regarded as “oil and gas income”.

#### 4.4 Additional deductions for capital expenditure

##### 4.4.1 Introduction

According to Van Blerck (1990:13-8), the capital allowance for natural oil mines is an incentive for the development of new mines. The allowance partly compensates a miner for the delay before the tax deduction takes place.

Under the OP26 regime, OP26 leaseholders were guaranteed a return on their investment in capital expenditure in the form of a tax deductible allowance of 12% per annum until such capital expenditure has been redeemed through mining income.

Under the Tenth Schedule regime, additional tax allowances are provided for in respect of exploration and development capital expenditure, at rates of 100% and 50%

---

<sup>118</sup> *Commissioner of Taxes Southern Rhodesia v Levy* 18 SATC 127

<sup>119</sup> *Trust Bank of Africa Ltd v SIR* (50 SATC 98).

A portion of the judgment of *African Life Investment Corporation v Secretary for Inland Revenue* is quoted in *Commissioner for Inland Revenue v Tod*, where the court decided on the nature of the proceeds of the sale of shares where a taxpayer bought shares for the purpose of the dividend to be declared on those shares:

*“I shall not attempt a precise definition of the distinction, but there would, I consider, be such a main purpose where there is a further purpose simultaneously pursued by way of an additional, albeit subsidiary, activity calculated and intended to yield a profit. Where, for instance, a company whose main concern as an investor is an income from dividends, confines its purchases to sound equities with the highest dividend yield, but, at the same time, intends, in order to increase its income, to sell whenever it is able to do so at a substantial profit, that intention, although so closely connected with its main object that it may be said to be inseparable from it, would not ordinarily rank as merely incidental to such a dominant purpose”.*

and the court concludes that “for there to be an ‘absolving dominant purpose’, it must be shown that the ‘pursuit of an overriding main objective of securing a dividend income merely provides the occasion for what is no more than a purely incidental change of investment [...]”.

respectively. These capital allowances are deductible in the year that the capital expenditure is incurred and may create tax oil and gas mining tax assessed losses.

#### **4.4.2 Unredeemed capital expenditure allowance**

Mining capital expenditure is divided into two categories:

- Pre-production expenditure and
- Production expenditure

Pre-production expenditure can be seen as expenditure preliminary to the establishment of a mine (Meyerowitz, 2006:22).

Both categories of mining capital expenditure are deductible under section 15(a) of the Income Tax Act, read in conjunction with section 36 of the Income Tax Act (refer to 3.9 of this dissertation).

For the purpose of this discussion, specific focus is given to the additional allowance provided for in respect of unredeemed capital expenditure in section 36 (11)(c) of the Income Tax Act, colloquially known as the “unredeemed capital expenditure allowance”. The unredeemed capital expenditure allowance is a 12% per annum uplift on capital expenditure incurred, deducted in each tax year of assessment until such capital expenditure has been recovered in full through the receipt of taxable income from mining, determined prior to the deduction of this allowance.

See Annexure D of this dissertation for an example of the application of the unredeemed capital expenditure allowance.

#### **4.4.3 Tenth Schedule additional capital allowances**

The Tenth Schedule to the Income Tax Act at paragraph 5(1) provides for a deduction of expenditure and losses incurred in that year in respect of exploration or production. Paragraph 5(2) furthermore allows additional deductions from oil and gas income derived in that year equal to 100 per cent of all expenditure of a capital nature actually

incurred in that year in respect of exploration; and 50 per cent of all expenditure of a capital nature actually incurred in that year in respect of production.

These provisions limit the deduction of expenditure and losses incurred to the year of assessment in which they are suffered by taxpayer. These provisions do not accommodate the deduction of capital expenditure incurred prior to the inception date of the Tenth Schedule.

#### **4.4.4 The treatment of pre Tenth Schedule capital expenditure**

It has been the policy of National Treasury (and the SARS before that for many years) that tax allowances or benefits upon which taxpayers have relied in good faith, should not simply terminate, but should be phased out or otherwise compensated for, particularly where a taxpayer or industry may be adversely affected.

Historically, transitory legislation introduced by National Treasury (and the SARS) has taken various forms. Examples are:

- Prospective legislation that allows for the accelerated utilization of unredeemed balances prior to the effective change such as the change from reducing balance to straight-line depreciation under section 11(e),<sup>120</sup>
- Full-utilization of unredeemed balances at the time of the change-over such as GST input claims in the transition to VAT,
- Valuation of unredeemed balances as a set-off to future tax liabilities such as the market value of an asset utilized as the base cost at the inception of CGT,
- Phasing-in provisions such as the days presence test introduced with the residence basis of taxation,
- Phasing-out provisions such as those typical of tax holidays<sup>121</sup> and tax incentives with a limited effective period,
- Change-in-use provisions such as those in respect of the movement of assets into or out of trading stock and VAT apportionment for changes to and from commercial use,

---

<sup>120</sup> See SARS Practice Note 19 at paragraph 8

<sup>121</sup> Section 37H of the ITA

- Phasing-out of LIFO as a stock valuation method under section 22(5) of the Income Tax Act, and
- Phasing-in of a new definition of “trading stock” over an 8-year period under section 22(3B) of the Income Tax Act.

No transitory tax provisions were legislated in terms of the cessation of the OP26 regime. Accordingly, there is lack of clarity with regard to whether or not oil and gas companies suffer a truncated tax allowance in relation to unredeemed oil and gas capital expenditure incurred prior to the inception of the Tenth Schedule.

One interpretation is that upon inception of the Tenth Schedule, the ability of an oil and gas company to claim an unredeemed capital expenditure allowance ceased with the demise of the OP26 regime. Therefore, the oil and gas company has no continuing deduction available in respect of oil and gas expenditure incurred prior to the Tenth Schedule. This would appear to be the interpretation favoured by National Treasury and the SARS.

But section 36<sup>122</sup> of the Income Tax Act provides that any excess (unredeemed) capital expenditure is carried forward and is deemed to be capital expenditure

---

<sup>122</sup> Section 36(7E) of the ITA:

The aggregate of the amounts of capital expenditure determined under section (7C) in respect of any year of assessment in relation to any mine or mines shall not exceed the taxable income (as determined before the deduction of any amount allowable under section 15(a), but after the set-off of any balance of assessed loss incurred by the taxpayer in relation to such mine or mines in any previous year which has been carried forward from the preceding year of assessment) derived by the taxpayer from mining, and any amount by which the said aggregate would, but for the provisions of this subsection, have exceeded such taxable income as so determined, shall be carried forward and be deemed to be an amount of capital expenditure incurred during the next succeeding year of assessment in respect of the mine or mines to which such capital expenditure relates.

Section 36(7C) of the ITA as at 1977:

The amounts to be deducted under section 15(a) from income derived during the first year of assessment of the taxpayer ending after 31 December 1973( hereinafter referred to as the transition year) and succeeding years of assessment from the working of any mine shall be-

- (a) Where such mine commences production during any such year of assessment, the amount of capital expenditure incurred up to the close of that year of assessment, and thereafter in respect of each succeeding year of assessment, the capital expenditure incurred during such succeeding year of assessment; or
- (b) Where such mine commenced production before the commencement of the transition year –
  - (ii) the capital expenditure incurred during the year of assessment in question; and
  - (iii) where there is in respect of such mine a balance of capital expenditure unredeemed at the commencement of the transition year, such amount as may be determined under the provisions of subsection (7D) in respect of the year of assessment in question.

(Sec. 7C inserted by sec. 21(a), Act 65,1973)

incurred in the next year in respect of the mine to which the capital expenditure relates. Accordingly, it may be interpreted that the unredeemed capital expenditure balance is deemed to be capital expenditure actually incurred under the Tenth Schedule regime. The impact is that although the 12% additional allowance has ceased, the taxpayer may now claim a deduction of such capital expenditure under paragraph 5 of the Tenth Schedule in full in its first tax year of assessment commencing on or after 2 November 2006. In addition, based on whether such unredeemed capital expenditure balance stems from exploration or production, the corresponding additional allowances for capital expenditure incurred under the Tenth Schedule should be granted. Whilst this interpretation may be viewed as aggressive by the revenue authorities, this interpretation is supported by the wording of the Income Tax Act and accordingly the rule of *contra fiscum* should apply in favour of the taxpayer.<sup>123</sup>

Those OPASA members that favour this interpretation requested that National Treasury should draft retrospective legislation to confirm that this treatment in respect of the balance of unredeemed capital expenditure is correct and is applicable to OP26 lessees who held former prospecting and mining OP26 leases and sub-leases.

The OPASA members proposed that sub-paragraph 5(1) of the Tenth Schedule should be amended as follows (Futter, 2010:A6-8):

*“5(1) For purposes of determining the taxable income of an oil and gas company in the first year of assessment commencing after the inception of this schedule, there shall be allowed as a deduction the balance of the unredeemed capital expenditure, as defined, by holders of the former OP26 prospecting and mining leases, and furthermore during any year of assessment, there will be allowed as a deduction from the oil and gas income of that company all expenditure and losses actually incurred (other than any expenditure or loss*

---

<sup>123</sup>Botha JA in *Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 (A) at 727F-G states: “Apart from the rule that in the case of an ambiguity a fiscal provision should be construed *contra fiscum* (*Estate Reynolds and others v Commissioner for Inland Revenue*, 1937 AD 57 at p70) which is but a specific application of the general rule that all legislation imposing a burden upon the subject should, in the case of an ambiguity, be construed in favour of the subject, there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation”(Seligson et al., 2010:23).

*actually incurred in respect of the acquisition of any oil and gas right, except as allowed in paragraph 7(3)) in that year in respect of exploration or production.*

*5(2) In addition to any other deductions (as contemplated in subparagraph (1) other than any expenditure or loss actually incurred in respect of the acquisition of any oil and gas right) allowable in terms of this paragraph, for purposes of determining the taxable income of an oil and gas company during any year of assessment, there will be allowed as deductions from the oil or gas income of that company derived in that year –*

- a) 100 per cent of all expenditure of a capital nature actually incurred in that year in respect of exploration in terms of an oil and gas right, including, in the first year of assessment commencing after the inception of this Schedule, the balance of unredeemed capital expenditure carried forward and deducted under paragraph 5(1); and*
- b) 50 per cent of all expenditure of a capital nature actually incurred in that year in respect of production in terms of an oil and gas right, including, in the first year of assessment commencing after the inception of this Schedule, the balance of unredeemed capital expenditure carried forward and deducted under paragraph 5(1).”*

Furthermore, it was suggested that a definition of “unredeemed capital expenditure” be inserted which replicates the provisions of clause 23.7.2 of the sub-lease agreements as follows:

*“ ‘unredeemed capital expenditure’ means -*

- (a) the costs of laying pipelines from the mining block to the points[...]*
- (b) the costs expended by the OP26 lessee on prospecting operations within the area covered by the mining block in any tax year or part thereof prior to the date of granting of the Mining Lease;*
- (c) the costs incurred by the OP26 lessee in connection with the viability of the relevant undertaking and the design, procurement, management (including also project management), transport and construction of the constituent parts (form and after raw material stage and including also the piles and other*

*foundations) of any marine or onshore receiving installations erected or to be erected on the mining block or onshore with a view to exploitation of the natural oil discovered or found in the mining block, including also the costs of training of personnel for any purpose in connection with such installations, at any time prior to the successful commissioning of such installations but excluding any assets belonging to another taxpayer; and*

*(d) a capital allowance equal to 12% (twelve per cent) compound interest per annum on the total amount of unredeemed capital expenditure, ranking for redemption, calculated from the end of the month during which such cost was incurred, until it be redeemed and calculated, as far as this can be done according to the provisions of section 26(3) and (4) of the Mining Rights Act, 1967, an example of which is attached hereto as Annexure 1.”*

In addition, the following amendment was proposed:

Paragraph 5(1A)(1) which should read as follows: *“Unredeemed capital expenditure as defined, will be deemed to be incurred by holders of the former OP26 prospecting and mining leases and sub-leases, under the provisions of section 36(7E), in the first year of assessment commencing after the inception of this Schedule.”*

This suggested wording clarifies that the correct treatment of the balance of the unredeemed capital expenditure is a deduction in full in the first year of applying the Tenth Schedule, as well as confirming that a 100% or 50% uplift in respect of this amount in the same year is applicable.

A further interpretation is that not unlike depreciation under section 11(e) or accelerated depreciation under section 12C, the sections applied are those in existence at the date of acquisition of the capital asset and any subsequent change to the section would only apply in respect of capital assets acquired on or after the inception of the new provisions. The old capital assets in such circumstances, unless specifically provided for in the amendment to the section, continue until the capital asset is fully depreciated. Although no tax case law could be found by the author in support of this

interpretation, there is case law relating to labour law and amendments to labour legislation that reflect this principle.

*“There is a strong presumption in South African Law that legislation is not intended [...] to interfere with existing rights and liberties”.*<sup>124</sup>

*“[...] it is presumed that the legislature did not intend to interfere with existing law and ‘a fortiori’, not to deprive parties of existing remedies for wrongs done to them. ‘A statute will be construed as doing so only if it appears expressly or by necessary implication [...]’ The same is true of the presumption against the deprivation of existing rights”.*<sup>125</sup>

However, where new legislation or an amendment to existing legislation is ambiguous, or the legislative amendments are unjust or inequitable,<sup>126</sup> and deprive a person from existing rights and liberties, Tickle & Lombaard (2010:2) argue that such legislation is unconstitutional. In other words, the extent of the legislation may be declared unconstitutional<sup>127</sup>.

The Tenth Schedule only applies to expenditure incurred in the taxpayer’s first year of assessment commencing on or after 2 November 2006. It follows, therefore that expenditure incurred prior to the inception of the Tenth Schedule would remain subject to the “old legislation”<sup>128</sup> (Tickle & Lombard, 2010:2). Thus, it may be possible to argue that the 12% annual capital expenditure allowance which applies to capital expenditure incurred prior to the inception of the Tenth Schedule, which arose consequent upon section 36(11)(c) of the Income Tax Act as at 1977, read with the OP26 mining lease, should still apply to capital expenditure unredeemed, until the expenditure has been redeemed. The author shares this interpretation.

---

<sup>124</sup> Quoted in *Ben Heqoa v Browns Cash & Carry and Another* LC/REV/331/06

<sup>125</sup> Quoted in *Fedlife Assurance Limited v Hendrik Johannes Wolfaardt* (SCA Case No. 450/99) with reference to *Stadsraad van Pretoria v Van Wyk* 1973 (2) SA 779 (A).

<sup>126</sup> Corbett JA in *CIR v Nemojim* 1983 (4) SA 935 (A) at 958G-H states:

“It has been said that ‘there is no equity about a tax’. While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus. And it may be fairly inferred that such a result is in conformity with the intention of the Legislature” (Seligson et al., 2010:13).

<sup>127</sup> *Minister of Home Affairs and Another v Fourie and Another* CCT 60/04

<sup>128</sup> Namely the tax treatment under the OP26 regime.

However, existing investors who favour this interpretation remain justifiably concerned about the correct interpretation with regard to the continuation of the unredeemed capital expenditure allowance. To obtain absolute certainty they proposed the following new paragraph to the Tenth Schedule in a submission to National Treasury (Futter, 2009:A3):

“The proposed wording of a new paragraph to the Tenth Schedule (as drawn from the wording of section 36(11) of the Income Tax Act) reads:

*CAPITAL EXPENDITURE INCURRED PRIOR TO THIS SCHEDULE’S  
INCEPTION*

*9. (1) There shall be allowed to be deducted from the oil and gas income derived by the taxpayer from the exploitation of the oil and gas right, a capital allowance calculated at the rate of 12 per cent per annum on the amount of the unredeemed balance of exploration and production expenditure of a capital nature incurred prior to the inception of this schedule.*

*(2) The unredeemed balance shall be determined by the deduction from the aggregate of capital expenditure referred to in sub paragraph (1) at the end of every year of assessment-*

- (a) of the taxable income derived from the production of such oil and gas right in that year, as determined before the deduction of any amount allowable under paragraph 5(2) in relation to such oil and gas right and before the set-off in terms of 5(3) and 5(4) of any balance of assessed loss which is attributable to any deduction made under paragraph 5(2) in relation to such oil and gas right ;  
and*
- (b) the sum of the amounts received or accrued in that year from the disposal of assets contemplated in paragraph 7 held prior to the inception of this schedule.”*

This suggested wording allows the OP26 unredeemed capital allowance, calculated at 12% on a diminishing unredeemed capital expenditure balance only, in respect of capital expenditure incurred prior to the inception of the Tenth Schedule. This unredeemed capital expenditure balance is reduced each year by oil and gas income and the proceeds on the disposal of an oil and gas right held prior to the inception of the Tenth Schedule.

## **4.5 Disposal of oil and gas rights**

### **4.5.1 Introduction**

A farm-in / farm-out involves a situation where the owner (the “farmor”) transfers a portion of its interest in a mining block to another party (the “farmee”) in exchange for a work commitment, for example, the farmee may agree to undertake exploration, development or drill a well(s). Farm-in / farm-out arrangements may take any number of forms. In some instances, the entire interest in a mining block is transferred to the farmee, and the farmor retains an overriding royalty on the mining block’s production. Another possibility is that the farmor transfers the interest to the farmee and retains a reversionary interest in the overriding royalty. That is, the overriding royalty reverts back to an interest in the mining block when the farmee’s net profits from the mining block’s production have been sufficient to enable the farmee to recoup its exploration and drilling costs. In the event that the exploration and/or drilling is unsuccessful, the farmor is under no obligation to reimburse the farmee.

The Tenth Schedule provides special rules for Capital Gains Tax purposes relating to the disposal of oil and gas rights at any stage of the exploration and production process and refers to the “rollover treatment” and the “participation treatment”, either of which can be elected by the company disposing of the right. But the Tenth Schedule does not provide for the transfer of fiscal stability<sup>129</sup> from the farmor to farmee of the production rights (refer to 4.2 of this dissertation).

---

<sup>129</sup> The “rollover treatment” and the “participation treatment” are limited to the proceeds directly associated with the disposal of an oil and gas right. Where fiscal stability agreement rights are

## 4.5.2 Taxation of farm-in/farm-out proceeds/expense under the OP26 regime

A taxpayer that prospects with the intention of exploiting (“mining”) the mineral right itself, is regarded as a miner. If a taxpayer has acquired a mineral right for the purpose of making a gain by selling the mineral right in a scheme of profit making,<sup>130</sup> the taxpayer would be regarded as a speculator. It is emphasised that the classification is not a matter of election, but is a consequence of the taxpayer’s conduct in relation to its interest.<sup>131</sup> A change of intention is also possible.<sup>132</sup>

A miner is taxed according to the general tax principles subject to the mining tax rules. A speculator is taxed on the general tax principles only.

### 4.5.2.1 OP26 regime

Clegg (2006:12) states that section 11(b) of the Income Tax Act as at 1977 provided for the deduction of non-capital expenditure incurred outside the Republic. Thus where the new participant is a speculator, the expenditure would be, subject to the Commissioner for Inland Revenue, deductible under section 11(b); on the other hand where the new participant is a miner/investor, the expenditure would not be tax deductible, although much may depend upon the exact wording<sup>133</sup> of the farm-in agreement.

The proceeds from a farm-out by the speculator would be taxable, whereas in the case of a miner should not be taxable (refer to 3.4.1 of this dissertation for the reasons why CGT should not be applicable). Note that the determination whether the proceeds from the disposal are on revenue or capital account in the context of oil and gas

---

transferred with the disposal of an oil and gas right it is submitted, that the difference in value (i.e. with v without fiscal stability agreements rights) will be taxed in accordance with the normal provisions of the Act (including the Eighth Schedule and possibly the “group rules” contained in section 41-46 of the Act).

<sup>130</sup> *CIR v Stott* 1928 AD 252

<sup>131</sup> *CIR v Lydenburg Platinum* 1929 AD 137

<sup>132</sup> *CIR v Richmond Estates (Pty) Ltd* 1950 AD

<sup>133</sup> The wording of the farm-in agreement would reflect of the nature of the farm-in consideration, namely whether such consideration is for the mineral rights or a commitment to perform or pay for specified exploration work or merely to share in future costs.

prospecting and mining is often difficult in practice ( and probably more so than in the case of hard rock mines where JV operations are not the industry norm) (Clegg, 2006:12).

#### ***4.5.2.2 Current Income Tax Act***

Clegg (2006:12) indicates that a speculator would claim a tax deduction under section 11(a) of the current Income Tax Act, and the costs expended by a miner would, subject to paragraph 20 of the Eighth Schedule, increase the “base cost” of the asset for CGT purposes.

The net proceeds/taxable income from a farm-out or other disposal by a speculator would be taxable (at income tax rates), whereas in the case of a miner would be subject to CGT.

#### **4.5.3 Taxation of the disposal of an oil and gas right under the Tenth Schedule regime**

Clegg and Steenkamp (2007:4) indicate that it is important to determine whether the consideration received from the disposal of a right will be income or capital in nature. As a general rule, if an asset (such as an oil and gas right) was held with the dominant purpose of producing production revenues, income derived from the disposal of the right would be of a capital nature, and subject to CGT. If the asset was acquired with the dominant purpose of disposing of it to another oil and gas company, consideration derived from its disposal would be for gross income and taxed as such. The nature of the industry has led to a practical situation in which relatively few mining blocks (and therefore producing wells) worldwide are held exclusively by one company. Frequently, in order to spread both the high risk of drilling a “dry well” and the consequentially immense costs of exploration and development, the practice has developed of even the major players “farming-out” shares in their oil properties to other participants. Consequently, the question whether such a sale is on capital or revenue account is likely to arise. And in some cases, where the participant is a small player and farms out 80% or 90% of each property to better resourced partners, it may

appear at first sight that such participant is “trading” in oil rights. The better view is probably that in the vast majority of cases, the original holder of the right acquired it with the dominant intention of holding it in order to prospect and produce oil reserves from that part which the holder could afford to retain and finance. The fact that the holder knows on acquisition that it will farm-out substantial undivided shares in the property to other participants should not affect the issue, since the acquisition of the whole property is generally a requirement in terms of bidding rules for the mining block concerned.<sup>134</sup>

Previously, where the oil and gas company derived capital gains in the case of a disposal of an oil and gas right (which was held as a capital asset), such capital gain would likely be considered to be “*derived by it from prospecting for Natural Oil and transactions in connection therewith*”,<sup>135</sup> and therefore be covered by the OP26 regime. The capital gain would thus not be subject to CGT, as CGT was not part of the Income Tax Act as at 1977. The term “transactions in connection therewith” in this context would probably be given a wide interpretation, to include, for example, the disposal or “farm-out” of a share in an oil and gas field.

Special rules apply to disposals of oil and gas rights by oil and gas companies. In addition to the basic rules provided elsewhere in the Income Tax Act, the Tenth Schedule contains two elections. The oil and gas company disposing of any oil and gas right to another company may elect to have either rollover treatment or participation treatment.

The effect of the rollover treatment is that the selling oil and gas company is deemed to have disposed of an oil and gas right for an amount equal to the tax cost of the right disposed, regardless of whether that right is capital asset or trading stock, eliminating all capital or ordinary gain upon disposal for the seller.

The effect of the participation treatment is that the selling oil and gas company treats all gains on the disposal of an oil and gas right as ordinary revenue, regardless of whether that right is capital or trading stock, resulting in an immediate deduction for

---

<sup>134</sup> See *CIR v Paul* 1956(3) SA 335 (A) (21 SATC) in support of this.

<sup>135</sup> Clause 28 of the generic sub-lease to the OP26 prospecting lease

the acquiring company equal to the deemed ordinary revenue gain included by the selling company.

Because of the elections that are available to the disposing company, the intention of the disposing company is no longer relevant in determining whether the disposal of the oil and gas is on capital or revenue account. The implication is that “miners” and “speculators” alike have the same elections available and tax treatment.

Accordingly, a speculator in oil and gas rights can realise a profit on the disposal of an oil and gas right tax free under the rollover treatment. This is clearly a more favourable tax treatment under the Tenth Schedule than under the OP26 regime for a speculator.

Furthermore, in contrast to the mining rules there are no recoupment<sup>136</sup> provisions in relation to the capital expenditure and the additional capital allowances provided for under paragraph 5 of the Tenth Schedule in respect of the disposal of mining equipment and assets. This too is a more favourable tax treatment under the Tenth Schedule than under the OP26 regime for miners and speculators alike.

#### **4.5.4 Interpretational issues**

The Explanatory Memorandum to the Revenue Laws Amendment Act, 2006 provides that an oil and gas company disposing of its oil and gas right in a profit situation (i.e. market value/selling price is greater than base cost/cost of the oil and gas right) is able to choose one of three methods to calculate the income tax consequences on disposal. Loss assets (i.e. those with a tax cost in excess of market value) simply trigger losses upon disposal as allowed elsewhere in the Income Tax Act.

---

<sup>136</sup> Tax cost is taken into account in terms of section 11(a), 22(1) or 22(2) of the ITA. In *Omnia Fertilizer Ltd v C:SARS* (2003 SCA) the court dealt with the meaning of “recover or recoup”. The court held that to recover or recoup meant to “return to the taxpayer’s pocket” something which had previously been an expense.

The example furnished in the Explanatory Memorandum (2006:22) is as follows:

**Facts.**

Company X, an oil and gas company, holds multiple oil and gas rights off the South African coast, including a Block A offshore right. Company X acquired the off-shore right for 30 million U.S. dollars and that right is worth 100 million U.S. dollars as of 15 July 2008. Company X has 400 million U.S. dollars in excess oil and gas losses. Company X has agreed to sell the Block A offshore right for 100 million U.S. dollars in cash to Company Y, another oil and gas company. Assume Company X held the oil and gas right as a capital asset before the sale.

**Result.**

Both Company X and Company Y have three choices:

- (i) If no election is made, basic capital gains tax principles apply. Under this scenario, Company X has 70 million U.S. dollars of capital gain (100 million – 30 million). Company Y meanwhile obtains a 100 million U.S. dollar base cost in the oil and gas right acquired.
- (ii) If a rollover election is made, the sale does not trigger any capital gains tax for Company X. Company Y obtains a 30 million U.S. dollar base cost in the oil and gas right acquired.
- (iii) If a participation election is made, Company X has ordinary revenue equal to 70 million U.S. dollars (which will be offset by the 400 million U.S. dollars of excess losses). Company Y obtains a 70 million U.S. dollar immediate deduction and obtains a 30 million U.S. dollar amount as the tax cost in the oil and gas right acquired.

The wording of the Tenth Schedule at paragraph 7 does not specifically provide for three options available to the disposing company with regard to the tax treatment of the proceeds on disposal of an oil and gas right. Existing investors in the oil and gas sector are concerned that the revenue authorities may interpret the provisions of subparagraphs 7(2) and 7(3) as being exhaustive and that the tax consequences on disposal of an oil and gas right are to be calculated in terms of one of the two provisions only.

Clegg & Van Riel (2010:2) indicate that an amendment to the Tenth Schedule would be important for oil and gas companies who may need to consider which provisions of the Act to apply in calculating the tax consequences of a business decision to sell off all or part of an oil and gas right.

Further, the elections provided for in the Tenth Schedule bind not only the disposing company, but also the acquiring company; potentially leading to a treatment that is undesirable to the acquiring company. Allowing the normal provisions of the Act to provide for further alternative(s) would promote flexibility and serve to encourage new or extended participation in the industry (Clegg & Van Riel, 2010:2).

OPASA, to avoid ambiguity in interpreting paragraph 7 of the Tenth Schedule, has proposed the following amendment in a submission to National Treasury (Clegg & Van Riel, 2010:3):

“Sub-paragraph 7(1) of the Tenth Schedule should be substituted with the following sub-paragraph:

*(7)(1)(i) If any oil and gas company disposes of any oil and gas right to another company, that oil and gas company may elect that, notwithstanding any provisions of this Act to the contrary, income tax consequences of that disposal be determined in terms of the rollover treatment as contemplated in sub-paragraph (2) or the participation treatment as contemplated in sub-paragraph (3).*

*(1)(ii) The election contemplated in sub-paragraph 7(1)(i) must be in the form and manner to be determined by the Commissioner.*

*(1)(iii) If no election is made as contemplated in sub-paragraph 7(1)(i), the remaining provisions of this Act shall apply.”*

The suggested wording clarifies that an oil and gas company may effectively choose whether they wish to have the income tax consequences of the disposal of an oil and gas right determined in the “normal” provision of the Act (including the Eighth Schedule and possibly the “group rules” contained in section 41-46 of the Act), or the

rollover treatment or the participation treatment options provided for in the Tenth Schedule.

#### **4.6 Conclusion**

The aim of the Legislature was to renew the core aspects of the OP26 regime in order to retain the existing investors, whilst allowing lesser aspects to fall away.<sup>137</sup> It is submitted that the Tenth Schedule fails to achieve this stated aim.

Arguably, the core aspect of the OP26 regime was the ability to “freeze” the tax benefits in the Income Tax Act at a specified date. In this chapter, it is identified that the Tenth Schedule provides for a fiscal guarantee as opposed to genuine fiscal stability, and furthermore that there is no transfer of a fiscal stability agreement in relation to a production right. Additional investor concerns examined in chapter 4 were: ring-fencing in the context of what constitutes oil and gas income or income derived from the refining of gas; the deduction of allowances in relation to capital expenditure incurred prior to the inception of the Tenth Schedule; and the tax treatment of the disposal of an oil and gas right. These investor concerns emanate from the taxation of a benefit or limitation of a deduction in accordance with the provisions of the Tenth Schedule that would not have existed under the OP26 regime by virtue of the tax treatment under the Income Tax Act at a specified date. Ironically, as depicted in chapter 3, it would appear to be the lesser aspects, namely ancillary legislation (such as VAT, customs and excise), the corporate income tax rates (consistent with the corporate income tax rate applicable to all companies in South Africa) and the full deduction of operating and mining expenses (consistent with the mining tax provisions as contained in section 15 and 36 of the Income Tax Act) that were preserved by the Tenth Schedule.

This chapter highlights the interpretational issues and proposed possible amendments to the Tenth Schedule that have been submitted by the oil and gas industry to National Treasury to clarify the application of the Tenth Schedule. In the absence of the

---

<sup>137</sup> The Explanatory Memorandum, 2006 at page 16.

acceptance and enactment of these amendments, the author would anticipate that the SARS may release interpretation notes offering guidance to oil and gas companies. Whilst case law would indicate that such interpretation notes have no legal standing or legal precedence, the interpretation notes would still provide valuable guidance and authority as to the SARS' opinion regarding the interpretation and application of the provisions contained in the Tenth Schedule.

University of Cape Town

## CHAPTER 5 – CONCLUSION

### 5.1 Context

Prior to 2 November 2006, the taxation of the exploration for and production of Oil and Gas in South Africa was contained in a myriad of OP26 prospecting, OP26 mining and OP26 sublease agreements (collectively known as the “OP26 regime”). The specifics of the OP26 regime, given the secrecy surrounding South African oil exploration during the apartheid era and the highly specialised nature of the industry, were largely unknown to the revenue authorities and tax practitioners, other than those closely involved in the industry (Clegg & Steenkamp, 2007: 1).

The OP26 was a favourable tax dispensation (given South Africa’s poor geological attractiveness) aimed at attracting and retaining investors in South Africa’s upstream oil and gas industry. The OP26 regime effectively “froze” the taxation of oil and gas companies in accordance with the Income Tax Act as at 1977 (and as such protected OP26 taxpayers from new legislation such as the ring-fencing of mining assessed losses, transfer pricing, thin-capitalisation and CGT whilst furthermore allowing the flexibility to choose between tax deductions available under the current Income Tax Act and those of the Income Tax Act as at 1977). An inherent weakness of the OP26 regime (at least in the eyes of the revenue authorities) was that it lacked standardisation and transparency (in that the terminology used in the OP26 lease agreements and the provisions of the OP26 lease agreements differed from one OP26 lease to another).

In 2002 the Mineral Petroleum Resources Development Act<sup>138</sup> (“MPDRA”) was enacted. The MPRDA vests all mineral rights in the state. The MPRDA has a number of objectives, including to:

- promote equitable access to the nation’s mineral and petroleum resources to all the people of South Africa;
- substantially and meaningfully expand opportunities for historically disadvantaged persons, including women, to enter the mineral and

---

<sup>138</sup> Act No 28 of 2002.

petroleum industries and to benefit from the exploitation of the nation's mineral and petroleum resources;

- promote economic growth and mineral and petroleum resources development in the country;
- provide for security of tenure in respect of prospecting, exploration, mining and production operations;
- give effect to section 24<sup>139</sup> of the Constitution by ensuring that the nation's mineral and petroleum resources are developed in an orderly and ecologically sustainable manner while promoting justifiable social and economic development; and
- ensure that holders of mining and production rights contribute towards the socio-economic development of the areas in which they are operating.

A consequence of the MPRDA was that the existing OP26 prospecting, OP26 mining leases and OP26 sublease agreements would either expire on 30 June 2007, or were to be converted to MPRDA exploration and MPRDA production rights respectively.

To fill the void created by the demise of the OP26 regime, the Legislature engaged the upstream oil and gas industry. Following a period of lengthy engagement, the Legislature drafted and promulgated the Tenth Schedule to the Income Tax Act. The aim of the Tenth Schedule was to bring the taxation of oil and gas companies into the legislative framework of the Income Tax Act, providing for standardisation and transparency. Furthermore, the Legislature sought to retain the existing oil and gas investors (through preservation of the tax benefits that attracted them to South Africa).

## **5.2 Summary of findings**

Chapter 2 provides the background of the OP26 regime and the Tenth Schedule regime. The author critically compared transparency and standardisation in relation to the OP26 regime to the Tenth Schedule regime. The author examined the purpose of transparency and standardisation in relation to anti-avoidance and consistent

---

<sup>139</sup> This states that everyone has the right to an environment that is not harmful to their health or well-being and to have the environment protected through reasonable legislative measures.

interpretation. Chapter 2 concluded that the Tenth Schedule does not in all circumstances afford greater transparency and standardisation particularly in relation to fiscal stability agreements.

Chapter 3 critically compares the OP26 regime to the tax treatment under the Tenth Schedule to identify their similarities. It is concluded that whilst there are similarities (such as tax rates, STC, VAT, customs duties, the deduction of operating expenses, the deduction of exploration and production expenses) between the tax benefits offered to oil and gas companies under the OP26 regime and the Tenth Schedule, it may be stated that companies engaged in the exploration for and production of oil and gas do not enjoy the same, if not more favourable, tax dispensation under the Tenth Schedule than under the OP26 regime. In fact, provisions such as the ring-fencing of oil and gas losses, CGT, thin capitalisation and transfer pricing are unfavourable in comparison to the OP26 regime.

Chapter 4 provides analysis of the primary concerns of existing investors in the upstream oil and gas sector in relation to the taxation of the exploration for and production of oil and gas in South Africa. The interpretational issues (such as defining the meaning of “oil and gas income”, the correct treatment of “unredeemed capital expenditure” incurred prior to the inception of the Tenth Schedule and the tax treatment on disposal of an oil and gas right) were discussed. It is submitted that possible amendments to the Tenth Schedule may be required. Chapter 4 concluded that not all of the core aspects of the OP26 regime have been fully preserved by the Tenth Schedule, specifically Fiscal Stability and the ability to transfer a fiscal stability agreement in relation to a production right.

### **5.3 Envisaged interventions by the revenue authorities**

The Tenth Schedule may be regarded as transitional legislation, in that it continues to evolve correspondent to the interpretational and practical difficulties identified by its stakeholders (namely the upstream oil and gas industry and government) over time. This metamorphosis is ascribed to the fact that the Tenth Schedule is unique from the legislation of any other country. Its construction was not borrowed, nor adapted from

any other established dispensation (as in the case of South Africa's VAT, CGT, anti-avoidance or transfer pricing legislation). Nonetheless, whilst the author has proposed possible amendments to the Tenth Schedule in chapter 4 of this dissertation, it should be noted that National Treasury are reluctant to make changes to the legislation that they construe as unnecessary in relation to the legislation's intended application or that frivolously entertain only academic argument. The amendments likely to be dealt with by National Treasury are limited to those within National Treasury's mandate, namely amendments linked to "fiscal policy".

It is the practise of the administrators of the tax legislation (namely the SARS) upon the introduction of new legislation in respect of which there may be administrative compliance or interpretational difficulties to periodically publish guidance to the taxpayer. Examples are the SARS Public Benefit Organisations ("PBO") guide (3<sup>rd</sup> Issue, 10 October 2007) and Interpretation notes 10,<sup>140</sup> 22,<sup>141</sup> 24,<sup>142</sup> 32,<sup>143</sup> 44<sup>144</sup> & 46<sup>145</sup> in relation to PBO's that fall within the ambit of the Ninth Schedule to the Income Tax Act. SARS also issued a Comprehensive Guide to Capital Gains Tax (Issue 3, May 2010) and The ABC of capital gains tax for companies (Issue 4, June 2008) in an attempt to improve the taxpayers understanding of the Eighth Schedule to the Income Tax Act. The author accordingly expects that the intervention and corrective action taken by the revenue authorities to be similar publications from SARS in relation to the Tenth Schedule.

It is submitted that the publication of practise notes, interpretation notes and guidelines, although beneficial for the guidance that they offer, would be unsatisfactory to existing investors in the upstream oil and gas industry. Such

---

<sup>140</sup> SARS Interpretation Note No 10 (24 March 2003) *Exemption: Public Benefit Organisations-Section 4(c) of the Skills Development Levies Act, No. 9 of 1999.*

<sup>141</sup> SARS Interpretation Note No 22 (Issue 2) (8 December 2008) *Exemption: Public Benefit Organisations and Statutory Bodies -Section 9(1)(c) and 9(1A) of the Transfer Duty Act No. 40 of 1949.*

<sup>142</sup> SARS Interpretation Note No 24 (Issue 2) (31 August 2007) *Public Benefit Organisations: Trading Rules - Partial Taxation of Trading Receipts-Section 10(1)(cN) of the Income Tax Act*

<sup>143</sup> SARS Interpretation Note No 32 (27 June 2005) *Public Benefit Organisations: Prudent Investments - Section 30(3)(b)(ii)(cc) of the Income Tax Act, 1962*

<sup>144</sup> SARS Interpretation Note No 44 (31 August 2007) *Public Benefit Organisations: Capital Gains Tax (CGT) - Paragraph 63A of the Eighth Schedule*

<sup>145</sup> SARS Interpretation Note No 46 (Issue 2) (18 February 2009) *Income Tax: Amalgamation of Amateur and Professional Sporting Bodies.*

publications have no legal standing or legal precedence and accordingly do not provide the same assurance an amendment to the tax legislation.

#### **5.4 The benefit of this research**

This dissertation describes the development of the taxation of oil and gas companies under the OP26 regime to the Tenth Schedule regime. This should benefit oil and gas companies (existing and potential new investors) and the revenue authorities (National Treasury and the SARS) through collation of the applicable legislation, case law, commentary and interpretational difficulties into one body of work. The author aimed to gain and demonstrate a knowledge base in respect of the taxation of the offshore exploration for and production of oil and gas in South Africa and to contribute toward the academic discussion of the Tenth Schedule.

#### **5.5 Suggestions for future research**

The author does not perceive that this dissertation is exhaustive in responding to all the concerns of stakeholders in the South African upstream oil and gas industry.

Omar (1998:2) states that the income tax rate is one of the most important factors determining investment in hydrocarbon production and should be appropriately set to attract the necessary foreign investment. The scope of this dissertation is limited to the taxation of the offshore exploration for and production of oil and gas in South Africa. As such this dissertation cannot answer the question: “Is the Tenth Schedule appropriate to attracting and retaining investors?” To determine whether the Tenth Schedule is attractive to investors would require a study to be conducted of the fiscal regimes offered by competing countries with similar geologies.

To ensure that the state as resource-owner receives an appropriate share of the economic rent generated from extraction of oil and gas, the fiscal regime must be appropriately designed. Oil and gas agreements and the associated fiscal rules establish the “price” of the resource in terms of the bonuses, royalties, taxes or other payments the investor will make to the government over the life of the project (Sunley

et al., 2001:1). This dissertation considers only the corporate income taxation of oil and gas companies. It does not consider the economic rent received by government on the extraction of oil and gas holistically. To evaluate whether or not such economic rent is appropriately priced, a detailed study of all the taxes (including specifically state royalties) levied on oil and gas companies in South Africa would be required.

## ANNEXURES

### ANNEXURE A

Table 1. OP26 Prospecting Lease v OP26 Mining Lease

<b>OP26 PROSPECTING LEASE</b>	<b>OP26 MINING LEASE</b>
<p>1. The OP26 prospecting leases and OP26 prospecting sub-leases are taxed in terms of the Income Tax Act as at 1977, or as specifically determined under the prospecting or mining sub-lease. Accordingly the deduction of a capital allowance of 12% on the unredeemed portion of capital expenditure under the current Income Tax Act would be restricted to only 6% under the Income Tax Act as at 1977.</p>	<p>1. Under the OP26 mining lease, the original lessee can <u>elect</u> the better of the deductions in the Income Tax Act as at 1977 or the current Income Tax Act. This elective provision allows the OP26 mining lessee to claim deductions in respect of one mine against the mining income of another mine or even its taxable income from non-mining operations that would have been ring-fenced under the current Income Tax Act.</p>
<p>2. The OP26 prospecting lease or the OP26 prospecting sub-lease agreements do not have a special incentive for taxable income derived from the disposal of natural oil.</p>	<p>2. The OP26 mining lease provides a special incentive reduction of tax at clause 23.10, <i>“an amount equal to 50% of so much of such tax as is relatable to taxable income derived from the disposal of natural oil from the mining block”</i>.</p>
<p>3. The OP26 prospecting lease and the mining sub-lease agreements do not give the Minister any discretion (in consultation with the Minister of Finance) to reduce the tax charge.</p>	<p>3. The OP26 mining lease contains a specific provision at clause 23.11 that <i>“the amount of tax payable... shall be reduced to or by such an amount and subject to the provisions as the Minister of Minerals and Energy, in</i></p>

	<i>consultation with the Minister of Finance, may determine”.</i>
4. Under the OP26 prospecting lease and the OP26 prospecting sub-lease agreements the tax rate is capped at a specified maximum as provided for in the relevant OP26 prospecting lease or OP26 prospecting sub-lease agreement	4. The tax rate for mining companies in OP26 mining lease is limited to a maximum of the current rate (i.e. 28%)
5. The OP26 prospecting lease and OP26 prospecting sub-lease does not contain an express exemption for STC (the terms being drafted prior to the introduction of STC)	5. The OP26 mining sub-leases specifically exempt the lessee from Secondary Tax on Companies (‘STC’) (clause 23.4.4 of the Mining Lease)

Table 2. Similarities between the OP26 regime and the Tenth Schedule regime

<b>OP 26 REGIME</b>	<b>TENTH SCHEDULE REGIME</b>
1. Tax rate = 28%	1. Tax rate = 28% and 31% for foreign companies.
2. No STC in terms of OP26 mining lease.	2. STC at 0% on dividends declared from OP26 right.
3. No CGT	3. CGT on the disposal of assets. Rollover relief election provided for in relation to the disposal of oil and gas rights.
4. No ring-fencing per mine nor industry	4. No ring-fencing per mine. Ring-fencing in relation to the set-off of oil and gas losses against non-oil and gas income.
5. Unrealised foreign exchange gains and losses excluded.	5. Unrealised foreign exchange gains and losses included.
6. No customs duties on the import of equipment and machinery required for mining operations.	6. No customs duties on the import of equipment and machinery required for mining operations.
7. VAT applies	7. VAT applies
8. Operating expenses fully deductible	8. Operating expenses fully deductible
9. Capital (prospecting and mining ) expenses fully deductible	9. Capital (exploration and production) expenses fully deductible.
10. No thin capitalisation or transfer pricing	10. “Safe harbour” for thin capitalisation. Transfer pricing provisions apply

Table 3. Petroleum Contracts: Fiscal Stability Clauses 1/

Fiscal stability clause 70 countries (63%)		Fiscal stability clause, excluding corporate income tax 15 countries (14%)	No fiscal stability clause 26 countries (23%)
Abu Dhabi	India	Albania 3/	Argentina
Algeria	Indonesia	Azerbaijan	Aruba
Angola	Jordan	Belize	Bolivia
Antigua	Kazakhstan 2/	China	Brazil
Bahamas	Kenya	Costa Rica	Czech Republic
Bahrain	Kyrgyzstan	Ecuador	Fiji
Bangladesh	Laos	Eritrea	Hungary
Barbados	Liberia	Ethiopia	Jamaica
Benin	Libya	Guatemala	Lithuania
Brunei	Madagascar	Lebanon 3/	Nicaragua
Bulgaria	Malaysia	Mauritania	Papua New Guinea
Burundi	Moldova	Namibia	Paraguay
Cambodia	Mongolia	Pakistan 3/	Poland
Cameroon	Morocco	Senegal	Russia
C.A.R.	Mozambique	Ukraine	Seychelles
Chad	Myanmar		Slovakia
Chile	Nepal		Suriname
Colombia	Niger		Thailand
Congo	Nigeria		Tonga
Cote d'Ivoire	Oman		Trinidad & Tobago
Croatia	Panama		Tunisia
Dominican Republic	Peru		Turkey
Dubai	Philippines		Uruguay
Egypt	Qatar		Uzbekistan
El Salvador	Romania		Venezuela
Equatorial Guinea	Somalia		Zambia
Gabon	South Africa		
Gambia	Sudan		
Ghana	Syria		
Guinea	Tanzania		
Guinea Bissau	Togo		
Guyana	Turkmenistan		
Honduras	Uganda		
	Vietnam		
	Yemen		

Source: Barrows (1997)

1/ Information reflects contracts in existence up until 1997, since then more countries have been offering fiscal stability assurances.

2/ repealed in 2002.

3/ Fiscal stability clauses for offshore projects

**ANNEXURE B**

**MEMORANDUM OF AGREEMENT**

entered into by and between

**THE GOVERNMENT OF THE REPUBLIC OF SOUTH AFRICA IN ITS  
NATIONAL TREASURY REPRESENTED BY THE MINISTER OF FINANCE  
("the Minister")**

and

**X  
IN RESPECT OF BLOCK Y**

**WHEREAS:**

The Tenth Schedule to the Income Tax Act, 1962, (“the Schedule”) with effect as of the date of this agreement provides that:

**The Minister may enter** into an agreement that contractually binds the State with any oil and gas company guaranteeing that the provisions of the Schedule as at the date the agreement is entered into will apply in respect of the company’s oil and gas right or in anticipation of that company acquiring an oil and gas right.

**AND X** is an oil and gas company that currently holds what is referred to as an “old order” right in Block Y in terms of an OP26 Prospecting Sub-Lease Agreement (“PSLA”), acquired pursuant to a purchase and sale agreement with Z and ceded to X. It is further anticipated that the OP26 PSLA will be converted into an exploration right granted in accordance with the terms and provisions of the Mineral and Petroleum Resources Development Act, Act 28 of 2002 (“MPRDA”).

**NOW THEREFORE THE MINISTER AND X AGREE AS FOLLOWS:**

1. This fiscal stability agreement is conditional upon an exploration right being granted to X in accordance with the terms and provisions of the MPRDA.
2. It is guaranteed that the provisions of the Schedule as at the date this agreement is entered into will apply to Xs’ exploration right in Y, as long as the right is held by X. For purposes of this agreement, a right includes the renewal of exploration rights and initial production right converted from an exploration right with all these rights being treated as one and the same.
3. X is incorporated in the Republic and accordingly is a resident and; therefore, the rate of tax referred to in paragraph 2(1)(a), read together with paragraph 2(2), of the Tenth Schedule to the Income Tax Act 58 of 1962 as at the date that the agreement applies.

4. X will be subject to secondary tax on companies as envisaged in paragraph 3(3)..
5. In relation to the current exploration right or renewal thereof held in Y:
  - 5.1 In the case of a disposal of the right to any other oil and gas company, X may assign all of its fiscal stability rights in terms of this agreement to any company.
6. In relation to the production right converted from an exploration right held in Y:
  - 6.1 The terms and conditions of this agreement will apply to all participating interests subsequently held by X in such rights.
  - 6.2 In the case of a disposal of such right, X may assign all of its fiscal stability rights in terms of this agreement to any other oil and gas company if at the time of the conclusion of this agreement the other company is a company within the same “group of companies” (as defined in section 1 of the Income Tax Act No 58 of 1962) as X.
7. X may at any time unilaterally terminate the application of this agreement in respect of the right held in Y, with effect from the commencement of the year of assessment immediately following the notification date of termination.
8. The portion of taxable income and profits of X derived from all oil and gas rights governed by the Schedule in effect on the date of this agreement must be determined in aggregate in terms of the Schedule.
9. Failure to apply this agreement for the benefit of X which has a material adverse economic impact on the taxation of income or profits of X, entitles X to:
  - 9.1 Compensation for the loss of market value caused by such failure; or
  - 9.2 An alternative remedy that otherwise eliminates the impact of the failure.

Thus done and signed at \_\_\_\_\_ on the \_\_\_\_\_ day of \_\_\_\_\_ 20\_\_

---

**X**

**being duly authorised hereto.**

---

**The Government of the Republic of  
South Africa in its National  
Treasury represented by the  
Minister of Finance.**

Thus done and signed at                      on the                      day of                      20\_\_

University of Cape Town

## ANNEXURE C

### *Illustration of the impact of the Tenth Schedule elections*

The participation and rollover elections in the Tenth Schedule allow the disposing company alternatives when evaluating whether or not to farm-out to an acquiring company. Furthermore, these elections give the disposing company negotiating power in determining the sale price based on the tax treatment of the proceeds.

In this illustration, the author will examine four scenarios from their tax perspective in relation to a proposed farm-out of a South African exploration right:

- Company A (“existing right holder”) does not farm-out and incurs all capital expenditure on exploration,
- The Company B (“Farmee”) pays for percentage participation and shares in capital expenditure on exploration in accordance with that percentage.
- Company B pays for its percentage participation and furthermore carries Company A in terms of the exploration work programme.
- Company A incurs all the capital expenditure on exploration and then disposes of 50% of the South African exploration right.

#### **Illustration of - Scenario 1**

In this scenario, Company A does not farm-out. Company A incurs capital expenditure of R120mil on exploration.

*Tax effect –*

	Tax deduction of	R120mil (exploration capital expenditure)
Plus	Tax uplift of 100%	<u>R120mil</u>
	Total tax deduction	R240mil

Impact – Company A incurs R120mil in costs but enjoys the R240mil deduction from its taxable income. Therefore, Company A shelters R240mil from tax (R67,2mil tax).

### **Illustration of – Scenario 2**

Company B pays R100mil for a 50% participation in the South African exploration right. The costs of exploration capital expenditure will be shared in the same proportion with Company A.

#### *A. Tax effect – Roll-over treatment*

R100mil - no tax as deemed to be sold for tax value

Impact – Company A receives R100 tax fee

Tax deduction of	R60mil (50% of capital expenditure)
Plus Tax uplift of 100%	<u>R60mil</u>
Total tax deduction	R120mil

Impact – Company A has utilised the proceeds received from Company B to finance its proportionate share of the exploration capital expenditure. Company A will enjoy the R120mil deduction from its taxable income. Therefore Company A has sheltered R120mil from tax (R33,6mil).

Company B has no tax deduction for the funds paid for participation in the South African exploration right. Furthermore, Company B inherits its base cost from Company A for CGT purposes. Namely, Company B will not receive any CGT benefit for the funds paid.

Company B incurs a further R60mil exploration capital costs but enjoys the R120mil deduction from taxable income. Company B has deferred its tax liability until the R120mil is set-off against future taxable income, reducing such taxable income and accordingly saving tax on R120mil (R33,6mil).

#### *B. Tax effect – Participation treatment*

R100mil - treated as taxable income

	Tax deduction of	R60mil (50% of capital expenditure)
Plus	Tax uplift of 100%	<u>R60mil</u>
	Total tax deduction	R120mil

Impact – Company A has utilised funds from Company B to finance its proportionate share of the exploration capital expenditure. Company A includes the funds from Company B in its taxable income. Company A enjoys a deduction of R120mil from its taxable income. Therefore, Company A has sheltered R20mil (namely R100mil-R120mil) from tax (R5,6mil).

Company B will have a tax deduction for the R100mil funds paid for its participation. Company B incurs a further R60mil in exploration capital costs but will enjoy a deduction of R120mil from its taxable income. Company B therefore has deferred its tax liability until the R220mil (R100mil plus R120mil) is set-off against future taxable income, reducing such income and accordingly saving tax on R220mil (R61,6mil).

### **Illustration of – Scenario 3**

Company B pays R40mil for a 50% participation in the South African exploration right. Company B carries Company A in respect of the cost of exploration capital expenditure.

#### *A. Tax effect – Roll-over treatment*

R40mil - no tax as deemed to be sold for tax value

Impact – Company A receives R40mil tax free.

Company B has no tax deduction for the funds that it paid for participation in the South African exploration right. Furthermore Company B will inherit its base cost from Company A for CGT purposes. Company B has not received any CGT benefit for the funds that it paid.

Company B incurs a further R120mil capital exploration cost but enjoys the R240mil deduction from its taxable income. Company B therefore defers its tax liability until the R240mil is set-off against future taxable income reducing such income and accordingly saving tax on R240mil (R67,2mil tax).

*B. Tax effect – Participation treatment*

R40mil - treated as taxable income

Impact – Company A includes the R40mil received from Company B in its taxable income. Therefore Company A pays additional tax on R40mil (R11,2mil).

Company B has a tax deduction for the R40mil that it paid for participation in the South African exploration right. Company B incurs a further R120mil exploration capital cost but will enjoy the R240mil deduction from its taxable income. Company B therefore defers its tax liability until the R280mil (R40mil plus R240mil) is set-off against future taxable income, reducing such income and accordingly saving tax on R280mil (R78,4mil).

**Illustration of - Scenario 4**

In this scenario, Company A incurs R120mil capital exploration expenditure. Company A then farms-out 50% of its participation in the South African exploration right to Company B for R160mil (R100mil initial cost plus 50% of exploration).

Tax effect – on capital expenditure

	Tax deduction of	R120mil (exploration capital expenditure)
Plus	Tax uplift of 100%	<u>R120mil</u>
	Total tax deduction	R240mil

*A. Tax effect on farm-out – Roll-over treatment*

R160mil - no tax as deemed to be sold for tax value

Impact – Company A receives R160mil tax- free

Company B will not have a tax deduction for the funds that it paid for its participation in the South African exploration right. Furthermore Company B inherits its base cost from Company A for CGT purposes. Namely Company B will not receive a CGT benefit either for the funds that it paid.

*B. Tax effect – Participation treatment*

R160mil - treated as taxable income

Impact – Company A will include the R160mil received in its taxable income. Therefore Company A will pay additional tax on R160mil (R44,8mil).

Company B has a tax deduction for the R160mil that it paid for participation in the South African exploration right. Therefore Company B has a saving tax on the R160mil (R44,8mil) in the future, when it generates taxable income.

**Table 1: Summary of scenario results**

Scenario 1	Scenario 2	Scenario 3	Scenario 4
Company A shelters R240 mil from tax by spending R120mil (effective cost R52,80mil)	A. Company A shelters R120mil from tax by spending Nil and nets R40mil tax free.  (effective saving R73,60mil)	A. Company A receives R40mil tax free.  (effective saving R40mil)  B. Company A incurs tax on an additional	A. Company A receives a tax deduction on R240mil and nets R40mil untaxed.  (effective saving R107,20mil)

	B. Company A shelters R20mil from tax by spending Nil.  (effective saving R5,6mil)	R40mil.  (effective cost R11,2mil)	B. Company A receives a tax deduction on R240mil but incurs tax on R160mil.  (effective saving R22,40mil)
<b>Scenario 1</b>	<b>Scenario 2</b>	<b>Scenario 3</b>	<b>Scenario 4</b>
N/A	A. Company B shelters R120mil from tax by spending R160mil.  (effective cost R126,40mil)  B. Company B shelters R220mil from tax from tax by spending R160mil.  (effective cost R98,40mil)	A. Company B shelters R240mil from tax by spending R160mil.  (effective cost R92,80mil)  B. Company B shelters R280mil from tax by spending R160mil.  (effective cost R81,60mil)	A. Company B receives no tax benefit from R160mil spent.  (effective cost R160mil)  B. Company B shelters R160mil from tax by spending R160mil.  (effective cost R115,20mil)

Note that the author has assumed that Company B is a South African resident for tax purposes. If Company B is a foreign entity, the tax rate of 31% instead of 28% should be used.

The scenario 4 is the most tax efficient for Company A, particularly when the subsequent farm-out is in conjunction with a roll over treatment election by the disposing company. In scenario 4 Company A obtained a tax deduction equal to 200% of the exploration capital expenditure at, in effect, no cost to Company A. Whilst Company B receives no tax benefit for income tax nor CGT purposes.

Where the participation treatment is elected by the disposing company, Company A obtains a tax deduction equal to 100% of the capital expenditure at in effect no cost to Company A. Whilst Company B will receive a tax deduction for its participation payment.

Where Company A is in a tax paying position, scenario 4 with the roll over treatment is favoured by the disposing company. Where Company A is in an assessed loss position, it may consider scenario 4 with the participation treatment election as a possible issue for price negotiation.

The scenario 3, favours Company B most when used in conjunction with the participation treatment election by the disposing company. Second to scenario 1 (namely, no farm-out) this is the only scenario with a cost to Company A. No farm-out may still be out is favoured to scenario 3 because Company A's interest is undissolved and the company stands to benefit 100% from revenue when the mining block enters production.

It should be noted that the Tenth Schedule is a schedule to the Income Tax Act and accordingly where the disposing company has failed to make an election (participation or rollover) that the taxation of the disposal of the oil and gas right reverts back to the "normal" provisions of the Income Tax Act<sup>146</sup> (Refer to 4.5 of this dissertation).

---

<sup>146</sup> This interpretation is supported by the example provided for in the Explanatory Memorandum to the Revenue Laws Amendment Act, 2006:22.

## ANNEXURE D

Annexure I of the OP26 lease<sup>147</sup> provides the following example of the application of the unredeemed capital expenditure allowance.

### *First year of pre-production activities*

Actual capital expenditure qualifying for redemption	Unredeemed balance of Capital Expenditure (C/E) for the purpose of calculating the Capital Allowance (C/A)
Incurred during the year    R2 000 000 C/A for the year <u>R 120 000</u> Carried Forward                R2 120 000	Incurred                            R2 000 000 C/A for the year (at 12% <u>R 120 000</u> pro rata for a portion of a year *) Carried Forward <u>R2 120 000</u>

### *Second year of pre-production activities*

Balance brought forward    R2 120 000	Balance brought forward    R2 120 000
Incurred during the year**   R2 000 000	Incurred during the year ** R1 940 000
C/A for the year <u>R 370 800</u>	C/A for the year (at 12%) <u>R 370 800</u>
Carried Forward <u>R4 490 800</u>	Carried Forward <u>R4 430 800</u>

\* C/E is calculated at 12% (or other applicable percentage) from the end of the month during which it was incurred until the end of the tax year. In this example, however, it is supposed that all the qualifying C/E was incurred just before the end of the 6<sup>th</sup> month of the tax year.

\*\* Interest and other finance charges on loans do not qualify for the C/A.

<sup>147</sup> Prospecting Lease No OP26, specifically prospecting lease no 1/96 in favour of Soekor (Pty) Ltd.

***First year of production***

<p>1) <u>Calculation of taxable income:</u></p> <p>Gross income           R3 000 000</p> <p>Working costs           <u>R3 740 000</u></p> <p>Working loss           R 740 000</p> <p>Redemption of C/E <u>R6 626 896</u></p> <p>Assessed loss           <u>R 7 366 896</u></p> <p>2) <u>C/E qualifying for redemption:</u></p> <p>Unredeemed balance b/f R4 490 800</p> <p>Incurred during the year R1 500 000</p> <p>C/A for the year           <u>R 636 096</u></p> <p>Total allowed for redemption</p> <p style="text-align: right;"><u>R6 626 896</u></p> <p>Thus no balance carried forward</p>	<p>3) Calculation of C/A in determining the balance of C/E for the purposes of the C/A</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;"><u>Unredeemed balance</u></th> <th style="text-align: right;"><u>C/A at 12%</u></th> </tr> </thead> <tbody> <tr> <td>Balance b/f           R4 430 800</td> <td style="text-align: right;">R531 696</td> </tr> <tr> <td>C/E incurred           R1 500 000</td> <td style="text-align: right;">R 90 000</td> </tr> <tr> <td>Possible C/E included in working costs but on which C/A is allowed R 240 000</td> <td style="text-align: right;"><u>R 14 400</u></td> </tr> <tr> <td>C/A for the year           <u>R 636 096</u>   ▶</td> <td style="text-align: right;"><u>R 636 096</u></td> </tr> <tr> <td style="text-align: right;">R6 806 896</td> <td></td> </tr> </tbody> </table> <p><u>Deduct</u></p> <p>C/E allowed for redemption:</p> <p>Amount deducted in the calculation of profits is R 6 626 896 but the deduction is restricted under section 26(3) to the amount of the “profit”,</p> <p>i.e.                                   <u>R NIL</u></p> <p>Unredeemed balance carried forward           <u>R 6 806 896</u></p>	<u>Unredeemed balance</u>	<u>C/A at 12%</u>	Balance b/f           R4 430 800	R531 696	C/E incurred           R1 500 000	R 90 000	Possible C/E included in working costs but on which C/A is allowed R 240 000	<u>R 14 400</u>	C/A for the year <u>R 636 096</u> ▶	<u>R 636 096</u>	R6 806 896	
<u>Unredeemed balance</u>	<u>C/A at 12%</u>												
Balance b/f           R4 430 800	R531 696												
C/E incurred           R1 500 000	R 90 000												
Possible C/E included in working costs but on which C/A is allowed R 240 000	<u>R 14 400</u>												
C/A for the year <u>R 636 096</u> ▶	<u>R 636 096</u>												
R6 806 896													

**Second year of production**

<p>1) <u>Calculation of taxable income:</u></p> <p>Gross income           R7 000 000</p> <p>Working costs           <u>R3 500 000</u></p> <p>Working profit           R3 500 000</p> <p>Deduct:</p> <p>Redemption of C/E <u>R1 900 828</u></p> <p>Assessed loss b/f    R 7 366 896</p> <p>Assessed loss c/f    <u>R 5 767 724</u></p> <p>2) <u>C/E qualifying for redemption:</u></p> <p>Balance b/f                NIL</p> <p>C/E incurred for the year R1000 000</p> <p>C/A for the year           <u>R 900 828</u></p> <p>Total allowed for redemption</p> <p align="right">R1 900 828</p>	<p>3) Calculation of C/A in determining the balance of C/E for the purposes of the C/A</p> <table border="0"> <tr> <td><u>Unredeemed balance</u></td> <td></td> <td><u>C/A at 12%</u></td> </tr> <tr> <td>Balance b/f</td> <td>R6 806 896</td> <td>R816 828</td> </tr> <tr> <td>C/E incurred</td> <td>R1 000 000</td> <td>R 60 000</td> </tr> <tr> <td>Possible C/E included in working costs but on which C/A is allowed</td> <td>R 400 000</td> <td><u>R 24 000</u></td> </tr> <tr> <td>C/A for the year</td> <td><u>R 900 828</u> ▶</td> <td><u>R 900 828</u></td> </tr> <tr> <td></td> <td>R9 107 724</td> <td></td> </tr> </table> <p><u>Deduct: C/E allowed for Redemption as calculated below</u>           *<u>R3 400 000</u></p> <p>Unredeemed balance carried forward           <u>R 5 707 724</u></p> <p><u>*C/E allowed for redemption</u></p> <p>Deemed deduction (section 26(4)) is R9 107 724 but the deduction is restricted under section 26(3) to the amount of the “profit” i.e:</p> <table border="0"> <tr> <td>Working profit</td> <td align="right">R3 500 000</td> </tr> <tr> <td>Plus: C/E included in working costs but which can for the purposes of the C/A be regarded as C/E</td> <td align="right"><u>R 400 000</u></td> </tr> <tr> <td></td> <td align="right">R 3 900 000</td> </tr> </table> <p>Deduct: So much of the loss brought forward which is not ascribable to the C/E (see below) #</p> <p align="right"><u>R 500 000</u></p> <p align="right">R 3 400 000</p>	<u>Unredeemed balance</u>		<u>C/A at 12%</u>	Balance b/f	R6 806 896	R816 828	C/E incurred	R1 000 000	R 60 000	Possible C/E included in working costs but on which C/A is allowed	R 400 000	<u>R 24 000</u>	C/A for the year	<u>R 900 828</u> ▶	<u>R 900 828</u>		R9 107 724		Working profit	R3 500 000	Plus: C/E included in working costs but which can for the purposes of the C/A be regarded as C/E	<u>R 400 000</u>		R 3 900 000
<u>Unredeemed balance</u>		<u>C/A at 12%</u>																							
Balance b/f	R6 806 896	R816 828																							
C/E incurred	R1 000 000	R 60 000																							
Possible C/E included in working costs but on which C/A is allowed	R 400 000	<u>R 24 000</u>																							
C/A for the year	<u>R 900 828</u> ▶	<u>R 900 828</u>																							
	R9 107 724																								
Working profit	R3 500 000																								
Plus: C/E included in working costs but which can for the purposes of the C/A be regarded as C/E	<u>R 400 000</u>																								
	R 3 900 000																								

	<u># The portion of the loss brought forward not resulting from the deduction of C/E</u>		
	Assessed loss brought forward		R 7 366 896
	Actual C/E (redemption allowance)	R6 626 896	
	C/E in working costs	<u>R 240 000</u>	<u>R 6 866 896</u>
			<u>R 500 000</u>

***Third year of production***

<p>4) <u>Calculation of taxable income:</u></p> <p>Gross income R8 000 000</p> <p>Working costs <u>R3 900 000</u></p> <p>Working profit R 4 100 000</p> <p>C/E redemption <u>R1 214 927</u></p> <p>Assessed loss b/f R 5 767 724</p> <p><u>Assessed loss c/f R 2 882 651</u></p> <p>5) <u>C/E qualifying for redemption:</u></p> <p>Unredeemed balance b/f NIL</p> <p>C/E incurred for the year R500 000</p> <p>C/A for the year <u>R714 921</u></p> <p><u>R1 214 927</u></p>	<p>6) Calculation of C/A in determining the balance of C/E for the purposes of the C/A</p> <table> <tr> <td><u>Unredeemed balance</u></td> <td></td> <td><u>C/A at 12%</u></td> </tr> <tr> <td>Balance b/f</td> <td>R5 707 724</td> <td>R684 927</td> </tr> <tr> <td>C/E incurred</td> <td>R 500 000</td> <td>R 30 000</td> </tr> <tr> <td>C/A for the year</td> <td><u>R 714 927</u> ◀</td> <td><u>R 714 927</u></td> </tr> <tr> <td></td> <td>R6 922 651</td> <td></td> </tr> </table> <p><u>Deduct: Redemption of C/E as calculated below</u> **<u>R4 100 000</u></p> <p>Balance c/f <u>R 2 822 651</u></p> <p><u>*C/E allowed for redemption</u></p> <p>Deemed deduction (section 26(4)) is R6 922 651 but the deduction is restricted under section 26(3) to the amount of the “profit” i.e:</p> <table> <tr> <td>Working profit</td> <td>R4 100 000*</td> </tr> <tr> <td>Deduct: So much of the loss brought forward not resulting from the C/E</td> <td><u>R NIL</u></td> </tr> <tr> <td></td> <td><u>R 4 100 000</u></td> </tr> </table>	<u>Unredeemed balance</u>		<u>C/A at 12%</u>	Balance b/f	R5 707 724	R684 927	C/E incurred	R 500 000	R 30 000	C/A for the year	<u>R 714 927</u> ◀	<u>R 714 927</u>		R6 922 651		Working profit	R4 100 000*	Deduct: So much of the loss brought forward not resulting from the C/E	<u>R NIL</u>		<u>R 4 100 000</u>
<u>Unredeemed balance</u>		<u>C/A at 12%</u>																				
Balance b/f	R5 707 724	R684 927																				
C/E incurred	R 500 000	R 30 000																				
C/A for the year	<u>R 714 927</u> ◀	<u>R 714 927</u>																				
	R6 922 651																					
Working profit	R4 100 000*																					
Deduct: So much of the loss brought forward not resulting from the C/E	<u>R NIL</u>																					
	<u>R 4 100 000</u>																					



## BIBLIOGRAPHY

### PUBLISHED REFERENCES

Barrows, G. (1997). *World Fiscal Systems for Oil*. New York: The Barrows Company Inc.

Clegg, D. (2010). *Global Oil and Gas tax guide*. Cape Town: Ernst & Young.

Clegg, D. (2010). *Income Tax in South Africa* (1). Durban: Lexis Nexis.

Clegg, D. & Steenkamp, L. (2007) *Oil and gas exploration and production in South Africa – A new tax regime*. Cape Town: Ernst & Young.

De Koker, A. (2009). *Silke on South African Income Tax* (4). Service 39. Cape Town: Lexis Nexis

De Meyer, W.A. (1992). *Evaluation of South African fiscal and contractual terms as applied to petroleum and production*. Cape Town: Soekor.

Devenish, D.E. (1992). *Interpretation of statutes*. Cape Town: Juta.

Du Plessis, L. (2002). *Reinterpretation of statutes*. Durban: Butterworths.

Garnaut, R. & Ross, A.C. (1983). *Taxation of Mineral Rents*. Oxford: Clarendon.

Huxham, K. & Haupt, P. (2009). *Notes on South African Income Tax* (28). Cape Town: Hedron Tax Consulting and Publishing CC.

Huxham, K. & Haupt, P. (2010). *Notes on South African Income Tax* (29). Cape Town: Hedron Tax Consulting and Publishing CC.

International Accounting Standards Board. (2004). *Financial reporting standards*. London: IASCF Publications Department.

Joubert, W.A. & Faris, J.A. (2001). *The law of South Africa*, 25(1). Durban: Butterworths.

Kellaway, E.A. (1995). *Principles of legal interpretation: statutes, contracts and wills*. Durban: Butterworths.

Lambrechts, K., Abdulai, D., Kabemba, C. & Olaleye, W. (2009). *Breaking the Curse: How Transparent Taxation and Fair Taxes can Turn Africa's Mineral Wealth into Development*. Johannesburg: Open Society Institute of Southern Africa.

Louw, I. (2007) *The new general anti-avoidance: A comprehensive discourse of this statute*. Dissertation. Cape Town: University of Cape Town.

Manuel, T. (2006) *Introduction of the Revenue Laws in the National Assembly, 2 November 2006*. Speech presented to the National Assembly, Parliament of South Africa, Cape Town.

Meyerowitz, D. (2006). *Meyerowitz on Income Tax 2006/2007*. Cape Town: The Taxpayer CC.

Meyerowitz, D. (2009). *Meyerowitz on Income Tax 2009/2010*. Cape Town: The Taxpayer CC.

Meyerowitz, D., Emslie, T.S. & Davis, D.M. (2007). Tax avoidance: section 80A(c)(ii). *The Taxpayer*, August 2007:147-160. Cape Town: The Taxpayer CC.

Mitchell, K. & Mitchell, L. (2007). *Deloitte: Tax Update Seminar February 2007*: 79-85. Pietermaritzburg: Mitchell & Mitchell Tax Service CC.

Mitchell, L. (2007). Tenth Schedule. *Income Tax reporter*, 46(4): 228. Pietermaritzburg: Lexis Nexis Tax Service.

OECD. (2008). *Model Tax Convention on Income and on Capital of the Organization for Economic Co-operation and Development*. (31 August 2008) Paris: OECD publications.

Olivier, L. & Honiball, M. (2008). *International tax: a South African perspective* (4). Cape Town: Siber Ink CC.

Omar, Anwar. (1998). *The Historical Development of Income Tax on South African Hydrocarbon Production: 2*. Oxford Project Report. The College of Petroleum and Energy Studies.

Pedregal, C. (2009). *Doing business in South Africa*. Rosebank: UHY International Ltd.

Ramboll, A.S. (2009). *Capital allowances available and the future utilisation of in the mining industry of South Africa –A comparative study*. Mini-dissertation. Pretoria: University of Pretoria.

Rutledge, I. & Wright, P. (1998). *Profitability and taxation in the UKCS oil and gas industry: analysing the distribution of rewards between company and country*. Energy Policy 26(10). London: HMRS.

Seligson, M., Kruger, D. & Rudnicki, M. (2010). *Business Tax and Company Law quarterly*. 1(1): March 2010. Cape Town: Siber Ink CC.

Scholtz, A. & Wilson, W. (2007). *Taxation of Oil & Gas Companies in South Africa*. Cape Town: Deloitte.

Silke, J. (1978). *Silke on South African Income Tax* 9<sup>th</sup> ed. Cape Town: Butterworths

Silke, J. (2005). Interest earned in mining operations. *Tax Planning Corporate and Personal*, 19: 4 August 2005.

Sunley, E.M., Baunsgaard, T. & Simard, S. (2002). *Revenue from the Oil and Gas sector: Issues and country experience*. Washington: International Monetary Fund.

Tordo, S. (2007). Fiscal systems for Hydrocarbons: Design Issues. *World Bank working paper no. 123*. Washington: The World Bank.

Van Blerck, M.C. (1990). *Mining tax in South Africa*. Rivonia: Taxfax CC

Van Schalkwyk, L. & Geldenhuys, B. (2009). Section 80A(c)(ii) of the Income Tax Act and the interpretation of tax statutes in South Africa. *Meditari Accountancy Research*, 17(2): 167-185

#### **UNPUBLISHED REFERENCES**

Arthur Andersen. (1993). *Overview of Income Tax treatment under OP26*. Section B. Extract from Fiscal Regime.

Clegg, D. (2006). *Summary of analysis of existing petroleum taxation regime vs normal mining taxation regime*. Cape Town: Ernst & Young. Opinion produced for BHP Billiton Petroleum Great Britain Ltd.

South Africa. Minister of Mines. 1967. *Prospecting Lease between the Honourable the Minister of Mines and Suidelike Olie-Eksplorasiekorporasie (Eiendoms) Beperk*. Filed under No.OP26 in the register of prospecting leases (Act No.20 of 1967): 5 July 1967. Johannesburg: Registrar of Mining Titles.

South Africa. National Treasury. 2007. *Memorandum of Agreement entered into by Forest Exploration International (South Africa) (Pty) Ltd and between the Government of the Republic of South Africa in its National Treasury represented by the Minister of Finance and in respect of block 2A*. Pretoria: National Treasury.

South Africa. National Treasury. 2008. *Memorandum of Agreement entered into by BHP Billiton Petroleum Great Britain Limited and between the Government of the*

*Republic of South Africa in its National Treasury represented by the Minister of Finance and in respect of block 3A4A.* Pretoria: National Treasury.

Tickle, D. & Lombaard, E. (2010) *Continuation of the 12% allowance on assets acquired under the OP26 regime.* Cape Town: KPMG. Opinion.

## **LEGISLATION**

South Africa. 1964. *Customs and Excise Act No 91 of 1964.* Pretoria: Government Printer. [Laws.]

South Africa. 1962. *Income Tax Act No 58 of 1962.* Pretoria: Government Printer. [Laws.]

South Africa. 1994. *Maritime Zones Act No 15 of 1994.* Pretoria: Government Printer. [Laws.]

South Africa. 1991. *Minerals Act No 50 of 1991.* Pretoria: Government Printer. [Laws.]

South Africa. 2001. *Mineral and Petroleum Resources Development Act No 28 of 2002.* Pretoria: Government Printer. [Laws.]

South Africa. 1967. *Mining Rights Act No 20 of 1967.* Pretoria: Government Printer. [Laws.]

South Africa. 2006. *Revenue Laws Amendment Act No 20 of 2006.* Pretoria: Government Printer. [Laws.]

South Africa. 1963. *Territorial Waters Act No 87 of 1963.* Pretoria: Government Printer. [Laws.]

Canada. 1985. *Canadian Federal Income Tax Act* RSC 1985, c. 1 (5th Supp.).  
Québec: Federation of Law Societies of Canada. [Laws.]

## **EXPLANATORY MEMORANDUMS**

South Africa. National Treasury. 2006. *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006* [W.P.2 – ‘06]: 15-23. Pretoria: Government Printer.

South Africa. National Treasury. 2009. *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2009* [W.P. – ‘09]: 69-70. Pretoria: Government Printer.

## **SARS PUBLICATIONS**

South Africa. South African Revenue Service. 1999. *Section 31 of the Income Tax Act, 1962 (The Act): Determination of the taxable income of certain persons from International Transactions: Transfer Pricing*. Practice Note: No 7 – 6 August 1999. Pretoria: Government Printer.

South Africa. South African Revenue Service. 1996. *Income Tax: Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic*. Practise Note: No 2 – 14 May 1996. Pretoria: Government Printer.

South Africa. South African Revenue Service. 1993. *Income Tax: Deduction in respect of wear and tear or depreciation in terms of section 11(e) of the Income Tax Act: machinery, plant, implements, utensils and articles (including vehicles and equipment)(excluding leased items as contemplated in practice note no. 15 dated 16 March 1992)*. Practise Note: No 19 – 30 April 1993. Pretoria: Government Printer.

South Africa. South African Revenue Service. 2003. *Interpretation Note: No. 10-Exemption: Public Benefit Organisations-Section 4(c) of the Skills Development Levies Act, No. 9 of 1999*. (24 March 2003). Pretoria: Government Printer.

South Africa. South African Revenue Service. 2008. *Interpretation Note: No. 22-Exemption: Public Benefit Organisations and Statutory Bodies -Section 9(1)(c) and 9(1A) of the Transfer Duty Act No. 40 of 1949.* (Issue 2) (8 December 2008). Pretoria: Government Printer.

South Africa. South African Revenue Service. 2007. *Interpretation Note: No. 24-Public Benefit Organisations: Trading Rules - Partial Taxation of Trading Receipts-Section 10(1)(cN) of the Income Tax Act.* (Issue 2) (31 August 2007). Pretoria: Government Printer.

South Africa. South African Revenue Service. 2005. *Interpretation Note: No. 32-Public Benefit Organisations: Prudent Investments - Section 30(3)(b)(ii)(cc) of the Income Tax Act, 1962.* (27 June 2005). Pretoria: Government Printer.

South Africa. South African Revenue Service. 2007. *Interpretation Note: No. 44 Public Benefit Organisations: Capital Gains Tax (CGT) - Paragraph 63A of the Eighth Schedule.* (31 August 2007). Pretoria: Government Printer.

South Africa. South African Revenue Service. 2009. *Interpretation Note: No. 46-Income Tax: Amalgamation of Amateur and Professional Sporting Bodies.* (Issue 2) (18 February 2009). Pretoria: Government Printer.

South Africa. South African Revenue Service. 1992. *VAT ruling: No. 64 – Input tax credit – prospecting and investigations* (28/3/1-5 May 1992). Pretoria: Government Printer.

South Africa. South African Revenue Service. 2006. *Tax avoidance and section 103 of the Income Tax Act: revised proposal.* [Online]. Available: <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=57447>.

[September 2006]

## **PROPOSALS TO NATIONAL TREASURY**

Clegg, D. & Van Riel, R. (2010). *OPASA: Proposed Amendment to the 10<sup>th</sup> Schedule*. Cape Town: OPASA. Proposal to National Treasury.

Clegg, D. (2008). *Oil and Gas companies-proposal for amendments*. Cape Town: OPASA. Proposal to National Treasury.

Futter, A.J. (2009). *The effect of the cessation of the OP26 unredeemed capex allowance*. Cape Town: OPASA. Proposal to National Treasury.

Futter, A.J. (2010). *Transfer of Fiscal Stability Agreement rights*. Cape Town: OPASA. Proposal to National Treasury.

Futter, A.J. (2010). *Proposal: Unredeemed Capital*. Cape Town: OPASA. Proposal to National Treasury.

## **COURT CASES**

*African Life Investment Corporation v Secretary for Inland Revenue* 1969 (4) SA 259 (A) (31 SATC 163)

*Atherton v British Insulated and Helsby Cables Ltd* (1926 AC 205) (10 TC 155)

*Ben Heqoa v Browns Cash & Carry and Another* LC/REV/331/06

*Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A) (37 SATC 1)

*Canada Trustco Mortgage Company v Canada* 2005 SCC54

*CIR v African Oxygen Ltd* 1963 (1) SA 681 (A) (25 SATC 67)

*CIR v Allied Building Society* 1963 (4) SA 1 (A) (25 SATC 343)

*CIR v Black* 1957(3) SA 536 (A) (21 SATC 226)

*CIR v Crown Mines Ltd* 1923 SA 121(A)

*CIR v D&N Promotions (Pty) Ltd* 1995 (2) SA 296 (A)

*CIR v Edgars Stores Ltd* 1986 (4) SA 312 (T) (48 SATC 89)

*CIR v G Brollo Properties (Pty) Ltd* 1993 (A) (56 SATC 47)

*CIR v Genn & Co (Pty)* 1955 AD (20 SATC 113)

*CIR v George Forest Timber Co Ltd* 1924 SA516 (A) (1 SATC 20)

*CIR v Golden Dumps (Pty) Ltd* 1993 (4) SA 110 (A) (55 SATC 198)

*CIR v Lever Bros and Unilever Ltd* 1946 SA 441 (A) (14 SATC 1)

*CIR v Lydenburg Platinum* 1929 SA 137 (A) (4 SATC 8)

*CIR v Nemojim* 1983 (4) SA 935 (A) (45 SATC 241)

*CIR v Paul* 1956 (3) SA 335 (A) (21 SATC )

*CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A) (20 SATC 355)

*CIR v Stott* 1928 SA 252 (A) (3 SATC 253)

*Commissioner for Inland Revenue v Tod* 1983 (2) SA 364 (N) (45 SATC 1)

*Commissioner of Taxes Southern Rhodesia v Levy* 1952 (2) SA 413 (A) (18 SATC 127)

*Concentra (Pty) Ltd v CIR* 1942 SA 509 (C) (12 SATC 95)

*Coopers v Lybrand & Bryant* 1995(3) SA761(A)

*CSARS v Contour Engineering (Pty) Ltd* 1999 (61 SATC 447)

*Dadoo Ltd v Krugersdorp Municipal Council* 1920 SA530 (A)

*De Beers Marine (Pty) Ltd v CSARS* 2002 (3) SA 181 (A)

*Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A) (50 SATC 81)

*Ernst v Commissioner for Inland Revenue* 1954 (1) SA318 (A)

*Estate Reynolds and others v Commissioner for Inland Revenue* 1937 SA 57 (A) (8 SATC 203)

*Fedlife Assurance Limited v Hendrik Johannes Wolfaardt* (SCA Case No. 450/99) 2001 12 BLLR 1301 (SCA)

*Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 (A) (37 SATC 294)

*IRC v Duke of Westminster* 1936 (19 TC 490)

*ITC 1499* 1989 (T) (53 SATC 266)

*ITC 1503* (53 SATC 342)(T)

*ITC 1636* (60 SATC 267)

*ITC 1643* (61 SATC 12)

*ITC1753* (65 SATC 310)

*ITC 1794 (2005) (67 SATC 262)*

*Jaga v Dönges, N.O. and Another; Bhana v Dönges, N.O. and Another 1950(4) SA 653*

*Joffe & Co. (Pty) Ltd v CIR 1946 SA 157 (A) (13 SATC 354)*

*KBI v Nasionale Pers Bpk 1984 (4) SA 551 (C) (46 SATC 83)*

*Minister of Home Affairs and Another v Fourie and Another CCT 60/04*

*Minister of Finance v De Beers (Pty) Ltd 2006 (69 SATC 105)*

*Nasionale Pers Bpk v KBI 1986 (3) SA 549 (A) (48 SATC 55)*

*New State Areas Ltd v CIR 1946 SA 610 (A) (14 SATC 155)*

*Omnia Fertilizer Ltd v C:SARS 2003 (4) SA 513 (SCA) (65 SATC 159)*

*Port Elizabeth Electric Tramway Co Ltd v CIR 1936 SA 241 (C) (8 SATC 13)*

*Rabinowitz & Another v De Beers Consolidated Mines Ltd 1958 (3) SA 619 (A), 3 All SA455 (A)*

*Rhodesian Metals Ltd (in liquidation) v Commissioner of Taxes, S Rhodesia 1940 SA432 (A) (11 SATC 244)*

*Sekretaris van Binnelandse Inkomste v Raubenheimer 1969 (4) SA314 (A) (31 SATC 209)*

*SIR v Eaton Hall 1975 (4) SA 953 (A) (37 SATC 343)*

*SIR v Geustyn, Forsyth and Joubert 1971 (3) SA 567 (A) (33 SATC 113)*

*Stadsraad van Pretoria v Van Wyk* 1973 (2) SA 779 (A)

*Strong & Co. Ltd v Woodifield* 1906 SA448 (AC), SA453 (AC); 28 Digest 57; 75 LTKB 864

*Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A) (15 SATC 380)

*Transvaal Hide & Skins Merchants v COT Botswana* 1967 (BCA)( 29 SATC 97)

*True Motives 84 (Pty) Ltd v Mahdi and another* 2009 (4) SA 153 (SCA)

*Trust Bank of Africa Ltd v SIR* 1978 (4) SA 850 (C) (50 SATC 98)

*Western Platinum Ltd v C:SARS* (2004) 4 All SA 611 (SCA) (67 SATC 1)

University of Cape Town