



**The University of Cape Town  
Department of Finance and Tax**

**A CRITICAL ANALYSIS OF HOW PARAGRAPH 5 OF THE TENTH SCHEDULE INTERACTS WITH  
SECTION 20 OF THE INCOME TAX ACT**

**South African Tax Masters Dissertation  
FTX5030W  
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## **Abstract**

The oil and gas industry has the potential to contribute to the country's economic growth, job creation and energy security. Until 2006, the OP26 lease regime governed the taxation of South Africa's upstream oil and gas mining rights. As the expiration of this regime approached, which coincided with the transition from the Minerals Act to the Mineral and Petroleum Resources Development Act, the National Treasury and the Minister of Finance proposed a Money Bill. Parliament's General Assembly supported the enactment of the Tenth Schedule to the Income Tax Act, which aimed to renew and standardise the tax treatment of oil and gas rights based on previous agreements that were only known to the parties involved.

The purpose of the Tenth Schedule is to incentivise foreign direct investment by offering favourable deviations from the general tax code, whilst providing investors with certainty and transparency. These deviations sought to recognise the unique risks faced by oil and gas companies and the varied geographical probabilities in the country.

In 2019 and 2020, the National Treasury announced plans to revise the oil and gas tax regime and the corporate income tax regime. The objective of this revision for oil and gas companies was to assess whether the current tax regime remained appropriate. Whilst for corporate taxpayers, the goal was to align the regime more closely with international standards. This review involved reducing the corporate income tax rate to encourage investment and revising tax incentives to ensure uniformity across all sectors. Ultimately, National Treasury concluded that the oil and gas tax regime would not change; however, the decrease in the corporate income tax rate introduced limitations on the assessed tax losses of companies and amended interest deduction rules concerning debts owed to entities not subject to tax.

Using the theoretical approach of legal interpretive research, which is doctrinal, this minor dissertation analyses the application of the tax loss limitation by oil and gas companies, focusing on how paragraph 5 of the Tenth Schedule interacts with section 20 of the Income Tax Act. In examining the relationship between the assessed loss rules in the Tenth Schedule and the broader body of the Act, the minor dissertation details the taxation of the oil and gas industry, discusses the applicable provisions along with their interpretative challenges, and considers whether the limitation on assessed loss, which is applied to other companies (except for those engaged in mining operations), should also pertain to oil and gas companies, especially in light of the Tenth Schedule's intended purpose.

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## Plagiarism Declaration

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## List of Abbreviations and Acronyms

<b>Terms</b>	<b>Explanation</b>
bbls	billion barrels
BOP	Balance of Payments
COP21	21st Conference of the Parties
COP26	26th Conference of the Parties
FSA	fiscal stability agreement
GAAR	general anti-avoidance rules
GDP	gross domestic product
GHG	greenhouse gas including carbon dioxide (CO <sub>2</sub> ), methane (CH <sub>4</sub> ), nitrous oxide (N <sub>2</sub> O), perfluorocarbons (PFCs), and hydrofluorocarbons (HFCs)
GloBE	Global Anti-Base Erosion
HDSA	Historically Disadvantaged South Africans
IMF	International Monetary Fund
IIR	Income Inclusive Rule
Income Tax Act or Act	Income Tax Act 58 of 1962
JET	Eskom's Just Energy Transition
MNEs	Multinational enterprises
MPRDA	Mineral and Petroleum Resources Development Act 28 of 2002
MPRRA	Mineral and Petroleum Resources Royalty Act 28 of 2008
NGOs	Non-Governmental Organisations
OECD	Organisation for Economic Co-operation and Development
OP26	OP 26 prospecting lease, OP 26 mining lease and OP 26 prospecting subleases
Parliament	Parliament of the Republic of South Africa
PASA	The Petroleum Agency of South Africa
PSC	production sharing contracts
QMDTT	Qualifying Domestic Minimum Top-up Tax
SARS	South African Revenue Service
tcf	trillion cubic feet
Tenth Schedule	Tenth Schedule to the Income Tax Act
TWh	terawatt-hours
UK pounds	United Kingdom Pound Sterling
UN	United Nations
UNFCCC	United Nations Framework Convention on Climate Change
UPE	Ultimate Parent Entity

US dollars	United States dollars
WEF	World Economic Forum
<i>CIR v Stott</i>	<i>Commissioner for Inland Revenue v Stott</i> 1928 AD 252
<i>Conshu v CIR</i>	<i>Conshu (Pty) Ltd v Commissioner for Inland Revenue</i> 1994 (4) SA 603 (A)
<i>Natal Joint Municipal Pension Fund v Endumeni Municipality</i>	<i>Natal Joint Municipal Pension Fund v Endumeni Municipality</i> 2012 (4) SA 593 (SCA)
<i>SA Bazaars v CIR</i>	<i>SA Bazaars (Pty) Ltd v Commissioner for Inland Revenue</i> 1952 (4) SA 505 (A)

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## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background

In the 2019 Budget Review, the National Treasury (2019:6) announced that it would review the tax regime for the oil and gas industry. This review is fifteen years after the introduction of the Tenth Schedule to the Income Tax Act 58 of 1962 (the Income Tax Act or the Act). The introduction of the Tenth Schedule to the Income Tax Act (Tenth Schedule) aimed to provide transparency and certainty, as the previous regime, which included OP 26 prospecting leases, OP 26 mining leases, and OP 26 prospecting subleases (OP26), came to an end. The Explanatory Memorandum on the Revenue Amendment Bill (2006:15) states that the intention behind the new regime was to formalise and renew key elements of the OP26 regime, thereby continuing to encourage oil and gas exploration and production.

The Tenth Schedule outlines the income tax consequences for oil and gas activities in South Africa and as provided in section 26B of the Income Tax Act, overrides some corporate income tax provisions. The review is to determine whether the regime is “still suitable for exploring and producing oil and gas in South Africa while balancing the need for sufficient Government revenue and working towards South Africa’s commitments in respect of climate change” (National Treasury, 2021a:4). Since the Tenth Schedule’s introduction in 2006, it has been said that the incentivising provisions are more generous than the provisions of comparable international regimes (Mausling, 2016:64). A provision that showcases this generosity is paragraph 5 of the Tenth Schedule, which provides for the “deductions from income derived from oil and gas activities”.

Paragraphs 5(1) and 5(2) allow oil and gas companies to deduct 200 per cent or 150 per cent of the capital expenditure actually incurred for ‘exploration’ or ‘post exploration’, respectively, during any year of assessment. These ‘uplifts’ or ‘super deductions’ were included to promote investments in the high-risk and high-capital-cost industry that oil and gas companies operate under (National Treasury Explanatory Memorandum on the Revenue Amendment Bill, 2006:15).

Paragraph 5(3) ring-fences the assessed losses (as defined in section 20) in respect of ‘exploration’ or ‘post-exploration’ against the oil and gas income and the income derived from the refining of gas. If any assessed losses remain after the set-off allowed in paragraph 5(3), 10 per cent of it may be set off against other income derived by the company as per paragraph 5(4). The 10 per cent provides relief for working capital. This rule is because oil and gas companies may have investments (in interest bearing accounts and pooled arrangements) that help fund their oil and gas activities (Davis Tax Committee, 2016:83). Excess that remains after applying paragraph 5(4) is to be carried forward to the next year of assessment per paragraph 5(5).

The National Treasury (2021a:6), in the Tax Policy Discussion Paper for Public Comment, propose no change to the above provisions. This proposal aligns with the recommendations of the Davis Tax

Committee (2016:8-10) in their Report on Oil and Gas for the Minister of Finance, except for their suggestion to clarify the classification of “capital expenditure”. It is, however, different to that of the International Monetary Fund (IMF). The IMF suggested in its Technical Assistance Report on South Africa that the ‘uplifts’ should be reduced and the 10 per cent set-off against other income of oil and gas companies be changed or removed (IMF, 2015:65).

In the following year, after the announcement to review the oil and gas tax regime, the Minister of Finance in the Budget Review (2020) announced that the corporate tax regime was being revised. The review aims to “work towards greater efficiency and a more uniform tax treatment across taxpayers, sectors and sources of finance” (National Treasury, 2021a:51). The restructuring of the corporate tax regime changes the corporate income tax rate from 28 per cent to 27 per cent for the years of assessment ending on or after 31 March 2023. To mitigate the loss in expected tax revenue, the tax base is broadened by limiting the set-off of assessed losses as per section 20 of the Income Tax Act and by amending the interest limitation rule as per section 23M of the same Act.

This minor dissertation will examine the application of the tax assessed loss limitation rule to oil and gas companies, which are likely to remain in a tax assessed loss position in their initial years of production due to the generous tax incentives they receive for exploration and post-exploration capital expenditures.

## 1.2 Research Objective

The Tenth Schedule to the Income Tax Act aims to be transparent and certain, thereby encouraging investments in the oil and gas sector. It provides special tax rules for these companies which are part of the corporate tax regime. A review of the corporate tax regime thus needs to ensure that the purpose of the provisions relating to oil and gas companies is unaffected.

This research aims to critically analyse how the Tenth Schedule, focusing on paragraph 5, interacts with the rest of the Income Tax Act. It seeks to determine whether the recent amendment to section 20 of the Income Tax Act has furthered transparency and certainty for oil and gas investors, considering their needs, by considering the law, its interpretation and explanation, and the recommendations from review committees and affected stakeholders.

## 1.3 Rationale for the Topic

Oil and gas companies are corporate taxpayers, and as such, they are subject to the provisions of the Income Tax Act, except where section 26B and the Tenth Schedule provide a specific override. Thus, a review of the corporate income tax regime and subsequent changes to the Income Tax Act may affect oil and gas companies.

Erskine (2015:1) noted that proposed amendments affect investor confidence. As oil and gas companies require certainty to calculate their returns, they may become hesitant to incur expenditures

when there are proposals for changes (Offshore Petroleum Association of South Africa, 2022:12). As shown above, paragraph 5 (an incentivising provision) refers to section 20 of the Income Tax Act. Section 20 of the Act is one of the broadening measures resulting from corporate income tax rate change, making it necessary to determine whether this change supports the objective of the Tenth Schedule.

Additionally, South Africa has been facing an energy crisis since late 2007 (Eskom, 2023). This energy crisis introduced scheduled electricity power cuts or blackouts, also known as load shedding, to meet electricity demands. In the years since 2007, these blackouts have worsened, with 2022 having 207 days of load shedding (The Outlier, 2023). As energy has become a necessity of life and plays a vital role in growing economies, as noted by Lenoke (2017:56), immediate and urgent action is thus being sought to resolve the country's energy crisis. One of the proposed actions has been to support and encourage the development of the gas industry (Department of Mineral Resources and Energy, 2020). Gas is viewed as a transitional source, a cleaner alternative to coal, on the path to greener energy alternatives (National Business Initiative, 2022). It is thus key to ensure the tax consequences relating to it do not deter economic decisions that support this transition and that they remain efficient and neutral.

#### 1.4 Research Method

This research will follow the theoretical approach of legal interpretative research, doctrinal in nature, which "provides a systematic exposition of the rules governing a particular legal category, analyses the relationships between rules, explains areas of difficulty and, perhaps, predicts future developments" (Hutchinson & Duncan, 2012:101). The research will be qualitative and involve a study of relevant tax legislation, related explanatory commentary and reports, case law, journal articles, textbooks, and other relevant writings.

#### 1.5 Limitation of Scope

This research will be limited to analysing the Tenth Schedule to the Income Tax Act and the relevant provisions in the Income Tax Act that interact with it. It will not consider other taxes or fiscal instruments within the oil and gas tax regime. Although there are other principles of a good tax policy, this minor dissertation has limited its discussion to the principles of certainty and transparency, as these are the main principles noted as areas of improvement in the previous regime and the focus of the Explanatory Memorandum on the Revenue Amendment Bill, 2006.

## 1.6 Structure

The current chapter serves as the introductory chapter, providing background and rationale for the minor dissertation, as well as explaining its objective. It also mentions the research method used, the scope limitation, and the structure of the minor dissertation.

Chapter Two provides the background by detailing the oil and gas industry in South Africa, explaining its fiscal tax regime and socioeconomic potential. The chapter will explain how tax policies, including their principles of certainty and transparency, can contribute to foreign direct investment and encourage growth.

Chapter Three examines the tax incentives available to oil and gas companies under the Tenth Schedule to the Income Tax Act. It describes the different risks associated with the oil and gas industry that led to deviations from the general tax code, and how the Tenth Schedule's formalisation aimed to achieve transparency and certainty, thus with the tax incentives encouraging foreign direct investment.

Chapter Four explains the assessed loss provision in section 20 of the Act. It details the provision's interpretational issues and recent amendments due to the corporate income tax revision, which decreased the corporate income tax rate from 28 per cent to 27 per cent.

Chapter Five considers the conflict between the assessed loss provision in the Tenth Schedule, Chapter Three, and the assessed loss provision in section 20 of the Act, Chapter Four. The chapter provides a brief explanation of the rules of interpretation and how they determine which rule applies to oil and gas companies.

Chapter Six concludes and outlines the findings of this research, examining whether oil and gas companies are affected by the recent amendment and whether this is intentional. It also considers whether the amendment should apply to oil and gas companies. The chapter also gives recommendations for issues or concerns found in this research.

## CHAPTER TWO

### OIL AND GAS COMPANIES

**Chapter Two provides the background by detailing the oil and gas industry in South Africa, explaining its fiscal tax regime and socioeconomic potential. The chapter will explain how tax policies, including their principles of certainty and transparency, can contribute to foreign direct investment and encourage growth**

#### 2.1 Introduction

The Oil and Gas Industry is a vital sector that plays a crucial role in the global economy. It is part of the energy sector and is divided into three main segments: the upstream, midstream, and downstream. The upstream segment is where exploration and production take place. The midstream segment ensures safe and appropriate transportation and storage of extracted natural resources. The downstream segment focuses on refining and processing the resources into finished products for customer distribution.

Oil and gas companies have a distinct fiscal tax regime compared to other companies due to the unique risks they face during the exploration and production stages. This regime is established by balancing the principles of a good tax system, economic development, and the country's geographical realities. This chapter aims to provide an overview of the South African industry, offer a brief understanding of the various fiscal tax regimes, and explain the principles of transparency and certainty, highlighting their importance in shaping tax policy.

#### 2.2 Oil and gas

South Africa is a country that has attracted significant foreign direct investment due to its natural resources (Igbayiloye & Bradlow, 2021:366). These investments, initially driven by diamond and gold discoveries, led to the country's industrial development (Kransdorff, 2010:72). Since then, the country's extractive industry has continued to evolve. It plays a key role in securing investment opportunities to improve the gross domestic product (GDP), furthering economic growth (Nhabinde & Heshmati, 2020:12).

Oil and gas exploration (which started in the 1960s) has not had the same success or made the same contribution as hard-rock mineral resources. The initial discoveries made in South Africa were not significant. At the time of these discoveries there was political uncertainty which made it challenging to keep and attract further investments in the exploration for and production of oil and gas (Petroleum Agency SA, 2017:14). As a result of a low exploration success rate and the inherent risks of exploration projects, which include the cost of development, the length of time it takes for the benefits and profits to materialise, the cost of failure, and environmental concerns, the oil and gas industry's development has been slow (Davis Tax Committee, 2016:11-13).

In 1998, the Department of Minerals and Energy, at the time, highlighted the importance of oil and gas resources and committed to promoting and developing the industry. Oil and gas, with coal and uranium, are fossil fuels that play a central role in the socio-economic development of the country (Department of Minerals and Energy, 1998:2). These fossil fuels, through the creation of energy, power various sectors, including agriculture, manufacturing, and mining, promoting further infrastructural and industrial development of the country.

Infrastructural development, which includes energy security, after institutions, has been listed by the World Economic Forum (WEF) as the second pillar of competitiveness (World Economic Forum, 2019:518). Its extensiveness and efficiency enable the macroeconomic environment, encouraging positive economic growth (Fedderke & Garlick, 2008:18). The supply of oil and gas as a potential transitional energy source, and existing (refinery and pipeline) infrastructure are positively correlated with the development of other industries and economic infrastructure. The establishment and maintenance of the energy sector is vital to furthering South Africa's development.

Currently, South Africa's electricity generation of 236.7 terawatt-hours (TWh) is 80.1 per cent met by local coal (The Council for Scientific and Industrial Research, 2023:2). Indigenous coal has been a crucial driver of economic growth by being a reliable source of energy as well as contributing to revenue generation through exports for over 100 years (Minerals Council South Africa, 2023). More recently, however, the world has emphasised the need to move from coal to more renewable resources.

Coal, as stated by the Department of Energy (2018:19), is a significant contributor to greenhouse gas (GHG) emissions. GHGs, which include carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide (N<sub>2</sub>O), perfluorocarbons (PFCs), and hydrofluorocarbons (HFCs), contribute to global warming, leading to climate change (Department of Forestry, Fisheries and the Environment, 2023). Their emissions through the regular publications by the Department of Forestry, Fisheries and the Environment (2023) in the National Greenhouse Gas Inventory Report are monitored "to support domestic and international reporting obligations" and set "a good foundation for effective mitigation responses".

These international reporting obligations came when South Africa signed and ratified the late 1990s United Nations Framework Convention on Climate Change (UNFCCC) international environmental treaty, which was in response to the Intergovernmental Panel on Climate Change noting climate change as a threat to humanity (Department of Forestry, Fisheries and the Environment, 2015:1). The National Greenhouse Gas Inventory Report by the Department of Forestry, Fisheries and the Environment (2015:67) notes that the energy sector is a broad emission one, as the country is rich in coal and exploits it as an energy source.

Around the world, countries, such as Botswana, in the 26<sup>th</sup> Conference of the Parties (COP26) of the UNFCCC, have pledged (Glasgow Climate Pact) to move away from coal because of these environmental concerns. South Africa is a part of the 2015 Paris Agreement adopted at the 21<sup>st</sup> COP session (COP21), which encourages the transition of energy from coal to more renewable sources of energy to improve climate conditions (United Nations Climate Change, 2022:4-5).

In addition to the international trend, the use of coal in South Africa has not been efficient in recent years. Its infrastructure has not kept up with the economic demands, leading to South Africa experiencing an energy crisis. This crisis, which began in 2007, has resulted in scheduled power outages called “load shedding” (Joffe, 2012:32-33). As explained above, energy is crucial for economic development, so this crisis has caused instability affecting multiple economic sectors, their investments, and growth (Naidoo, 2023:10). The country, because of climate change commitments and electricity demand exceeding supply, has a greater need to meet its 1998 objective of diversifying energy sources to ensure competitiveness is kept and securing the Republic’s access to energy in the form of electricity (Department of Minerals and Energy, 1998:2).

The 1998 White Paper on the Energy Policy of the Republic of South Africa recognised oil and gas as a potential resource to diversify the energy sources (Department of Minerals and Energy, 1998:2). Gas, especially, though a fossil fuel, produces less greenhouse gas emissions and air pollutants than coal when burnt to generate electricity, with oil being in between (Department of Forestry, Fisheries and the Environment, 2015:77). These resources are thus the link between coal, and renewable sources of energy. Their usage enables a gradual transition from coal to renewable energy sources, such as solar and wind power, which do not result in downtime. They would facilitate industrial and infrastructural development, positively influencing investments (Singh & Inglesi-Lotz, 2021:7).

In allowing this transition, consideration is not abruptly stopping what South Africa currently does, as that would result in production downtime, but a gradual approach is taken. This phased approach has been encouraged and noted in the National Development Plan by the National Planning Commission of South Africa (2014:65), which amongst other objectives seeks to improve economic infrastructure, which includes energy, and also in Eskom’s Just Energy Transition (JET) plan (2023) to transition towards renewable energy whilst diversifying the energy mix.

South Africa’s oil and gas resources have not been fully explored. The Petroleum Agency of South Africa (PASA) estimates that the country has 27 billion barrels (bbls) and 60 trillion cubic feet (tcf) of prospective oil and gas resources (Central Energy Fund, 2021). They, if successfully explored, can positively contribute towards the country’s development as seen with multiple countries before, such as Norway, Namibia and more recently Guyana, whose 11 billion barrels of oil and gas resources discovered thus far improved their economy by 62.3 per cent (Minister of Mineral Resources and Energy, Mr Gwede Mantashe, 2023 and Mao, 2023).

South Africa could improve its infrastructure, diversify its energy mix, improve energy security, and progress towards its National Development and JET plans. In addition, the resources can improve the country’s balance of payments (BOP) (Department of Minerals and Energy, 2023:13). There would be fewer imports of these oil and gas resources, where the price is in United States dollars (US dollars) and controlled by the market, and possibly exports, improving the country’s competitiveness. Investments in the country’s extractive industry could encourage job creation, GDP growth, and further socio-economic development (Department of Minerals and Energy, 2022:3).

Interest in the oil and gas industry, which had minimalised over the years due to reasons noted above and ongoing litigations against exploration and development of oil and gas, by foreign-funded Non-Governmental Organisations (NGOs), has been improved with the findings by TotalEnergies off the South Coast of South Africa (Minister of Mineral Resources and Energy, Mr Gwede Mantashe, 2023). These discoveries of gas and gas condensate, if successfully explored, are estimated to “yield around 1 billion barrels of total resources of gas and condensate” (Felix, 2019). This estimation has been described as a “game changer” by many, including President Cyril Ramaphosa in the 2019 State of the Nation Address (2019), and would positively improve the South African economy. These resources would alleviate the concerns of current depleting exploration projects and enable the country’s objective to secure an energy supply through diversity to be met, thereby bridging the path towards renewable energy.

A study by PASA (Tukwayo, 2022) shows that TotalEnergies’ exploration and development of the discoveries made in Block11B/12B for the period 2026 to 2045 would contribute positively to GDP, employment, poverty alleviation, tax collection, and the balance of payments for South Africa (See Appendix A). The PASA case study demonstrates that upstream oil and gas projects, as well as the broader development of the oil and gas industry, have immense socio-economic potential in South Africa. As noted, however, its competitiveness requires healthy institutions, which the WEF (2019:518) identifies as the first pillar of competitiveness. One of those institutions is the fiscal regime, which enables the country to attract foreign direct investment and utilise it to obtain its share in those investments conducted within the country.

### 2.3 Fiscal Tax Regime

The Tenth Schedule applies to oil and gas companies, which it defines as “any company that holds any oil and gas right; or engages in exploration or post-exploration in terms of any oil and gas right”.

It then defines an oil and gas right to mean:

- (a) any reconnaissance permit, technical co-operation permit, exploration right, or production right as defined in section 1 of the Mineral and Petroleum Resources Development Act or any interest therein;
- (b) any exploration right acquired by virtue of a conversion contemplated in item 4 of Schedule II to the Mineral and Petroleum Resources Development Act or any interest therein; or
- (c) any production right acquired by virtue of a conversion contemplated in item 5 of Schedule II to the Mineral and Petroleum Resources Development Act or any interest therein.

The Mineral and Petroleum Resources Development Act 28 of 2002 (MPRDA) currently regulates the sustainable development of the nation’s mineral and petroleum resources. In Chapter Two of the MPRDA, it recognises the State as the custodian of these resources. It allows, among other things, for fair access to them while ensuring that holders of exploration or production rights contribute to the country’s socio-economic development. As shown above, one way oil and gas exploration and production companies contribute to economic growth is through fiscal revenue.

The fiscal regime or tax policy that applies to oil and gas companies differs from the regimes that apply to other companies. This distinction arises because the natural resources extracted by the upstream sector are challenging to obtain, may be less abundant than initially estimated, and tend to deplete over time, posing geological risks. In addition, the industry experiences other risks, which include the cost of development, the length of time it takes for the benefits and profits to materialise, the cost of failure, and environmental concerns as noted by the Davis Tax Committee (2016:13) in their Report on Oil and Gas for the Minister of Finance. Because of this distinguishable nature, it is common for countries to develop a separate fiscal regime that incentivises and accommodates these differences (National Treasury, 2021a:9-10).

There are two main oil and gas regimes that countries worldwide follow, a concessionary system and a contract-based system. These regimes seek to balance the State's interest, which often acts as the custodian of the natural resources, being the host country, and the oil and gas investor's interest, namely the investor, and vary across countries. Nations are interested in direct investment in oil and gas projects due to their immense potential for economic growth, as shown above. In encouraging and accepting these investments, the State aims to maximise the profits receivable, the employment and training for local people, and to be compensated for the extraction and depletion of its non-renewable resources (Tordo, Johnston & Johnston, 2009:11). The investor then seeks to maximise their profit, time efficiency and autonomy and be rewarded and incentivised for bringing industrial expertise in a high-risk area. Because these goals conflict, agreements stipulated by the fiscal regimes are entered into to determine how the State and the investor will share the profits from and costs of oil and gas activities. Although designing these agreements is not a simple task, it is vital for developing a country's oil and gas sector (Sunley, Baunsgaard & Simard, 2002:153). The regime's provisions have an impact on the investor's favourability and will be more or less generous, depending on the scale and quality of the nation's resources. Countries that offer terms which are in balance with their oil and gas prosperity improve their ability to attract investment opportunities. As such, these factors are considered when adopting a concessionary system or a contract-based system.

South Africa follows a concessionary regime, which is an agreement that grants the investor the exclusive right to explore and produce oil and gas resources in a specific region for a specified period. In this type of agreement, the investor bears all the costs and risks associated with the project. It then allows the State to benefit through rentals, taxes and royalties. It is the oldest and simplest agreement, mainly adopted by developed oil and gas-producing countries such as Canada, Norway, and the United States (National Treasury, 2021a:29).

The other regime, the contractually based one, includes production sharing contracts (PSCs) and service agreement contracts, and is generally preferred by both developed and undeveloped oil and gas-producing nations. In production sharing contracts, the legal right to explore and produce oil and gas stays with the host nation. The investor, like concessionary regimes, still bears the costs and risks of oil not discovered. However, unlike the concessionary system, they can recover those costs from profits made and share in profits at certain times, based on formulas stipulated in the contract. The terms of PSCs are thus separated into distinct and sequential exploration, development, and production

periods (Tordo, Johnston & Johnston, 2009:12). Service agreement contracts differ and occur when the State hires a contractor to provide expertise on existing exploration and production projects for a specified amount of time. The contractor generally provides its services for a fee but may occasionally be given the option to purchase a proportion of the production at an agreed-upon price (Tordo, Johnston & Johnston, 2009:13).

The Tenth Schedule to the Income Tax Act and the Mineral and Petroleum Resources Royalty Act 28 of 2008 (MPRRA), along with their respective administration Acts, are the primary legislation that provide for South Africa's concessionary tax policy. The Income Tax Act aims to maximise the revenue generated by oil and gas projects with the Tenth Schedule recognising the differences oil and gas investors face compared to other taxpayers. The MPRRA's purpose is to compensate the State, as the custodian of the resources, for the depletion of these resources by production operations. While aiming to utilise these provisions to maximise revenue collection from oil and gas projects, the government still faces the issue of not providing sufficient incentives to encourage exploration and production due to the perceived high risk associated with South Africa's nascent oil and gas industry. As a result, the Tenth Schedule has incentivising provisions, such as tax incentives, that hope to attract investment whilst creating certainty and transparency.

## 2.4 Tax Incentives

Tax incentives are popular tools used worldwide to encourage particular actions and activities. They have been implemented around the globe as early as the 1940s by countries seeking to use tax policies to enhance their international competitiveness by encouraging foreign direct investment (Lent, 1967:250). South Africa, too, has utilised tax incentives to encourage domestic industries, such as small business corporations, promote certain behaviours such as youth employment and attract foreign investments in, for instance, Special Economic Zones (Department of Trade and Industry, 2016:3).

The World Bank, with the IMF, Organisation for Economic Co-operation and Development (OECD), and the United Nations (UN) in their joint report (2015:8), define a tax incentive as "any special tax provision granted to qualified investment projects or firms that provides favourable deviation from the general tax code". Zolt (2015:5-6) states that tax incentives are special provisions which allow for the reduction or deferral of tax liability or preferential treatment. Tax incentives are thus a reduction in tax for a particular purpose, which Surrey (1970:711) states is when a monetary benefit is available. Munogo, Akanbi, and Robinson (2017:154) agree, stating that it is to counteract the increased cost of doing business in a country with poor infrastructure and weak macroeconomic conditions.

In conducting business, foreign direct investors consider "socio-cultural factors (relating to language, religion, values, attributes and material culture); legal factors (relating to international laws, regional laws and domestic laws) as well as economic factors (relating to the development of economies and currency movement)" as noted by Van der Berg, Mazibuko and Rootman (2021:6). Li (2006:63) says that governments may form generous tax incentives policies to compensate for that lack of infrastructure, modern technology and natural resources. With the upstream sector of the oil and gas

industry in its development stage, providing favourable tax treatment may ensure that tax, a legal factor related to domestic law, is one less factor in an unproven prospect environment that deters investments. The Tenth Schedule aims to provide for a preferential deviation from the provisions of the Act to oil and gas investors. However, as stated by Moolman and van der Zwan (2016:231-232), its favourable treatment will be effective only where its objective is clear, if it is flexible yet stable (certain), regularly monitorable and transparent.

## 2.5 Certainty and Transparency

Adam Smith (1776:644) noted that equity (progressivity), certainty, convenience, and efficiency (neutrality) are the basic principles required to establish a good tax policy. Since then, various organisations and countries around the globe have expanded these principles to recognise global development. In applying these guiding principles, fiscal policymakers must strike a balance them to ensure that they achieve the intended outcome of the policy. The National Treasury (2006:15) explains that the Tenth Schedule's special override for oil and gas companies was to formalise central aspects of the previous OP26 regime into explicit law. As the previous regime was only known to a few stakeholders, formalising it sought to create certainty and transparency for oil and gas exploration and production projects.

### 2.5.1 Certainty

Certainty or stability, as noted by the National Treasury (2021a:38), can be understood from the perspectives of both the taxpayer and the revenue collector on behalf of the State, which in South Africa is the South African Revenue Service (SARS). For an investor, certainty means having simple and understandable tax laws and administration, which is particularly important as many tax systems, including South African tax systems, require the taxpayer to self-assess their tax liability (The Association of Chartered Certified Accountants, 2014:3). If tax policies are not simple, understandable and are subject to frequent change, it increases the risk oil and gas investors face. Tax systems that frequently change affect their stability. The Association of Chartered Certified Accountants (2020:9) say that certainty and stability are connected, that “‘certainty’ is about knowing what the answer to a given question ought to be [and] ‘stability’ is about whether the current answer will still be correct in one, two or ten years”.

As the oil and gas environment is risky, this affects the investor's decision-making process, resulting in doubt in the prospect of commercial discoveries in oil and gas projects. The uncertainty potentially distorts investment decisions, as oil and gas investors become unable to ascertain the tax consequences related to their investment and its return, affecting the neutrality or efficiency principle of tax policies. Investors not taking up projects means that the State, viewing certainty or stability as the ability to estimate the inflow of revenue, cannot determine revenue streams. Taxpayers' uncertainty about their tax liability leads to noncompliance and non-cooperation with the State, requiring the State

to spend money on collection and compliance processes. It is, thus, vital for tax policymakers to balance the need for the policy with what makes that policy good and efficient.

The National Treasury (2006:15) states that the Tenth Schedule aims to provide certainty and transparency whilst incentivising investments. This aim is achievable where the provisions of the Act instil investor confidence, encouraging investment and reaching the intended goal for all parties involved. The provisions should strike a balance between the principles of a good tax policy, allowing the people of South Africa and the oil and gas investors to reap the maximum benefits from the resources (National Treasury, 2019:35).

### 2.5.2 Transparency

Tax transparency plays a crucial role in good and efficient tax policies. It allows taxpayers to know what they are paying and the benefits of those payments. As a result, it leads to less maltreatment of tax provisions, as stated by Futter (2010:09), since tax laws are publicly available and well-known. The oil and gas investor can determine its liability before undertaking projects. In the previous OP26 regime, the investor needed to have taken those projects before entering into agreements with the State, where they would then know the consequences. In addition, SARS can better determine if the provisions of the Income Tax Act have been “misused or abused” per section 80A(c)(ii) of the same Act as does not promote the “object, spirit or purpose of the provisions” as stated by De Koker and Williams (2023) quoting the Supreme Court of Canada in *Canada Trustco Mortgage Company v Canada* 2005 SCC 54 (at paragraph 54).

Futter (2010:12) further states that although the provisions of the Tenth Schedule seek to formalise and standardise the key aspects of the OP26 (improving on the previous regime), they do not sufficiently improve the tax transparency of the oil and gas regime due to the fiscal stability agreements that can be entered into. A fiscal stability agreement (FSA) is an agreement between the investor and the State that the provisions of the Tenth Schedule will not change throughout their investment in oil and gas projects in South Africa. FSAs, as per paragraph 8 of the Tenth Schedule, permit the freezing of tax provisions and policies. FSAs can be essential to taxpayers (oil and gas investors) in a risky environment, as they can ensure the stability of their tax consequences in an ever-evolving world, where transactions and tax policies are constantly changing. In the 2019 Budget Review, the National Treasury (2019:46) acknowledges that South Africa has not entered into a fiscal agreement for the past five years and, since the enactment of the Tenth Schedule, 2006, only a few agreements have been entered into. As such, although fiscal stability agreements potentially compromise transparency and standardisation, as noted by Futter (2010:18), no agreements have been entered into for the past couple of years, despite being a vital component of the Tenth Schedule.

## 2.6 Conclusion

The Tenth Schedule was introduced to replace the previous OP26 regime for the tax treatment of oil and gas companies, concomitant with the implementation of the MPRDA. Given the potential of oil and gas exploration and production in South Africa to contribute to the country's energy needs and the positive socio-economic benefits associated with the development of oil and gas discoveries, the Tenth Schedule includes tax incentives to attract foreign direct investment and unlock the country's hydrocarbon potential. The Tenth Schedule further ensured certainty and transparency regarding the tax treatment of oil and gas companies. The next chapter will examine the provisions of the Tenth Schedule and its incentivising elements in greater detail.

## CHAPTER THREE

### TAXATION OF OIL AND GAS COMPANIES

**Chapter Three examines the tax incentives available to oil and gas companies under the Tenth Schedule to the Income Tax Act. It describes the different risks associated with the oil and gas industry that led to deviations from the general tax code, and how the Tenth Schedule's formalisation aimed to achieve transparency and certainty, thus with the tax incentives encouraging foreign direct investment.**

#### 3.1 Introduction

An oil and gas company's taxable income is determined using the provisions of the Income Tax Act, but is subject to the Tenth Schedule of the same Act per section 26B(1). This Schedule came into operation on 02 November 2006 and applies to any year of assessments commencing on or after that date.

Before its introduction, private agreements governed the exploration and production of oil and gas. These agreements, which led to the OP26 regime discussed in earlier chapters, had key favourable provisions which encouraged oil and gas exploration and production in the country. As their expiration, 30 June 2007, came close, the Parliament of the Republic of South Africa (Parliament) enacted the provisions of the Tenth Schedule as part of the Income Tax Act to provide certainty the OP26 regime's incentivising features would be kept (National Treasury Explanatory Memorandum on the Revenue Amendment Bill, 2006:15).

In addition to this certainty, the provisions sought to create transparency, unlike the OP26 regime agreements, which were private and only known to the parties involved, which included the oil and gas companies and their tax advisors, the SARS and the Department of Minerals and Energy (Futter, 2010:8). Since the enactment of the Tenth Schedule, there have been several changes to its provisions. This chapter aims to offer a detailed analysis of the current tax incentives available to oil and gas companies, their necessity, and how they seek to promote transparency and certainty.

#### 3.2 Provisions

The Tenth Schedule provides the following:

##### 3.2.1 Definitions

Paragraph 1 of the Tenth Schedule provides the definitions and states that the Tenth Schedule applies only to the upstream sector of the oil and gas industry, where exploration, appraisal, and production occur (Appendix B). This is not a tax incentive or a special tax deviation for a particular purpose as

defined by the OECD, IMF, UN and World Bank (2012:8) but simply a part of this Schedule that defines the terms used in it and who it applies to aiming to give oil and gas taxpayers certainty and transparency.

### 3.2.2 Rate

Paragraph 2 of the Tenth Schedule says, “The rate of tax on taxable income attributable to oil and gas income of any oil and gas company must not exceed 28 cents on each rand of taxable income”. Omar (1998:2) notes that the income tax rate is a crucial factor determining investment in oil and gas exploration and production. Given South Africa’s uncertain geological conditions and significant international competition for these investments, the country needs to establish an appropriate tax rate to attract these investments. Futter (2010:10) states that the Tenth Schedule, which limits the tax rate to the rate applicable to all companies in South Africa, 28 per cent, the same as with the OP26’s regime, is not aimed at attracting investors. The 28 per cent rate applying to all companies is not a favourable deviation from the general tax code (World Bank, IMF, OECD & UN, 2015:8). Moolman (2012:45) notes that although this is true, comparing the rate to international rates, it can be incentivising, all other things being equal, to invest in South African oil and gas projects.

Since the year of assessment ending on or after 31 March 2023, the corporate tax rate has decreased from 28 per cent to 27 per cent. This change follows the global trend of lowering the corporate income tax rate to “create a conducive environment for businesses to grow, increase investment and employ more people”, as said by Minister of Finance Enoch Godongwana (2022). The rate that would thus apply to oil and gas projects for years of assessment ending on or after 31 March 2023 would be 27 per cent, as paragraph 2 sets the limits on the maximum tax rate, not the minimum tax rate. It does not provide special treatment to oil and gas investors as the corporate income tax rate applies uniformly to all companies in South Africa. Given the global trend of decreasing corporate income tax rates and the fact that South Africa has not made significant discoveries of oil and gas resources, it is unlikely that a 27 per cent tax rate would be favourable compared to the rates in countries rich in proven hydrocarbons. Nonetheless, paragraph 2 provides certainty and transparency, as the tax rate on taxable income is known and cannot exceed 27 per cent.

### 3.2.3 Withholding Taxes

Per paragraph 3 of the Tenth Schedule, dividends paid from oil and gas income are subject to dividends tax at 0 per cent. This paragraph is a tax reduction, a tax incentive, as other taxpayers, generally, are subject to dividends tax at a rate of 20 per cent where section 64E of the Act applies and any exclusions under the section do not. The paragraph applies to oil and gas income as defined in paragraph 1 of the Tenth Schedule, meaning that dividends paid from income from other activities of the oil and gas company will be subject to dividends tax at 20 per cent. The 20 per cent rate, like that of other taxpayers, can be reduced under an applicable double tax treaty.

Paragraph 3 also allows interest paid by an oil and gas company for loans applied to fund capital expenditure related to an oil and gas right to have a withholding rate of 0 per cent. Interest paid to a

non-resident is subject to a withholding tax of 15 per cent per the Act section 50B. This allows oil and gas companies' interest paid on foreign loans to fund exploration or post-exploration capital expenditure to have nil withholding taxes.

This paragraph is beneficial, thus a tax incentive, which is certain and transparent, as it states when it would apply and when it would not.

### 3.2.4 Foreign Currency Gains and Losses

Oil and gas companies must determine their currency gains and losses, whether realised or unrealised, using their functional currency and the translation method used for financial reporting purposes, per paragraph 4 of the Tenth Schedule. In addition, any amounts received by or accrued to, or expenditure incurred by the oil and gas company, which is in a currency other than South African rands, should be determined using the company's functional currency and translated to South African rands by applying the average exchange rate for the year.

Companies whose principal trading or functional currency is, for instance, United Kingdom Pound Sterling (UK pounds) or US dollars can calculate their taxable income and tax due using UK pounds or US dollars and then translate the tax amount into rands at the average exchange rate for the year of assessment (National Treasury, 2021a:34). This paragraph is a tax incentive as it provides favourable deviation from the general tax code, which is in section 24I of the Act. Without this provision, oil and gas companies, like other companies, would generally use the spot rate for their foreign currency transactions as required by section 24I(3). The paragraph affords oil and gas companies simplicity when determining the tax payable to SARS.

### 3.2.5 Deductions from Income Derived from Oil and Gas Activities

Paragraph 5 of the Tenth Schedule sets three special rules relating to oil and gas exploration and production expenditures (National Treasury, 2006:18).

In determining their taxable income, paragraph 5(1) allows oil and gas companies to deduct all expenditures and losses actually incurred in respect of an oil and gas right (excluding expenditure or losses actually incurred in respect of the acquisition of any oil and gas right) for exploration or post-exploration activities. This provision allows oil and gas companies to deduct all operating expenditures and losses, including those of a capital nature, that section 11(a), read in conjunction with section 23(g), would not. In addition, paragraph 5(2) allows oil and gas companies to deduct an additional 100 per cent of capital expenditure used for exploration, and 50 per cent of capital expenditure for post-exploration purposes in respect of an oil and gas right (excluding the acquisition of any oil and gas right). Paragraphs 5(1) and 5(2) equate to oil and gas companies being allowed to deduct 200 per cent for capital expenditure in respect of exploration activities and 150 per cent in respect of post-exploration activities.

These increased deductions, super-deductions, or uplifts, aim to incentivise oil and gas investors to invest in “high risk, high-cost capital expenditure that probably represents long-term sunken capital”, as stated by the National Treasury (2006:19). Exploration activities receive a higher uplift because this phase is riskier due to costly searches in uncertain geological prospectives where losses will probably not be deductible against income. This provision recognises the different risks associated with oil and gas companies and their exploration and production stages. Although it does not lead to an immediate cash flow, as noted by Moolman (2012:46), quoting Otto et al. (2006:11), its deferral of tax liability—a tax incentive—leads to immediate expenditure savings. This deferral, which results from the generous deductions that effectively result in no tax being payable by oil and gas companies for several years, allows oil and gas investors in South Africa to enjoy a higher after-tax return (Ochieze, 2007:10).

Paragraphs 5(1) and 5(2) refer to ‘exploration’ and ‘post-exploration’ as per the definitions in paragraph 1 of the Tenth Schedule as shown in Appendix B and allow expenditure of a capital nature to have uplifts of 100 per cent or 50 per cent, respectively. Daniel et al. of the IMF (2015:14-15) note that definitions not specifying whether an activity falls under exploration or production rights are likely to create difficulties when determining whether a particular expenditure qualifies for the 100 per cent or 50 per cent uplift. In addition, the term “of a capital nature” is not defined in the Income Tax Act but depends on a complex body of law. The incentivising paragraphs thus cause uncertainty, as they encourage non-compliance and non-cooperation, whereby investors hold exploration rights longer to skew capital expenditure towards the initial phases of the project, thereby retaining capital allowances (National Treasury, 2021a:54).

The third special rule relates to assessed losses. Paragraph 5(3) says that exploration and post-exploration assessed losses, as defined in section 20 of the Act, may only be set off against oil and gas income and refining of gas income regarding any oil and gas right held by an oil and gas company. Paragraph 5(4) then allows where any assessed loss remaining after applying paragraph 5(3), 10 per cent of it to be set off against any other income derived by oil and gas companies with paragraph 5(5) then allowing the remaining assessed loss to be carried forward to the succeeding year or assessment. The National Treasury (2006:19) states that the purpose of allowing 10 per cent of oil and gas tax-assessed losses to be offset against other non-oil and gas income is to provide relief for ordinary working capital. Oil and gas companies, because of the high-risk nature of exploration, are unable to secure external funding for exploration activities and need to self-fund from their investment holdings (Davis Tax Committee, 2017:83). Paragraph 5(4) aims to provide relief for this, with any remaining assessed loss to be carried forward indefinitely like the rest of the Income Tax Act.

The assessed loss rule refers to section 20 of the Act. With the decrease in the corporate income tax rate from 28 per cent to 27 per cent, sections 20 and 23M were amended to mitigate the loss in tax revenue to the South African fiscus. Section 20, which had generally carried forward tax assessed losses indefinitely and allowed unlimited utilisation to the point of taxable income, changed to limit utilisation to offset a maximum of 80 per cent of taxable income per year. Section 23M of the Act amended the rules and formulas that limit the interest deduction (and foreign exchange losses on exchange items for years of assessment ending on or after 31 March 2023) in respect of debts owed

to persons not subject to tax, currently to 30 per cent. As a result of the amendment to section 20 of the Income Tax Act, the assessed loss provisions of the Tenth Schedule are now uncertain and untransparent. The third rule is now less easily interpretable, as shown in Chapters Four and Five, and may impact the aim of the Tenth Schedule, which aims to foster investor confidence and achieve the intended goals for both oil and gas investors and the State.

### 3.2.6 Exploration and Post-Exploration Expenses

Tenth Schedule paragraph 6 says a company that holds an oil and gas right as defined in paragraph (a) or (b) of the definition of oil and gas right is deemed to be carrying on a trade in respect of that oil and gas right, and expenditure and losses incurred by that company in respect of that oil and gas right are deemed to be incurred in the production of income of that company.

Carrying on trade, as defined in section 1 of the Income Tax Act, can be complex to determine where an entity's activities do not fall within the definition in section 1, the activities have taken place before the commencement of trade, the company conducts non-trade activities after it has ceased trading, or the anti-avoidance provisions of section 103(2) apply (SARS Interpretation Note 33(5), 2017:4). The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013 (2013:66) notes that there is uncertainty with whether a company solely engaged in exploration is conducting a trade. *SA Bazaars (Pty) Ltd v Commissioner for Inland Revenue* 1952 (4) SA 505 (A) ("*SA Bazaars v CIR*") at paragraph 510F establishes that temporary ceasing trade despite intending to resume trading activities at a future date means that the taxpayer has not been carrying on of a trade, which results in the loss of historically accumulated tax losses. As oil and gas companies temporarily cease operations and conduct post-production rehabilitation activities, they may fail to meet the 'carrying on a trade' requirement. This requirement is essential in the general deduction formula outlined in section 11(a), in conjunction with section 23(g), and the assessed loss provision in section 20, which allows for assessed losses to be carried forward where applicable, as discussed in Chapter Four. As a result, the deemed carrying on a trade requirement provides a favourable deviation for oil and gas companies, whilst companies in other industries would need to prove to SARS that they are carrying on a trade.

Another requirement of the general deduction formula is determining whether an expense is incurred in the production of income, as per section 11(a). Huxham and Haupt (2023:117) say this requirement is probably the most onerous of the section. It is not defined in the Act but has been attempted to be defined in several court cases. These cases include *Port Elizabeth Electric Tramway Company Ltd v Commissioner for Inland Revenue* 1936 CPD 241, *Joffe & Co. (Pty) Ltd v Commissioner for Inland Revenue* 1946 AD 157, *Sub-Nigel Ltd v Commissioner for Inland Revenue* 1948 (4) SA 580 (A), and more recently *Warner Lambert SA (Pty) Ltd v Commissioner for the South African Revenue Service* 2003 (5) SA 344 (SCA) and *Commissioner for the South African Revenue Service v Mobile Telephone Networks Holdings (Pty) Ltd* 2014 ZASCA 4 using the guiding principles of earlier cases. They, briefly, say that expenditure or loss will be in the production of income if it is necessary for the performance of the business operation, if it is attached to the business operation by risk or chance or if

the expense is genuinely incurred to carry on the business operation more efficiently (Goldswain & Swart, 2015). The paragraph deeming expenditure and losses incurred by oil and gas companies with an oil and gas right per paragraph (a) or (b) of the definition in respect of that oil and gas right to be in the production of income means that these companies, unlike other taxpayers, are less burdened to prove the requirement.

### 3.2.7 Disposal of Oil and Gas Right

Paragraph 7(1) of the Tenth Schedule says, “If an oil and gas company disposes of any oil and gas right to another company, that oil and gas company and that other company may (instead of any other provision of this Act) agree in writing that rollover treatment as contemplated in subparagraph (2) or participation treatment as contemplated in subparagraph (3) applies in respect of that right.”

Paragraphs 7(2) and (3) outline the rollover and the participation treatment. Where the oil and gas company choose the rollover treatment, the paragraph deems the company disposing of the oil and gas right (‘transferor’ or ‘seller’) to do so at its base cost if disposing of a right held as a capital asset or cost price if the right held as trading stock. The transferee or the acquiring company is, in turn, deemed to have acquired the oil and gas right at base cost or cost price if they obtain the right as a capital asset or trading stock. Explanatory Memorandum on the Revenue Amendment Bill (2006:21) says the tax cost rolls over from the seller to the buyer in the same way Part III of Chapter II of the Income Tax Act (‘the corporate restructuring rules’) deferral of tax consequences apply, in this case allowing any gain, capital or income, to be passed on the next owner of the oil and gas right. The rollover treatment provision is thus a certain and transparent one, as it allows the oil and gas investor, if they agree to the provision, to know the effect of disposing of an oil and gas right. The provision, although similar to corporate restructuring rules, provides a favourable deviation from the general tax code. Unlike the corporate restructuring rules, other than section 42 asset-for-share transactions, the companies transacting must form part of the “same group of companies” at the end of the day of the transaction. This requirement, if not met or ceases to be met within six years, has onerous degrouping provisions.

If the taxpayer chooses the participation treatment, paragraph 7(3) deems the transferor’s gain, whether capital (holding a right as a capital asset) or not (holding a right as trading stock), where the market value exceeds the base cost or the cost price, to be gross income. The transferee incurring that expenditure to acquire the right can deduct from its oil and gas income the amount the transferor included in their gross income. This treatment provides oil and gas investors with certainty and transparency as they can ascertain the tax consequences. It is a tax incentive as this preferential treatment allows the transferor to utilise assessed losses probably due to the super deductions under paragraph 5 and allows the transferee to deduct the amount from its oil and gas income and not apply the provisions of the Eighth Schedule at a later time, “essentially [allowing] the transferor to transfer ordinary losses to an oil and gas company acquirer” as stated in the Explanatory Memorandum on the Revenue Amendment Bill (2006:22).

### 3.2.8 Fiscal Stability

Paragraph 8 allows the Minister of Finance to agree with an oil and gas company that the Tenth Schedule provisions (as of the date of the agreement) will apply in respect of the company's oil and gas right as long as the company holds that right. The paragraph, given the high costs of initial sunken capital, combined with high risk and delayed potential profit of oil and gas projects, provides oil and gas investors stability (Explanatory Memorandum on the Revenue Amendment Bill (2006:23)). As noted in Chapter One, changes to legislation affects investment decision (Erskine, 2015:01). This stability then allows oil and gas investors comfort and confidence as they can predict their return on investments better. The paragraph in subparagraph 2 says that the disposal of an oil and gas right relating to exploration to another oil and gas company will pass all of the fiscal stability rights attached to that oil and gas right. Where the oil and gas rights relate to production rights, the fiscal stability rights attached will pass to the oil and gas right acquirer where that acquirer is an oil and gas company within the same group of companies as the oil and gas transferor. Paragraph 8(3) allows fiscal stability agreements of oil and gas companies holding a participating interest in an oil and gas right to be applied to companies that have that interest. Subparagraph 4 then allows oil and gas companies to unilaterally terminate a fiscal stability agreement entered into with the Minister of Finance, allowing them to benefit from future legislation that becomes more beneficial to them. Paragraphs 8(5) and 8(6) then say that the oil and gas companies taxable income and profits will be determined using the Tenth Schedule as on the date of the agreement and where the State fails to comply with the terms of the agreement, the oil and gas investor is entitled to compensation for the loss of market value caused by it or to an alternative remedy that otherwise eliminates the full impact of that failure. Subparagraph 7 defines an oil and gas right for paragraph 8 to be;

- (1) an "oil and gas right" means any—
  - (i) exploration right or production right as defined in section 1 of the Mineral and Petroleum Resources Development Act or any right or interest therein;
  - (ii) exploration right acquired by virtue of a conversion contemplated in item 4 of Schedule II to the Mineral and Petroleum Resources Development Act or any interest therein; or
  - (iii) production right acquired by virtue of a conversion contemplated in item 5 of Schedule II to the Mineral and Petroleum Resources Development Act or any interest therein; and
- (2) an exploration right, a renewal of that exploration right and an initial production right converted from any exploration right or renewal thereof held by a company will all be deemed to be one and the same oil and gas right in the hands of that company to the extent that those rights relate to the same geographical area.

The definition in this subparagraph only applies to paragraph 8. Unlike the definition in paragraph 1, a fiscal agreement contract does not apply where a reconnaissance permit or a technical cooperation permit is in place.

The Explanatory Memorandum on the Revenue Amendment Bill (2006:23) says that this paragraph is an essential tool in oil and gas fiscal regimes and provides the following example:

#### **“Facts**

Company X, an oil and gas company, enters the region in 2007 for the purpose of oil exploration and production. Company X obtains an oil and gas right in 2007. Company X renews the exploration right in 2012 and eventually converts that right to a production right in 2014. In 2044, Company Y renews the production right.

#### **Result**

The Minister has the power to enter into a fiscal stability agreement with Company X. If the agreement arises in 2007, the 2007 version of the Tenth Schedule remains in effect from 2007 through 2044 (the full period of the initial exploration right, the period of exploration renewal and the period of the initial production right). The Minister may choose to enter into a new agreement on 2044 with the terms set by the tax law on that date.”

Melapi (2021:58), citing Moolman (2015:54) and Futter (2010:57), notes that although the provisions of the paragraph aim to provide oil and gas investors with stability and preferential tax treatment, the objective is sometimes not met due to three main reasons. The provisions of the fiscal stability agreement do not apply to other taxes to which oil and gas investors are subject, such as the value-added tax under the Value-Added Tax Act 89 of 1991. They also do not prevent the introduction of new taxes, such as the Carbon Tax Act 15 of 2019. Furthermore, the transfer of fiscal stability agreements is limited to oil and gas companies within the same group once production begins. As noted in the SARS Interpretation Note 75 (Issue 4) (2022), determining the same “group of companies” can be complex, especially when numerous parties are involved and reorganisations have occurred over time. Nonetheless, and ignoring that the State has not entered into one of these agreements in the past seven years (National Treasury, 2021a:57), fiscal stability agreements, amongst other reasons, “benefit first movers”, as stated in the National Treasury Public Consultation Document (2022:24-29) encouraging new interest and foreign direct investment. The paragraph also notes that the production phase has less risk than the exploration phase. Thus, the increased certainty of production allows for further ease of transferring agreements among group companies. This paragraph, therefore, furthers the objective of the Tenth Schedule to provide certainty and transparency in the country, promoting oil and gas investments.

### **3.3 Conclusion**

The Explanatory Memorandum on the Revenue Amendment Bill (2006) stated that the enactment of the Tenth Schedule was intended to formalise the central aspects of the previous OP26 regime into explicit law. The OP26 regime provided favourable treatment and tax incentives, which, if not maintained, along with South Africa’s limited proven oil and gas findings, could lead to a further decline in foreign direct investment interest. Their formalisation in the Tenth Schedule allowed for certainty and transparency. This chapter examined these provisions, including the assessed loss utilisation rules, and detailed their incentivising features. The next chapter will discuss section 20, the assessed loss provision in the body of the Act, as well as its amendment.

## CHAPTER FOUR

### ASSESSED LOSS

**Chapter Four explains the assessed loss provision in section 20 of the Act. It details the provision's interpretational issues and recent amendments due to the corporate income tax revision, which decreased the corporate income tax rate from 28 per cent to 27 per cent.**

#### 4.1 Introduction

Section 26B of the Income Tax Act says that the taxable income of any oil and gas company is determined in accordance with the provisions of the Income Tax Act, but subject to the Tenth Schedule of the same Act. This means, as explained in Chapter Five, the Tenth Schedule allows an override to the Income Tax Act provisions when the taxpayer is an oil and gas company as defined in that schedule.

The Tenth Schedule, which provides the tax treatment of certain transactions, as detailed and summarised in Chapter Three, references other sections in the body of the Income Tax Act. This chapter aims to understand the meaning of assessed losses (as defined in section 20) as directed by paragraph 5(3) of the Tenth Schedule, including the sections of the provision, its interpretational issues and the amendment of the section.

#### 4.2 Previous Section 20

Section 20(2) defines an “assessed loss” for the purposes of the section to mean “any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible”. The assessed loss provisions before their amendment with effect from 31 March 2023 summarised provided that companies may deduct against taxable income the balance of assessed loss brought forward from the previous year of assessments and any assessed loss incurred during the current year in carrying on any other trade in the Republic if the taxpayer is carrying on a trade and has derived income from carrying on that trade. These two requirements of the section, carrying on a trade and derived income from carrying on that trade, have been defined in the Act and case law over the years.

##### 4.2.1 Carrying on a Trade

Section 1 of the Act interprets “trade” to include “every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature”. Trade is broadly defined in our courts to encompass every profitable activity (ITC 770 (1953) 19 SATC 216 (T)). It is given the widest interpretation and includes a broad spectrum of activities (*Burgess v Commissioner for Inland Revenue* 1993 (4) SA 161 (A)).

Although it has a broad meaning, trade does not encompass all activities that may generate a profit. A taxpayer's intention to benefit from an activity must be supported by systematic and regular activity where the taxpayer can demonstrate that effort and management of the activity have been made (*Commissioner for Inland Revenue v Stott* 1928 AD 252 ("*CIR v Stott*"). While the reason and motive are irrelevant, active steps beyond mere planning are required to establish that a trade is being conducted (ITC 1476 (1989) 52 SATC 141 (T)). Passive activities, such as income from surplus funds, for instance, holding shares that lead to dividend income, may not be considered a trade, as no active step has been taken. This active step requirement suggests more than just the watching over of investments (ITC 1275 (1978) 40 SATC 197 (C)). Further, the courts consider the reasonable prospect of profitability and the economic realities of an activity in determining whether it qualifies as a trade.

Carrying on a trade is determined based on the facts and circumstances of the taxpayer, as established in *CIR v Stott*. The requirement for carrying on a trade implies continuity, indicating that preparatory activities have concluded and business activities have commenced. Preparing to carry on a trade is distinct from carrying on a trade (*Commissioner for South African Revenue Service v Contour Engineering (Pty) Ltd* 1999 (E) 61 SATC 447). While continuity is suggested, it is not a prerequisite but a guideline, similar to the profit motive. In *Stephan v Commissioner for Inland Revenue* 1919 WLD 1, it was established that even a single venture (included in the 'trade' definition), such as the salvage of a single vessel, can be considered as carrying on a trade, if it involves multiple business transactions, employment of staff, and the use of capital.

In *SA Bazaars v CIR*, Centlivres CJ noted that "The mere fact that it kept itself alive during that and subsequent periods does not mean that during those periods it was carrying on a trade. It is clear from the stated case that it closed down its business and as long as it kept its business closed, it cannot be said to have been carrying on a trade, despite any intention it might have had to resume its trading activities at a future date". According to French and Stretch in *Income Tax in South Africa Commentary* (2024), while cases have held that a lack of continuity or profit motive may exclude a taxpayer from carrying on a trade, these cases address whether the expenditure was laid out for trade, not whether a trade has been carried on. Moreover, the principle of continuity may limit deductions against rental income from a single property, as the mere "letting of any property" does not necessarily constitute carrying on a trade. However, it is a trade under section 1 of the Act (Stiglingh et al., 2022:125).

Regarding the profit motive, Corbett JA in *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* [1986] 1 All SA 310 (A), based on *Modderfontein Deep Level Ltd & another v Feinstein* 1920 TPD 288, accepted that a taxpayer may choose to trade for some other commercial advantage for their business. Thus, whether a taxpayer is carrying on a trade, making a loss but obtaining some other commercial benefit, or conducting a single venture, the nature and extent of the taxpayer's activities as a whole must be examined in answering this question (*Estate G v COT* 1964 (2) SA 701 (SR)).

#### 4.2.2 Derived Income from Carrying on that Trade

The Act defines “income” as “the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I [Normal Tax] of Chapter II [The Taxes]”. When interpreting statutes, there is a presumption that words in a statute are used consistently unless the context indicates otherwise (ITC 1420 (1986) 49 SATC 69 (T) at 74). Therefore, the term “income” in section 20(1), noting that Tax Court judgments do not create a precedent, may be presumed to mean the definition in section 1, gross income less exempt income, unless the context proves otherwise.

Section 20 of the Act allows the set off against taxable income of the balance of assessed loss brought forward if the taxpayer is carrying on a trade and has derived income from carrying on that trade. For many years, there has been contention on whether a company that has carried on a trade in the current year but made no income can set off the balance of assessed loss brought forward and what the word “income” in this context means. Can the term income be presumed to mean gross income less exempt income, or does it mean something else in a particular context, such as in *Commissioner of Inland Revenue v Simpson* 1949(4) SA 678 (A), where the court held that the word “income” for sections 7(2) to 7(7) had to be given the meaning of profits and gains accruing to the taxpayer and not “income” as defined?

In the case of *Conshu (Pty) Ltd v Commissioner for Inland Revenue* 1994 (4) SA 603 (A) (“*Conshu v CIR*”), the majority judgment held that the word “income” for section 20 of the Act should not be interpreted in its defined sense as gross income less exempt income. Instead, it should be understood as the income that would be taxable if not for the offsetting of assessed losses. This means that a set off in terms of section 20 can only arise if there is taxable income (“income” as defined in section 1 of the Act, less any deductions).

In coming to this conclusion, Harms JA used the definitions of “taxable income”, “income” and “gross income” (see Appendix B) to say, “from an accounting point of view the taxable income of a company is calculated by taking a number of steps in a predetermined sequence. The gross income is first established. From it the amounts exempted are deducted in order to determine the “income” as defined. Thereafter the allowable deductions are deducted ... Adjustments are then made by adding or eliminating items required or permitted by the Act. If, at this juncture, there is a loss, the Commissioner has to issue an assessment of the loss “ranking for set-off” (s 1 sv “assessment”). This loss is then carried forward to the succeeding year. On the other hand, if an assessed loss has been brought forward from the preceding year, it is set off against the profit (if any) thus far calculated.”

The predetermined sequence is thus as follows:

Gross Income (section 1)	XXX
Less: Exempt Income (section 10)	(XXX)
Income	XXX
Less: Deductions (section 11 to section 19)	(XXX)
Taxable Income before Assessed Loss Set-off (Profit)	XXX
Assessed Loss Set-off (section 20)	(XXX)

Taxable Income	XXX
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If, in the current year, there is an assessed loss, that amount is carried forward to the following year to be utilised against taxable income. Where there is a taxable income in the current year and a balance of assessed losses brought forward from the prior year, the taxable income is reduced by the assessed loss brought forward.

The minority judgment in the *Conshu v CIR* case stated that this interpretation may lead to anomalous situations, whereby a company that incurs a loss in years one and two cannot carry the loss from year one forward to year three due to the continuity of the set-off guideline in section 20. In getting to this opposing view, Grosskopf JA says that the “taxable income” definition entails the deduction from the “income” and the set-off against such “income” and that section 20 is the only section which “provides for a set-off against income”. The position thus is that “taxable income” is made up of “income” less deductions (mainly of costs and expenses) and less the set-off of assessed losses. “There is nothing in the Act to indicate that the set-off can operate only after the deductions have been made, and only if there then remains a profit, as suggested by Harms JA”. The dissenting judgment then illustrates the following.

If a company has

Year 1: Assessed loss of R50 000

Year 2: Earns income of R20 000 and incurs deductible expenditure of R30 000 (net deficit of R10 000)

If “income” means taxable income but for the set-off of an assessed loss, because there is a net deficit in year two, section 20 cannot apply, and the assessed loss in year two would be R10 000. Grosskopf JA continues to say that, due to the principle in the *New Urban Properties v Secretary for Inland Revenue* 1966 (1) SA 217 (A), the R50 000 brought forward from year one cannot be utilised in year two and will be lost.

*New Urban Properties v Secretary for Inland Revenue* 1966 (1) SA 217 (A) at 224:

“if, for any reason, the assessed loss cannot be so set off and balanced in any particular year, there is then no ‘balance of assessed loss’ for that year which (viewed from that year of assessment) can be carried forward to the succeeding year, or (viewed from the succeeding year of assessment) there is no ‘balance of assessed loss which has been carried forward from the preceding year of assessment;’ in other words, the essential continuity has been fatally interrupted.”

The minority judgment says that this result, where, due to the negative taxable income, the balance of assessed loss cannot be set off and gets effectively lost, “would be inconsistent with the scheme of the Act that it would require clear language to achieve it.” In the example above, the dissenting judgement continues to say that in year two, there is one credit item, income of R20 000, and two debit items, the expenditure of R30 000 and the assessed loss brought forward from the preceding year of R50 000. The expenditure, deducted against income, and the balance of assessed loss, set off against income,

should both be brought into account to determine the balance between the credit item and the debit items. The result is then a newly assessed loss of R60 000.

Income	R20 000	VS	Income	R20 000
Less: Deductions (section 11 to section 19)	(R30 000)		Less: Deductions (section 11 to section 19)	(R30 000)
Taxable Income before Assessed Loss Set-off (Profit)	(R10 000)			Note 2
Assessed Loss Set-off (section 20)	Note 1		Assessed Loss Set-off (section 20)	(R50 000)
Taxable Income or Assessed Loss	(R10 000)		Taxable Income or Assessed Loss	(R60 000)

#### Notes

Note 1: "On the other hand, if an assessed loss has been brought forward from the preceding year, it is set off against the profit (if any) thus far calculated" - Harms JA.

Note 2: "There is nothing in the Act to indicate that the set-off can operate only after the deductions have been made, and only if there then remains a profit, as suggested by Harms JA" - Grosskopf JA.

Ngalwana (1996) agrees with the majority judgement and notes that setting off a balance of assessed loss against income and ignoring the arithmetical process described by Harms JA could ignore allowable deductions. In addition, they note that where a taxpayer has multiple trades, not following the sequential order would create a problem in which it is unclear whether the assessed loss of one trade should be set off against the income or the taxable income (pre-tax profit) of another trade.

Although the *Conshu v CIR* case in 1994 dealt primarily with tax avoidance utilising assessed losses (now section 103 of the Act), the opposing views on the meaning of "income from trade" have been contended for many years since the *SA Bazaars v CIR* case in 1952 asked the question "whether, in the case of a company, an assessed loss can be carried forward when a trade has been carried on during a particular year but no income has been derived from such trade during that year".

Some, like the majority judgment in the *Conshu v CIR* case, argue that if there is no income (not in its defined sense, but rather taxable profit), then no set-off can be achieved, which SARS says are those that argue in favour of the "income from trade" requirement (SARS Interpretation Note 33(5), 2017:12). A few cases, such as ITC 664 (1948) 16 SATC 125 (U) and ITC 1679 (1999) 62 SATC 294 (O) rejecting ITC 777 (1953) 19 SATC 320 (T) which concluded the opposite, have held that it is essential that a taxpayer derive income from the carrying on of a trade. In *Commissioner for the South African Revenue Services v Megs Investments (Pty) Ltd & another* 2005 (4) SA 328 (SCA), the court concluded that although the company had traded because it did not earn any trade income, it was not entitled to set off its assessed loss. However, the court highlighted that this decision was based on the concession made by the respondents, accepting the "income from trade" requirement, and was not a binding precedent as the Supreme Court of Appeal.

The arguments against the “income from trade” requirement in SARS Interpretation Note 33(5) (2017:14) are based on the view that the requirement is irrational from a policy perspective. They argue that a taxpayer can claim a deduction under section 11(a) of the Act, read with section 23(g), if the expenditure is incurred to produce income and that the income does not necessarily have to be earned in the same year of assessment (*Sub-Nigel Ltd v Commissioner for Inland Revenue* 1948 (4) SA 580 (A)). Similar to the minority judgment in the *Conshu v CIR* case, they assert that the term “income” in section 20(1)(a) should be interpreted according to its defined meaning. In ITC 777 (1953) 19 SATC 320 (T), the court ruled that an assessed loss can be carried forward if a trade has been carried on, but no income has been earned. This argument, like the minority judgment in the *Conshu v CIR* case, is the preferred practice of SARS. The Commissioner in SARS Interpretation Note 33(5) (2017:14) confirms that earning income from trade, except in exceptional cases, is not necessary as long as the carrying on of a trade is evident. SARS will use an objective test to establish that a trade is being carried on and that the absence of income from that trade must be incidental or a result of the trade carried out by the company, for example, a pecan nut farm that may not generate income while it is planting and cultivating pecan nut trees (SARS Interpretation Note 33(5), 2017:14-15).

The question posed in *SA Bazaars v CIR*, “whether, in the case of a company, an assessed loss can be carried forward when a trade has been carried on during a particular year, but no income has been derived from such trade during that year,” has led to contentious views. Although the SARS practice is preferable for the taxpayer, it is not binding on the courts or the taxpayer (*Marshall and Others v Commission for the South Africa Revenue Service* 2019 (6) SA 246 (CC)). The section 20(1) requirements of “carrying on a trade” and having “derived income from carrying on that trade” are determined through a subjective and objective enquiry that considers the taxpayer’s intention and their specific actions, facts and circumstances.

#### 4.3 Amended Section 20

Although the *SA Bazaars v CIR* case raised a question that led to contentious views on what the “income from carrying on that trade” requirement means, what was made clear by the case is that where a taxpayer fails to show that they are carrying on a trade any assessed loss brought forward from the previous years of assessment will be lost. Section 20, before the amendment explained below, allowed for the carry forward of assessed losses indefinitely and their utilisation in any year of assessment to be 100 per cent where the taxable profit (as per the majority view in the *Conshu v CIR* case) is equal to or greater than the assessed loss brought forward. What that meant is that using the minority view or SARS preferred way of the meaning of “income from carrying on that trade”, in any year of assessment, a company that made income can set off the assessed loss carried forward or when made no income can carry the assessed loss to the next year of assessment when it makes income. All the assessed losses brought forward can be utilised in one year of assessment where there is income before the utilisation that is equal to or greater than the assessed loss.

As noted in Chapter One, in 2020, the then Finance Minister, Tito Mboweni, in the Budget Review (2020) announced that the corporate tax regime was getting revised to boost economic growth. The revision, following global trends, was intended to lower the corporate income tax rate to stimulate business investment, expand production, enhance South Africa’s attractiveness as an investment destination and reduce the incentive for base erosion and profit shifting. As lowering the tax rate results in revenue losses, to counteract this, the tax base would be widened by minimising tax incentives, introducing new interest deduction rules, and limiting assessed loss utilisation. Although the Budget Review (2020) initially proposed the corporate tax rate to be lowered from 28 per cent to 27 per cent to be effective for years of assessment commencing on or after 1 April 2021, it was postponed to years of assessment commencing on or after 31 March 2023 due among other things to the Coronavirus disease (COVID-19) pandemic. On the same day, section 20, set-off of assessed losses, and section 23M, limitation of interest deductions in respect of debts owed to persons not subject to tax, amendments to the Act become effective for the same years of assessment.

Section 20(1)(a) was amended as follows:

Before Amendment	Amendment
<p>20. Set-off of assessed losses.—</p> <p>(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—</p> <p>(a) any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment: Provided that no person whose estate has been voluntarily or compulsorily sequestered shall be entitled to carry forward any assessed loss incurred prior to the date of sequestration, unless the order of sequestration has been set aside, in which case the amount to be so carried forward shall be reduced by an amount which was allowed to be set off against the income of the insolvent estate of such person from the carrying on of any trade;</p>	<p>20. Set-off of assessed losses.—</p> <p>(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—</p> <p>(a)</p> <p>(i) that is a company, other than a company referred to in subparagraph (ii), any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment, to the extent that the amount of such set-off does not exceed the higher of R1 million and 80 per cent of the amount of taxable income determined before taking into account the application of this section;</p> <p>(ii) that is a company carrying on mining operations as contemplated in section 15, any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment, to the extent that the amount of such set-off does not exceed the higher of R1 million and 80 per cent of the amount of</p>

	<p>taxable income determined before taking into account the application of—</p> <p>(A) this section; and</p> <p>(B) the provisions of section 36 (7C);</p> <p>or</p> <p>(iii) that is not a company, any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment: Provided that no person whose estate has been voluntarily or compulsorily sequestered shall be entitled to carry forward any assessed loss incurred prior to the date of sequestration, unless the order of sequestration has been set aside, in which case the amount to be carried forward shall be reduced by an amount which was allowed to be set off against the income of the insolvent estate of such person from the carrying on of any trade</p>
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The amendment thus summarised provides that companies, other than companies carrying on mining operations, may deduct against taxable income the balance of assessed loss brought forward from the previous year of assessments and any assessed loss incurred during the current year in carrying on any other trade in the Republic if the taxpayer is carrying on a trade and has derived income from carrying on that trade. However, that set-off will be limited to R1 million and 80 per cent of taxable income, whichever is greater.

Previously, a taxpayer could utilise 100 per cent of the assessed loss brought forward where the taxable income before setting off of assessed losses was equal to or greater than the assessed loss. Now, taxpayers must limit the set-off to the higher of R1 million and 80 per cent of their taxable income; thus, a company previously not in a tax-paying position may now be in a tax-paying position due to the amendment. The amount of the assessed loss brought forward not utilised is then carried forward to the next year of assessment, where the taxpayer will have to perform the set-off limitation calculation again. Appendix C illustrates the amendment using examples. As explained above, the amendment was to limit the tax loss expected from the decrease in tax rate and applies to all companies, as the corporate tax regime review aimed for a more uniform tax treatment across taxpayers and sectors (National Treasury, 2021a:51). Thus, the amendment may apply to oil and gas taxpayers.

#### 4.4 Conclusion

Section 20 of the Act allows a taxpayer carrying on a trade and having derived income from carrying on that trade to set off the balance of assessed losses brought forward against that income. Previously, taxpayers could utilise all the assessed loss brought forward where the income was equal to or greater than the assessed loss. Due to the amendment to section 20, taxpayers are now limited to utilising the higher of R1 million or 80 per cent of the taxable income before the utilisation. As this amendment, following the decrease in the corporate tax rate from 28 per cent to 27 per cent, was intended to apply to all companies, this chapter interprets section 20, addresses the interpretation difficulties, the amendment and explains that it may apply to oil and gas companies. Chapter Five will determine whether the amendment to section 20 conflicts with paragraphs 5(3), 5(4), and 5(5) of the Tenth Schedule and how the interpretation of statutes guides us in determining which provision applies.

## CHAPTER FIVE

### SECTION 26B

**Chapter Five considers the conflict between the assessed loss provision in the Tenth Schedule, Chapter Three, and the assessed loss provision in section 20 of the Act, Chapter Four. The chapter provides a brief explanation of the rules of interpretation and how they determine which rule applies to oil and gas companies.**

#### 5.1 Introduction

The previous chapters described the oil and gas industry, its fiscal tax regime, and its provisions in the Tenth Schedule. Chapter Four explained the assessed loss provision in section 20 of the Act and noted that its amendment was intended to apply to all companies, including oil and gas companies. As paragraphs 5(3), 5(4) and 5(5) of the Tenth Schedule provide different assessed loss provisions, as summarised in Chapter Three, this chapter seeks to determine if the provisions conflict. Where provisions of the Act conflict, the rules of interpretation guide us in determining the rule that prevails. This chapter will further explain how the Tenth Schedule overrides some provisions of the Act, as mentioned in the previous chapters, and determine whether it is necessary to change the provisions of the Tenth Schedule.

#### 5.2 Section 20 v Paragraphs 5(3), 5(4) and 5(5)

Chapter Three explored paragraphs 5(3), (4) and (5) of the Tenth Schedule, which provides the rules relating to assessed losses for oil and gas taxpayers. The chapter showed that the paragraph allows oil and gas companies with favourable deviation. The National Treasury (2021a:34) summarises the rules as, “An oil and gas company can set off assessed losses from upstream activities against income from downstream activities, and 10 per cent of losses remaining can be set off against any other income (i.e. non-oil and gas income, such as investment income). Any remaining after that can be carried forward to be offset against oil and gas income and income from the refining of gas”.

Paragraphs 5(1) and (2) of the Tenth Schedule provide oil and gas companies with super-deductions that generally cause high assessed losses. This paragraph aims to recognise the different risks that oil and gas companies face compared to other taxpayers, as well as the distinct risks associated with their exploration and production stages. Thus, a change to section 20 that applies to all companies, including oil and gas companies, that limits the set off of assessed loss against all the income, as explained in Chapter Four, conflicts with the provisions of paragraph 5 of the Tenth Schedule. The following simplified example explains the conflict (Janisch, 2023:7):

If an oil and gas company has

- Oil and gas and refining income of R8 000 000

- Other income in the same trade of R2 000 000
- Assessed loss of R20 000 000

### Applying

Section 20		VS	Tenth Schedule	
Oil and gas and refining income	R8 000 000		Oil and gas and refining income	R8 000 000
Other income in the same trade	R2 000 000		Paragraph 5(3)	(R8 000 000)
Taxable Income before Assessed Loss Set-off	R10 000 000		Other income in the same trade	R2 000 000
Assessed Loss Set-off (section 20) Higher of	(R8 000 000)		Paragraph 5(4): 10 per cent or remaining assessed loss	(R1 200 000)
<ul style="list-style-type: none"> <li>- R1 million and</li> <li>- 80 per cent of taxable income, R8 000 000</li> </ul>			<ul style="list-style-type: none"> <li>- (R20 000 000 – R8 000 000) x 10 per cent</li> <li>- = R12 000 000 x 10 per cent</li> </ul>	
Taxable Income	R2 000 000		Taxable Income	R800 000
Assessed Loss Carried Forward	R12 000 000	Assessed Loss Carried Forward	R10 800 000	

Section 20(1) of the Act, as amended, and paragraphs 5(3), 5(4) and 5(5) of the Tenth Schedule are thus in conflict, as they result in different outcomes concerning exploration and post-exploration activities. Before the amendment, different results would have been obtained with the treatment of other income, as stipulated in paragraph 5(4). Then, however, it was understandable that paragraphs 5(3), 5(4) and 5(5) of the Tenth Schedule prevailed over the previous section 20 as the Tenth Schedule was enacted after section 20 to treat oil and gas companies differently.

What results in the amended section 20(1) being a concern to oil and gas companies is that the National Treasury (2022) intended for the section 20(1) limitation to apply to all companies, as the decrease of the corporate tax rate does. This results in the research objective of this paper, which is to determine the intention behind section 20(1) aligns with the language of the Act, specifically section 26B.

### 5.3 Section 26B

Section 26B(1) states that oil and gas companies must determine their taxable income according to the provisions of the Income Tax Act, but subject to the requirements in the Tenth Schedule to the Income Tax Act. Section 26B(2) specifies that the tax on dividends paid from oil and gas income should also be determined using the provisions of the Income Tax Act, but subject to the Tenth Schedule. Furthermore, Part IIA of Chapter III of this Act, which contains the general anti-avoidance rules (GAAR), applies to the Tenth Schedule notwithstanding any provision to the contrary contained in subsections (1) and (2).

Section 26B(1) applies when interpreting the section 20 provision and its application to oil and gas companies. The words “subject to” are not defined in the Act. The court in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) (“*Natal Joint Municipal Pension Fund v Endumeni Municipality*”) case said,

“Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors.<sup>15</sup> The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document.”

The Supreme Court of Appeal in *Commissioner for The South African Revenue Service v Bosch and Another* 2015 (2) SA 174 SCA applied the *Natal Joint Municipal Pension Fund v Endumeni Municipality* passage to fiscal legislation, where it held, “The words of the section provide the starting point and are considered in the light of their context, the apparent purpose of the provision and any relevant background material”.

Using the above cases, “subject to” may mean:

- Words of the sections (including ordinary rules of grammar and syntax)

Section 26B(1) says that an oil and gas company’s taxable income is determined using the provisions of the Income Tax Act, but subject to the Tenth Schedule. The Oxford English Dictionary defines “but” as a conjunction to say, “In a simple sentence, introducing a word, phrase, or (rarely) a clause which is excepted from the general statement”. “Subject to”, the Merriam-Webster Online Dictionary and Thesaurus define as a phrasal verb with the meaning to be “affected by or possibly affected by (something), e.g. The firm is subject to state law”, “likely to do, have, or suffer from (something), e.g. My cousin is subject to panic attacks” or “dependent on something else to happen or be true, e.g. The sale of the property is subject to approval by the city council”.

- The context in which the provision appears and the apparent purpose to which it is directed

Section 26B is a provision in the Income Tax Act that directs how oil and gas companies should determine their taxable income, the dividends tax on dividends paid from oil and gas income and how to apply GAAR. It was inserted in the Act by section 21(1) of the Revenue Laws Amendment Act 20 of 2006 and deemed to have come into operation on 2 November 2006 and applicable in respect of any year of assessment commencing on or after that date. This insertion is read with the Tenth Schedule inserted on the same day by section 63(1) of the Revenue

Laws Amendment Act 20 of 2006, as explained in Chapter Two, which formalised the central aspects of the previous OP26 regime into explicit law and to provide oil and gas taxpayers certainty and transparency (National Treasury Explanatory Memorandum on the Revenue Amendment Bill, 2006:15).

- The material that is known to those responsible for its production

Section 26B and the Tenth Schedule were added to the Act to formalise key aspects of the previous OP26 regime. The aim was to provide certainty and transparency to oil and gas taxpayers. It can be concluded that the responsible parties for section 26B and the Tenth Schedule production were aware of the OP26 regime agreements, which were not widely known. They recognised that due to the uncertain geographical realities in South Africa, investors would lose interest if the previous OP26 regime incentivising provisions were not maintained. Therefore, these provisions can be seen as a deviation from the ordinary rules.

- Relevant Background information and Case Law

In *Sentra-Oes Kooperatief Bpk v Kommissaris van Binnelandse Inkomste* 1995 (3) SA 197 (AD), it was stated:

“In the majority judgment in *S v Marwane* 1982(3) SA 717(A) at 747H-748B, Miller JA explained that the purpose of the phrase "subject to" when used in a legislative provision, is –

". . . to establish what is dominant and what subordinate or subservient; that to which a provision is 'subject', is dominant - in case of conflict it prevails over that which is subject to it. Certainly, in the field of legislation, the phrase has this clear and accepted connotation. When the legislator wishes to convey that that which is now being enacted is not to prevail in circumstances where it conflicts, or is inconsistent or incompatible, with a specified other enactment, it very frequently, if not almost invariably, qualifies such enactment by the method of declaring it to be 'subject to' the other specified one. As Megarry J observed in *C and J Clark v Inland Revenue Commissioners* (1973) 2 All ER 513 at 520:

‘In my judgment, the phrase 'subject to' is a simple provision which merely subjects the provisions of the subject subsections to the provisions of the master subsections. When there is no clash, the phrase does nothing: if there is collision, the phrase shows what is to prevail.’”

- Corbett JA, in *Rennie NO v Gordon and Another NNO* 1988 (1) SA 1 (A) at 21D-G, endorsed the dictum in *S v Marwane* 1982(3) SA 717(A).
- An earlier case as noted by De Koker & Williams (2024), *Commissioner for Inland Revenue, Transkei and Another v JALC Holdings (SA) (Pty) Limited and Another* [1991] 4 All SA 380 (Tk), held that:

“The words “subject to” can, depending upon the context in which they are used, infer or determine the existence of a condition precedent, or amount to no more than the term of an agreement. Where those words appear in a statutory provision

“. . . (g)enerally speaking, the words 'subject to' have the effect of introducing a qualification, limitation or condition precedent, thereby curtailing a person's exercise of otherwise unrestricted rights. It does not,

in this sense, mean an alternative or optional right without affecting an unfettered original right.” (Per Goldin J in *Hickman v The Attorney-General* 1980 (2) SA 583 (R) at 585E–F.)

In other statutory provisions, the same words may mean ‘except as curtailed by’...

Depending on the context, the same words can prescribe the manner and fashion in which certain powers and duties may, or must be exercised...

The words “subject to” could also constitute a condition precedent, meaning that a test or action must be completed, that something has to take place before the agreement does in fact become binding upon the parties thereto...”

The above analysis of the words “subject to” shows that section 26B(1) describes that in determining the taxable income of oil and gas companies, where there is conflict, inconsistency or incompatibility with the Tenth Schedule provisions and the provisions in the body of the Act, the Tenth Schedule’s provisions will prevail. As explained previously, the section 20 amendment conflicts with paragraphs 5(3), (4) and (5) of the Tenth Schedule. Because section 26B(1) describes how to determine the taxable income of oil and gas companies, the Tenth Schedule’s assessed loss provisions apply to oil and gas taxpayers and not section 20 of the Act.

As discussed in previous chapters, the amendment to section 20 was a result of the review of the corporate tax regime. This review lowered the corporate tax rate by 1 per cent and expanded the tax base through changes to sections 20 and 23M. Additionally, the review evaluated and modified various tax incentives, including the “research and development” incentive outlined in section 11D, and revised the expiration dates for this and other incentives (National Treasury, 2020:42). The National Treasury noted that certain favourable tax treatment results in vested interest that “erode the equity of the tax system or do not meet their intended objectives” (National Treasury, 2021:44). Thus, the review, including the tax assessed loss limitation, intended to treat taxpayers more similarly.

In concluding that the tax assessed loss limitation would be the higher of 80 per cent of taxable income and R1 million, the National Treasury (2020:46) considered limiting the tax assessed loss to several years, which is one of three ways countries have limited the utilisation of tax assessed loss, the last being restricting the utilisation to a specified percentage of accumulated tax assessed losses that may be used to reduce taxable income (Warneke, 2023). National Treasury (2020:42) noted that a restriction due to years would unfairly impact businesses with significant initial investments or long lead times to profitability, as seen above in Chapter Three, where the “income from the trade” requirement for assessed loss is considered. The National Treasury, in the 2020 Budget Review, concluded on the limitation in one year as it is viewed this method as reasonably affecting all businesses equally. In 2022, the National Treasury (2022:135) clarified the section 20 amendment concerning companies carrying on mining operations. In 2024, the National Treasury proposed clarification of the interaction between section 20 and the corporate rules for companies that are party to section 44 and section 47, and have to liquidate, as well as on exchange differences on foreign transactions.

Although, as noted previously, Tax Court judgements do not set a precedent, a recent one, *A v Commissioner for The South African Revenue Services* (46206) [2023] ZATC 1; 84 SATC 225 added valuable guidance to the interpretation of two conflicting legislative provisions. Lessing (2023) summarises the guidelines from that case as:

- “an interpreter should follow a unitary approach of interpretation (which encapsulates the *contra fiscum* rule of interpretation), where the language used in the legislation remains the point of departure, but the legislation must be read in its specific context;
- when considering the context of legislative provisions, the interpreter should pay attention to the legislative history of the provisions in question;
- where there is an irreconcilable conflict between two provisions, an interpreter should regard an earlier enactment as impliedly repealed by a later one; and
- an interpreter should apply the sensible and business-like test, where the interpreter should have regard to the impact of the interpretative approach followed, by asking, “whether it gives rise to sensible and business-like results, as opposed to insensible or even absurd consequences that could not have been intended“.”

As explained above, where the legislation was read considering the language, context and legislative history (summarised in Appendix D), section 26B, including the words “but subject to” resolves any conflict between section 20 and paragraph 5 of the Tenth Schedule. Although the amendment to section 20 came after the introduction of section 26B and the Tenth Schedule, applying it to oil and gas taxpayers may not yield sensible and commercial-like results, particularly given the purpose and history of the Tenth Schedule. Additionally, the 2021 Tax Policy Discussion Document for Public Comment, titled “What is the Most Appropriate Tax Regime for the Oil and Gas Industry?” was released following the 2020 Budget Speech, which announced the review of the corporate tax regime. In this Discussion Document, the National Treasury intends to maintain the Tenth Schedule and thus keep section 26B unchanged. Consequently, it is unclear what the National Treasury’s intention was regarding the tax assessed loss limitation for oil and gas companies. However, this amendment does not apply to these taxpayers, as the phrase “but subject to,” as analysed above, resolves any potential conflict. This non-applicability is advantageous for the taxpayers, allowing them to continue their operations as they have in the past.

As noted in Chapter One, upcoming amendments to the Tax Acts result in uncertainty, with investors hesitating or reducing their investments, thereby affecting the tax neutrality principle. Furthermore, Chapter Three explains how assessed losses are applied. Using section 20 instead of paragraphs 5(3), 5(4), and 5(5), or applying section 20 before those paragraphs, would complicate the tax provisions for oil and gas companies, thereby impacting the principle of tax certainty. As the Tenth Schedule was enacted to provide oil and gas taxpayers certainty and transparency because of the unique risk and challenges these taxpayers find themselves in and in a country where this industry is still in its nascent stage with uncertain probabilities, it is recommended that section 26B and the Tenth Schedule to remain as is so that section 20 does not apply to them.

#### 5.4 Conclusion

It is unclear whether the National Treasury aims to restrict the utilisation of tax assessed losses for oil and gas taxpayers to the higher of R1 million or 80 per cent of taxable income, or to apply paragraph 5 of the Tenth Schedule rules regarding tax assessed losses. This chapter analyses the legislation and case law, demonstrating that the amendment to section 20, due to the phrase “but subject to”, cannot be applied to oil and gas companies if that was the National Treasury’s intention. Given that oil and gas companies have a different risk profile compared to other companies—a point acknowledged by the Explanatory Memorandum accompanying the enactment of the Tenth Schedule, as discussed in Chapter Two—it seems appropriate that section 20 does not influence the utilisation of tax assessed losses. These losses generated from the additional tax allowances were designed to incentivise capital expenditure in oil and gas exploration.

## CHAPTER SIX

### CONCLUSION

**Chapter Six concludes and outlines the findings of this research, examining whether oil and gas companies are affected by the recent amendment and whether this is intentional. It also considers whether the amendment should apply to oil and gas companies. The chapter also gives recommendations for issues or concerns found in this research.**

#### 6.1 Synopsis of the dissertation

The purpose of this minor dissertation was to analyse the application of tax loss limitation to oil and gas companies. In examining the application, the paper questioned and answered whether the amendment to section 20 applied to oil and gas taxpayers.

In the analysis of the application of tax loss limitations to oil and gas companies, chapters two to five, the author addressed the following;

Chapter Two provided background information by detailing the oil and gas industry in South Africa, explaining its fiscal tax regime, and highlighting its socio-economic potential. It explained that the exploration and production of oil and gas in the country have the potential to contribute significantly to the country's energy needs and positively impact socio-economic growth, such as through job creation, industry development, and reduced balance of payments. As such, the Tenth Schedule, introduced to replace the previous OP26 regime, includes tax incentives to attract foreign direct investment and provide these investors with certainty and transparency in a risky environment. The Chapter aimed to set the foundation that allowed Chapter Three to examine the provisions of the Tenth Schedule and their incentivising features in detail.

After Chapter Two concluded, the benefits of oil and gas exploration and production were explained, and why companies engaged in such activities have a different tax policy. Chapter Three summarised the tax provisions under the Tenth Schedule. The Chapter described the distinct risks associated with the oil and gas industry that led to deviation from the general tax code, such as with holders of oil and gas rights being deemed to be carrying on a trade as oil and gas companies temporarily cease operations and conduct post-production rehabilitation activities, resulting in the carrying on a trade test required under the general deduction formula and assessed loss provision in the body of the Act to be unmet. It also showed how the Tenth Schedule provides generous deductions to recognise the high-cost capital expenditure and incentivise foreign direct investment, resulting in no tax payable by oil and gas companies for the initial years after entering into production. In explaining the deductions from income derived from oil and gas activities, the Chapter emphasised the tax assessed loss rules relating to oil and gas companies and how they contribute to the purpose of the Tenth Schedule, which is to provide certainty and transparency.

Chapter Four explained the tax assessed loss provision in section 20 of the Act. It detailed the provision's interpretational issues and recent amendments due to the corporate income tax revision, which decreased the corporate income tax rate. The Chapter explained that previously, section 20 allowed taxpayers to utilise all their tax assessed loss brought forward where the income was equal to or greater than the tax assessed loss and the taxpayer was carrying on a trade and derived income from carrying on that trade. With the corporate revision reducing the corporate income tax rate from 28 per cent to 27 per cent to be more in line with international standards and to encourage investment growth, section 20 was amended to broaden the tax base by limiting the utilisation of the tax assessed loss brought forward to the higher of R1 million and 80 per cent of the taxable income before the utilisation. As the corporate tax revision was also intended to tax taxpayers more uniformly, the Chapter concluded by stating that, in the absence of anything otherwise, the amendment may apply to oil and gas companies.

After Chapter Three explained the assessed loss per the Tenth Schedule and Chapter Four explained the assessed loss provisions per section 20 of the Act, Chapter Five considered whether there was a conflict between the assessed loss provisions and determined which rule would apply to oil and gas companies. In doing so, the Chapter briefly explained the rules of interpretation and how to determine which rule applies to oil and gas companies when the provisions of the body of the Act and those in the Tenth Schedule conflict, are inconsistent, or are incompatible. Although the amendment to section 20 was a result of the corporate income tax review that, amongst other things, aimed to tax companies more uniformly, the Chapter concluded by saying that the Tenth Schedule's rule prevails whether or not it was intended this way and recommended that section 26B and the Tenth Schedule remain as is so that section 20 does not apply to oil and gas companies, as Chapter Two and Three showed the benefits and risks of the industry.

The section 20 amendment was intended to apply to all taxpayers in South Africa as a whole, except for the carve-out afforded to hard-rock mining, for which there is recognition of the provisions of section 36(7C). There is no comparable exemption provided for oil and gas mining, indicating that the National Treasury intended for the loss limitation to also apply to oil and gas mining companies. Alternatively, the National Treasury may not have perceived a need to exclude oil and gas mining taxpayers, as these taxpayers were already structurally excluded, as discussed in Chapter Five. To include oil and gas companies in the loss limitation would require amendments to the Tenth Schedule, specifically paragraphs 5(3), 5(4), and 5(5), which the National Treasury has not deemed necessary. But this possible omission might be offset by:

## 6.2 Other taxes as levied on Oil and Gas Companies

Oil and gas companies contribute to the fiscus through other fiscal tools such as royalties, as mentioned in Chapter Two. Royalties, as noted by the National Treasury (2021a:28), are payments specified by law or contract made to mineral rights owners for the right to extract and produce oil and natural gas from a specific piece of land. As these companies extract oil and gas, a portion of their sales revenue

or the volume of resources produced is paid to the government, irrespective of profitability (resulting in the criticism that royalties are a regressive tax). The MPRRA, which administers the royalties payable, thus already ensures that the government receives a contribution toward royalties from oil and gas companies irrespective of profitability (National Treasury, 2022:27).

Besides royalties, oil and gas companies also contribute to value-added tax, securities transfer tax, and transfer duty, among other taxes, in their transactions. The fossil fuel energy sector is also the most impacted by the carbon tax. These taxpayers are charged for their emissions to encourage efficiency and emissions mitigation, as well as to address the negative consequences of their emissions (Kalaba, 2019). However, as indicated in Chapter Two, oil and gas taxpayers have a vital role in transitioning the country from coal-powered energy sources to more renewable sources. Oil and gas companies, thus, contribute to the fiscal revenue through multiple taxes.

## 6.3 Global Minimum Tax

### 6.3.1 Overview of GMT

On 30 October 2024, the Minister of Finance tabled the Global Minimum Tax Bill 2024 (B20-2024). The Global Minimum Tax Bill implements (with retrospect to 1 January 2024) the Global Anti-Base Erosion (GloBE) Pillar 2 Rules in South Africa. GloBE Pillar 2 briefly aims to ensure that multinational enterprises (MNEs) with a consolidated revenue of EUR 750 million or more in at least two of the four immediately preceding fiscal years in the fiscal year in question pay a minimum effective tax rate of 15 per cent, in each of the countries in which the MNE operates.

The Income Inclusive Rule (IIR) seeks to consider MNEs whose Ultimate Parent Entity (UPE) is in South Africa, whilst the Qualifying Domestic Minimum Top-up Tax (QMDTT) aims to consider MNEs whose UPE is in a foreign company but has operations in South Africa. These entities within the scope will have to pay a top-up tax to an effective rate of 15 per cent where their effective tax rate is below 15 per cent.

Although South Africa has a corporate income tax rate of 27 per cent, oil and gas companies are afforded capital uplifts or super deductions (as discussed at Chapter Three) that will result in their effective tax rate which is determined in reference to accounting profits being below 15 per cent when the oil and gas company first enters into production and is still in a tax assessed loss position.

### 6.3.2 GMT impact on Oil and Gas

Oil and gas companies that are MNEs with a consolidated revenue of EUR 750 million or more in at least two of the four immediately preceding fiscal years in South Africa may be required to make a top-up payment to SARS in accordance with the QMDTT rule. This top-up payment is calculated in accordance with the guidelines of the GloBE Model Rules, as outlined in Part IV of the Global Minimum Tax Bill. It essentially represents the difference between the global effective tax rate and 15 per cent of

the GloBE income, as per the rules. Oil and gas companies in the country have generous capital allowances, as explained in Chapter Three, which could potentially result in their global effective tax rate being less than 15 per cent, requiring them to make a top-up payment for the difference. The Tenth Schedule was enacted to retain the incentivising features of the previous OP26 regime in a country with uncertain potential for hydrocarbons, thereby encouraging foreign direct investment. GloBE Pillar 2 thus has the potential to reduce the efficacy of the Tenth Schedule in achieving its objective.

Thus, whether examining the corporate income tax regime in isolation or in conjunction with other taxes and fiscal instruments, oil and gas companies with a consolidated revenue of EUR 750 million that operate in South Africa will now have to consider the GloBE Model Rules, which will be a complex and costly endeavour. These entities within the scope of Pillar 2 may now be required to pay more tax than previously expected, similar to the result of the section 20 amendment, as seen in Appendix C, where companies that previously did not pay tax may now be subject to taxation. Smaller oil and gas companies, especially those with Historically Disadvantaged South Africans (HDSA) participants, are not covered by Pillar 2. These companies often have cash flow problems (National Treasury, 2022:46). Since section 20 does not apply to them, they can continue operating without tax issues affecting their decisions. Additionally, this aligns with government initiatives such as Operation Phakisa, which aims to promote and develop South Africa's ocean economy (Department of Planning, Monitoring and Evaluation, 2014).

#### 6.4 Conclusion

It is clear from the critical analysis conducted in this dissertation that the amendment to section 20 does not apply to oil and gas taxpayers. However, there are other fiscal tools, such as royalties and carbon taxes, etc. that raise tax revenue. The contribution to the fiscus through multiple taxes and socio-economic benefits is greater than the loss to the fiscus by oil and gas taxpayers not applying the section 20 loss limitation.

In addition, with the implementation of the GloBE Pillar 2 Rules, large oil and gas companies operating in South Africa will make a top-up payment when they first enter production until their tax-assessed losses (derived from the additional tax allowances on capital expenditure) are fully utilised from a corporate tax standpoint.

Accordingly, the author recommends that there be no amendment to the Tenth Schedule to accommodate the loss limitation amendment in section 20 of the Act, and that the current *status quo* remain.

**Potential socio-economic benefits of an upstream project**

**A case study of Block 11B/12B by Yonela Tukwayo, Petroleum Agency SA (15 September 2022)**

<b>A: Background</b>
<p>In 2019 &amp; 2020 the Block 11B/12B JV partners made gas and condensate discoveries in the Paddavisie play (Brulpadda and Luiperd) located in the Southern coast of South Africa (Eden district)</p> <p>The Agency commissioned a study to understand the potential contribution of the upstream petroleum industry, particularly gas, to socio-economic development in the country with specific focus on these discoveries.</p> <p>The Block 11B/12B discoveries can be developed in one or two phases:</p> <p><b>Phase 1:</b> Early production scheme - which focuses on fast-track delivery of the gas and condensate to PetroSA’s GTL refinery using the existing PetroSA offshore infrastructure.</p> <p><b>Phase 2:</b> Full field development –gas and condensate supply to potential new gas markets (e.g. Gas to Power, Industry, Transport)</p> <ul style="list-style-type: none"> <li>This study focuses on only <b>phase 1</b> and evaluates the potential financial and socio-economic impacts of the project for South Africa, the Western Cape province, and the Eden district.</li> </ul>
<b>B: Methodology</b>
<p><b>Two Main Assessment tools:</b></p> <ol style="list-style-type: none"> <li>Financial and Economic Cost-Benefit Analysis (CBA); and</li> <li>Macro Economic Impact Assessment Model (MEIA)</li> </ol> <p><b>1. Cost Benefit Analysis (CBA):</b></p> <p>The CBA is a system where revenues and costs of a project are analysed to evaluate the financial and economic viability of the project</p> <div style="display: flex; justify-content: space-around; align-items: center;"> <div style="border: 1px solid black; padding: 5px; width: 45%;"> <p><b>Financial CBA:</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Viewed from <u>shareholder</u> perspective</li> <li><input type="checkbox"/> Market prices</li> <li><input type="checkbox"/> Current prices</li> </ul> </div> <div style="font-size: 2em; margin: 0 10px;">vs</div> <div style="border: 1px solid black; padding: 5px; width: 45%;"> <p><b>Economic CBA:</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Viewed from a <u>community</u> perspective</li> <li><input type="checkbox"/> Shadow prices - externalities</li> <li><input type="checkbox"/> Constant prices</li> </ul> </div> </div> <p>Assessment criteria used to analyse the net benefit/cost are:</p> <ul style="list-style-type: none"> <li>Net Present Value (NPV);</li> <li>Internal Rate of Return (IRR); and</li> </ul>

- Discounted Benefit-Cost Ratio (BCR)

## 2. Macro Economic Impact Assessment Model (MEIA):

Used to analyse the macroeconomic / socio-economic impacts

Based on a Social Accounting Matrix (SAM) for South Africa and Western Cape Province

Indicators:

- Gross Domestic Product (GDP);
- Employment Creation;
- Household Income;
- Fiscal Revenue;
- Balance of Payment (BOP);

### Phases of Macroeconomic impact:

- Construction,
- Operational,
- Re-investment / Savings phase

Within each phases, the direct, indirect and induced impacts are calculated, which when combined give the total impact

### C: Key assumptions

<b>Fiscal Terms</b>	<b>Value or %</b>
<b>Royalty</b>	0.5% - 5%
<b>Corporate Income Tax (CIT)</b>	27%
<b>Tax deductible capital costs (uplifts)</b>	
<b>Exploration</b>	100%
<b>Post exploration</b>	50%
<b>State Participation</b>	10%
<b>Black Economic Empowerment (BEE)</b>	10%

<b>Economic &amp; Project assumptions</b>	<b>Value or %</b>
<b>Natural gas price</b>	\$5.35/MMBTU (study assumption)
<b>Crude Oil price</b>	\$70/Barrel
<b>Nominal Financial discount rate</b>	10%
<b>Real Financial discount rate</b>	8%
<b>Construction period</b>	2023 - 2025
<b>Operational period</b>	2026 - 2045
<b>Base year</b>	2022
<b>Exchange rate ZAR/US\$</b>	15
<b>Gas Volumes</b>	3.8 Tcf (study assumption)
<b>Condensate Volumes</b>	177 Million Barrels

#### **D: Results Potential Socio-Economic Benefits**

1. CBA Results
2. Macro/socio-economic impacts for **South Africa**
3. Macro/socio-economic impacts for **Eden district**

*Note: These are estimates based on currently available information which is subject to change as the project progresses. The study will also be updated as new information becomes available.*

##### **1. CBA Results (20 years)**

###### **Financial CBA:**

- NPV(10%): R58,945 million
- BCR: 1.7
- IRR: 21%

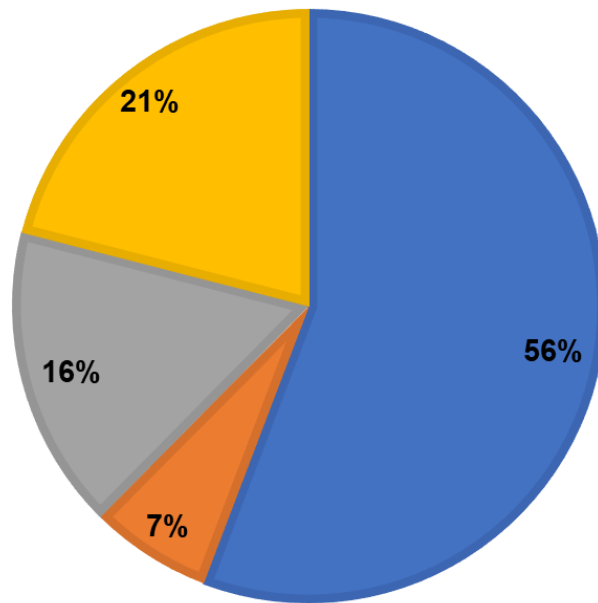
###### **Economic CBA:**

- NPV(10%): R38,624 million
- BCR: 1.5
- IRR: 19%

Note: The economic CBA differs from the financial CBA in that externalities and shadow prices were taken into account it is also done in Real Prices while the Financial CBA is done in Nominal Prices.

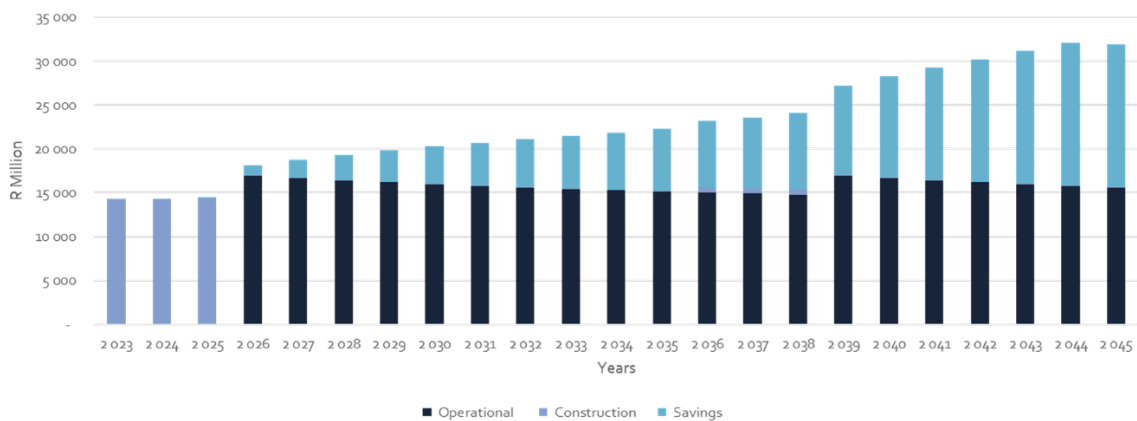
##### **2. Macro/socio-economic impacts for South Africa: GDP**

**Annual GDP Impact: R22 279 Million, 2022 constant prices**



■ Direct Impact 
 ■ Indirect Impact 
 ■ Induced Impact 
 ■ Savings/Reinvestment Impact

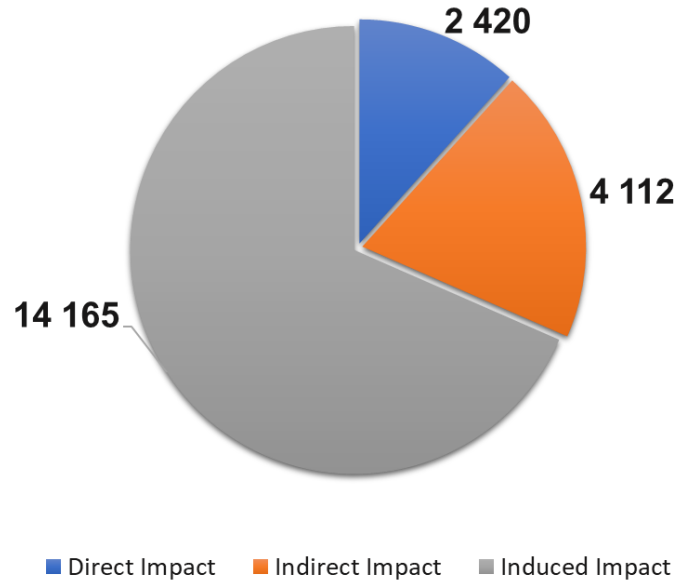
### Project Component GDP Timeline Impact



Operational cash flows are the initial material contribution with the role of savings (reinvested cash flows) becoming increasingly important over time.

### Impact on employment (number of jobs created)

Number of jobs : 20 697 (excluding reinvestment phase)



[The total number of jobs created is **39 148** including the savings/reinvestment phase]

#### Sectoral Impact

	GDP (R Million)	GDP %	Employment (Numbers)	Employment %
<b>Sector</b>				
1.Agriculture	305	1%	2027	5%
2.Mining	9813	<b>44%</b>	974	2%
3.Manufacturing	4527	<b>20%</b>	<b>9795</b>	<b>25%</b>
4.Electricity & water	458	2%	356	1%
5.Construction	858	4%	2804	7%
6.Trade & accommodation	2325	10%	<b>10210</b>	<b>26%</b>
7.Transport & communication	983	4%	1946	5%
8.Financial & business services	2695	12%	<b>7172</b>	<b>18%</b>
9.Community services	314	1%	3864	10%
<b>Total</b>	<b>22279</b>	<b>100%</b>	<b>39148</b>	<b>100%</b>


Total employment number of 39 148 includes job creation from the reinvestment phase

#### Fiscal Impact (R Million p.a.)

	<b>Fiscal Impact</b>
A. Project Related Taxes	<b>2 077</b>
Total Royalties	<b>986</b>
Total Taxes	<b>1 092</b>
B. Project Indirect	<b>6 534</b>
B1. Indirect: Operational and Construction	<b>4 991</b>
B2. Savings Re-Investment	<b>1 543</b>
<b>Total Fiscal (A+B)</b>	<b>8 611</b>

[Average p.a. over the period 2026 – 2045, R Million, 2022 Constant Prices]

**Additional Social Infrastructure potentially funded by government from the Project fiscal contribution R8,611 Million per year**




Additional Educators

1671




Additional Hospital Beds Served

1071



Additional Doctors

137



Additional Low-Cost Houses

108

[Average p.a. over the period 2026 – 2045, R Million, 2022 Constant Prices]

**Balance of Payment (R Million, p.a.; 2022 constant prices)**

	<b>Total Project</b>	<b>Reinvestment and Savings</b>	<b>Total</b>
Import substitution	28 454.9	4 153.2	32 608.2
Exports	-	358.1	358.1
Direct and Indirect Imports of Materials and household goods and services	-5 116.1	-2 191.4	-7 307.5
<b>Balance of Payments</b>	<b>23 338.8</b>	<b>2 319.9</b>	<b>25 658.8</b>

- Domestic Production lead to Export and/or Import Substitution of Goods and Services produced in South Africa as a result of the Project.
- The total BOP impact is the sum of the Project net exports plus the broader economy net exports, resulting in a total BOP impact of R25 659 Billion, 2022 prices.

### 3. Macro/socio-economic impacts for Eden district

#### Summary: South Africa, Western Cape and Eden District.

	<b>Total Impact on South Africa</b>	<b>Total Impact on Western Cape</b>	<b>Total Impact on Eden District</b>
Impact on Gross Domestic Product (GDP) [R million]	22279	18219	14 773
Impact on capital formation [R million]	103158	88958	78 624
Impact on employment [number of job opportunities]	39148	28062	10 820
- Skilled impact on employment [number of job opportunities]	8688	5645	2 484
- Semi-skilled impact on employment [number of job opportunities]	20764	12770	5 663
- Unskilled impact on employment [number of job opportunities]	9697	6056	2 672
Impact on Households [R million]	11442	6281	2 570
- Low Income Households [R million]	1336	796	325
- Medium Income Households [R million]	1669	905	372
- High Income Households [R million]	8437	4580	1 873

[Average p.a. over the period 2026 – 2045, R Million, 2022 Constant Prices]

#### Summary

**Main socio-economic benefits of the project for the country:**

<b>Indicator</b>	<b>Impact</b>
<b>Annual Gross Domestic Product (GDP)</b>	22 279
<b>Job Creation (#) (excluding savings phase)</b>	20 697
<b>Job Creation (#) (including savings phase)</b>	39 148
<b>Poverty Alleviation</b>	1 336
<b>Fiscal Benefits</b>	8 611
<b>Balance of Payment (BoP)</b>	25 659

[Average p.a. over the period 2026 – 2045, R Million, 2022 Constant Prices]

**E: Conclusion**

- Significant socio-economic benefits can potentially be realised from the project
- The Agency has finalised its own socio-economic impact study of the Block 11B/12B development and will use this during the adjudication of the production right application
- The Agency is developing a model for monitoring the socio-economic benefits during the project life if the project were to be implemented

## APPENDIX B

### Income Tax Act Provisions

- 1. Interpretation.**—(1) In this Act, unless the context otherwise indicates—
- “gross income”**, in relation to any year or period of assessment, means—
- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
  - (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature,

**“income”** as “the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II”.

**“taxable income”** means the aggregate of—

- (a) the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and
- (b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act;

#### Previous section 20

- 20. Set-off of assessed losses.**— For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—
- (a) any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment: Provided that no person whose estate has been voluntarily or compulsorily sequestrated shall be entitled to carry forward any assessed loss incurred prior to the date of sequestration, unless the order of sequestration has been set aside, in which case the amount to be so carried forward shall be reduced by an amount which was allowed to be set off against the income of the insolvent estate of such person from the carrying on of any trade;
  - (b) any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares:

Provided that there shall not be set off against any amount—

- (a) . . . . .
- (b) derived by any person from a source within the Republic, any—
  - (i) assessed loss incurred by such person during such year; or
  - (ii) any balance of assessed loss incurred in any previous year of assessment, in carrying on any trade outside the Republic; or
- (c) that is a retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit or severance benefit included in taxable income, any—
  - (i) balance of assessed loss;
  - (ii) “assessed loss” as defined in subsection (2) incurred in such year before taking into account that retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit.

**Amended section 20**

**20. Set-off of assessed losses.**— For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—

- (a)
  - (i) that is a company, other than a company referred to in subparagraph (ii), any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment, to the extent that the amount of such set-off does not exceed the higher of R1 million and 80 per cent of the amount of taxable income determined before taking into account the application of this section;
  - (ii) that is a company carrying on mining operations as contemplated in section 15, any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment, to the extent that the amount of such set-off does not exceed the higher of R1 million and 80 per cent of the amount of taxable income determined before taking into account the application of—
    - (A) this section; and
    - (B) the provisions of section 36 (7C); or
  - (iii) that is not a company, any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment: Provided that no person whose estate has been voluntarily or compulsorily sequestrated shall be entitled to carry forward any assessed loss

incurred prior to the date of sequestration, unless the order of sequestration has been set aside, in which case the amount to be carried forward shall be reduced by an amount which was allowed to be set off against the income of the insolvent estate of such person from the carrying on of any trade.

- (b) any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares:

Provided that there shall not be set off against any amount—

- (i) . . . . .
- (ii) derived by any person from a source within the Republic, any—
  - (i) assessed loss incurred by such person during such year; or
  - (ii) any balance of assessed loss incurred in any previous year of assessment,
- (iii) in carrying on any trade outside the Republic; or
- (iv) that is a retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit or severance benefit included in taxable income, any—
  - (i) balance of assessed loss;
  - (ii) “assessed loss” as defined in subsection (2) incurred in such year before taking into account that retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit.

## Tenth Schedule

### Definitions

1. For the purposes of this Schedule, unless the context otherwise indicates—

“**exploration**” means the acquisition, processing and analysis of geological and geophysical data or the undertaking of activities in verifying the presence or absence of hydrocarbons (up to and including the appraisal phase) conducted for the purpose of determining whether a reservoir is economically feasible to develop;

“**gas**” means any subsoil combustible gas, consisting primarily of hydrocarbons, other than hydrocarbons converted from bituminous shales or other stratified deposits of solid hydrocarbons;

**“oil”** means any subsoil combustible liquid consisting primarily of hydrocarbons, other than hydrocarbons converted from bituminous shales or other stratified deposits of solid hydrocarbons;

**“oil and gas company”** means any company that—

- (i) holds any oil and gas right; or
- (ii) engages in exploration or post-exploration in terms of any oil and gas right;

**“oil and gas income”** means the receipts and accruals derived by an oil and gas company from—

- (a) exploration in terms of any oil and gas right;
- (b) post-exploration in respect of any oil and gas right; or
- (c) the leasing or disposal of any oil and gas right;

**“oil and gas right”** means—

- (a) any reconnaissance permit, technical co-operation permit, exploration right, or production right as defined in section 1 of the Mineral and Petroleum Resources Development Act or any interest therein;
- (b) any exploration right acquired by virtue of a conversion contemplated in item 4 of Schedule II to the Mineral and Petroleum Resources Development Act or any interest therein; or
- (c) any production right acquired by virtue of a conversion contemplated in item 5 of Schedule II to the Mineral and Petroleum Resources Development Act or any interest therein;

**“post-exploration”** means any activity carried out after the completion of the appraisal phase, including—

- (d) the separation of oil and gas condensates;
- (e) the drying of gas; and
- (f) the removal of non-hydrocarbon constituents,

to the extent that these processes are preliminary to refining.



## APPENDIX D

### History

#### Brief history:

- ▶ 2006: Section 26B and the Tenth Schedule enacted
- ▶ 2017: Davis Tax Committee Report on Oil and Gas For the Minister of Finance
- ▶ 2018: Davis Tax Committee Report on the Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance.
- ▶ 2019 Budget Review: Revise oil and gas regime
- ▶ 2020 and 2021b Budget Reviews: Revise corporate tax regime and sections 20 and 23M amendments
- ▶ 2021a: Tax Policy Discussion Document for Public Comment "What is the Most Appropriate Tax Regime for the Oil and Gas Industry?"
- ▶ 2022 Budget Review: Clarify sections 20 and 23M amendment due to corporate regime revision for mining companies
- ▶ 2024 Proposal: Relaxing the assessed loss restriction rule under certain circumstances and reviewing the interaction of the set-off of assessed loss rules and rules on exchange differences on foreign exchange transactions

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