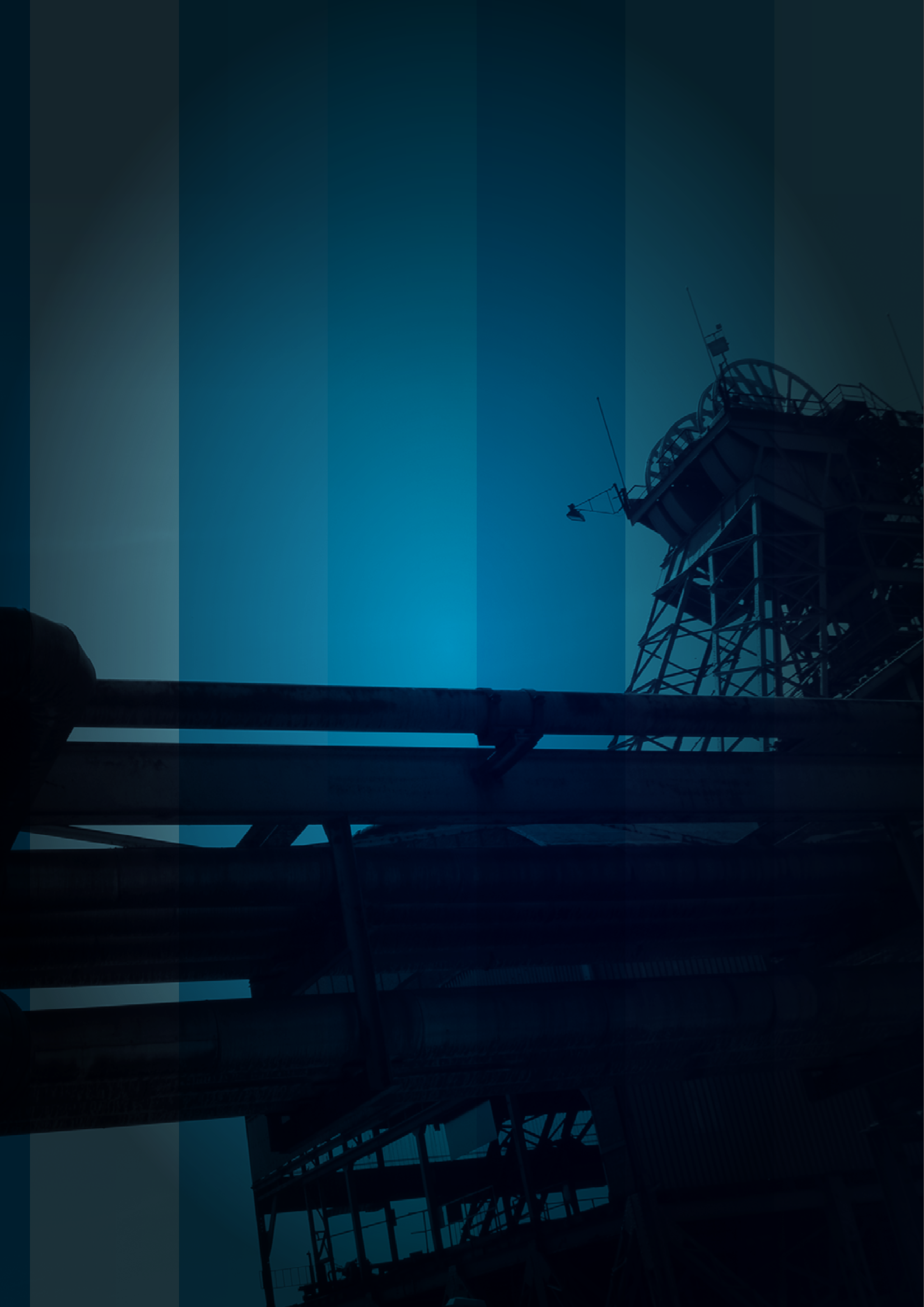
Improving South Africa's mining revenues and transparency:

The need for government action

Economic Justice Network (EJN) of FOCCISA

OXFAM



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INTRODUCTION

Taxes are the most important, sustainable and predictable source of finance for governments and taxes from the mining sector – which amounted to R21.4 billion in 2012[1] - contribute significantly to South Africa's economy. Figures from the Chamber of Mines are that mining has contributed R2.1 trillion to the country's GDP over the past decade (including all taxes, remuneration of workers and company procurement).[2] South Africa is the world's largest producer of platinum group metals, chrome ore, manganese and vanadium and a major supplier of gold, coal, iron ore, nickel and uranium. The country exported R269 billion worth of minerals in 2012, amounting to 38 per cent of all exports.[3]

Yet, despite these impressive figures, the mining sector in South Africa is insufficiently transparent while companies' use of tax havens increases the risk of illegal tax evasion and tax avoidance. Together with generous tax incentives given to mining companies, the effect is to reduce revenues to the state. There is a growing sense in South Africa that the minerals in the ground belong to the people, as stated in the mining law[4], and that they should contribute even more to national economic development[5]. This briefing suggests that South Africa has the potential to raise more revenue from mining by taking action nationally and internationally to review its tax policies and help break open the financial secrecy of tax havens. It is a popular summary of the Economic Justice Network's recent submissions on base erosion and profit shifting (BEPS) and mining taxation to the Davis Tax Committee.[6]

1 South African Chamber of Commerce, *Facts and Figures 2012*, p.13, http://chamberofmines.org.za/media-room/facts-and-figures

2 South African Chamber of Commerce, *Facts and Figures 2012*, p.2, http://chamberofmines.org.za/media-room/facts-and-figures

3 South African Chamber of Commerce, *Facts and Figures 2012*, p.2, http://chamberofmines.org.za/media-room/facts-and-figures

4 The Mineral and Petroleum Resources Development Act of 2002 states: 'South Africa's mineral and petroleum resources belong to the people and... the State is the custodian thereof' (Preamble)

5 Parliamentary Monitoring Group, *Mining Taxation: The South African Context*, August 2013, p,2, www.pmg.org.za

6 EJN and Oxfam, 'Submission to the Mining Taxation Sub-Committee on Mining Taxation', May 2014; EJN, 'Submission to the Base Erosion and Profit-Shifting Sub-Committee', 2014

02

GENEROUS TAXES

South Africa provides generous tax treatment to mining companies. In recent years, various mining laws have been revised and new legislation introduced for the mining of diamonds, precious metals and for health and safety, while a new mining act and a new royalty bill have been written. While the introduction of new legislation has been a positive step forward, the opportunity to significantly raise state revenues from mining has been missed, thereby creating an enabling environment for tax abuse. The most important features of South Africa's generous tax regime are:

- South African mines (and multinational companies operating in South Africa) are allowed to write off against tax all their capital expenditures in the year of acquisition and can carry forward any losses indefinitely, also offsetting them against tax liability – common practice in most mining regimes.
- But in addition, mining companies pay no VAT on their exports and are entitled to a refund for all the input taxes paid by them. This is a major gain for gold and diamond companies which export virtually all of their production.
- Gold mining companies' taxable income is derived from a formula which takes account of the ratio of profits to revenues. If the company makes no profits (or low profits at around 5 per cent of revenues), the state receives no tax; however, shareholders can still receive dividends in this scenario. Since some companies manage more than one mine (cross-ownership) this makes it easier for gold mine owners to distribute their profits amongst their companies, thus reducing their total tax payments.
- Royalty rates are lower than originally proposed. The Royalty Bill that was drafted over several years culminating in its adoption in 2010 reduced proposed royalty rates after each draft, caving in to industry pressure. One analysis is that the government loses between $359-$499m a year in revenues with the current royalty rates compared to those rejected in the previous draft of the Bill.[7]

7 Mark Curtis, 'Mining and Tax in South Africa: Cost and Benefits', February 2009, http://www.curtisresearch.org/pubs.php?filter=Mining

03

INSUFFICIENT TRANSPARENCY & EXTENSIVE USE OF TAX SHELTERS

On some measures, South Africa scores well on transparency, such as the Open Budget Survey Index, which ranks the country second in the world for the transparency and accountability of its budget processes.[8] As regards the financial aspects of mining, however – South Africa's key industry - there are major key failings, particularly concerning the transparency of revenue received and managed by government.

First, South African law does not require mining (or other) companies to provide public details on their profits/losses and tax payments to the government on a country-by-country or project-by-project basis. The presentation of financial information in consolidated accounts that do not disaggregate reporting by country and project makes it impossible for the government and citizens to scrutinise whether companies are avoiding taxes or paying their fair share. This lack of evidence prevents government from identifying and proving where key tax revenue losses are occurring. Some mining companies operating in South Africa, such as BHP Billiton, Rio Tinto, Anglo Gold Ashanti, Newmont Mining and Anglo American do voluntarily disclose some payments to governments but this is not mandatory, is typically not disaggregated by project, and does not include all subsidiary companies or all financial information that is needed by the public.

A global transparency standard for the extractive industries is emerging: In 2010, the US adopted into law a requirement for extractives companies listed on US stock exchanges to publish what they pay to governments as part of their annual reports to the US financial regulator, the Securities and Exchange Commission. In 2013 the European Union also signed into law similar requirements for extractives and forestry companies that covers both listed companies and large, private companies. Canada and Australia have tabled similar legislation, with passage in Canada due shortly. In Canada, the largest mining associations have established a Working Group with civil society groups, the Publish What You Pay Canada coalition, as well as the Natural Resources Governance Institute, and provided joint recommendations to government on disclosure rules.

Second, South Africa does not adequately clamp down on possible aggressive transfer pricing by mining companies – the practice whereby subsidiaries of companies trade with each other, often in tax havens, at prices set by themselves rather than at market prices, to reduce their taxable profits. This allows for tax avoidance on a colossal scale. One recent study suggests that diamond-producing companies in South Africa may be engaged in aggressive transfer pricing by over-valuing import prices and/or under-valuing export prices, in order to reduce taxable income; losses from unpaid corporate income tax are estimated to be around R1 billion a year.[9] The Income Tax Act of 1962 gives the government the power to demand companies trade at 'arm's length' prices (ie, normal market prices). However, the political will to ensure this is often absent, leaving millions of rands of potential revenue uncollected by the Treasury. In addition, companies are not required to provide the authorities with adequate financial information to enable the government to assess whether certain intra company transfers pose a risk of transfer pricing.

Third, the extensive use of tax havens and secrecy jurisdictions by mining companies operating in South Africa increases the

8 See: http://www.southafrica.info/about/democracy/budget-290113.htm #.U3PDg9KSz0o.

9 Sarah Bracking and Khadije Sharife, 'Rough and Polished: A case study of the diamond pricing and valuation system', *LCSV Working Paper Series N.,4*, Leverhulme Centre for the Study of Value, May 2014

risk that they are avoiding paying sufficient taxes in the country. There are a variety of means by which companies can shift their taxable income from higher tax to lower tax jurisdictions when they have subsidiaries in secrecy jurisdictions, notably by making payments from one subsidiary to another for intra-company loans or management fees. Indeed, these subsidiaries can be no more than a "shelf company" or "post box" company with no employees or assets. To take a random example of one company using tax havens: Petra Diamonds, the second largest diamond producer in South Africa, is registered in Bermuda (whose corporate tax rate is 0 per cent), has a group management office domiciled in Jersey (a well-known secrecy jurisdiction)[10] and has a fully-owned holding company linked to its Cullinan mine in South Africa registered in the tax haven of the British Virgin Islands[11].

Fourth, international law, and South African law, does not sufficiently demand that the beneficial owners (ie, the real owners) of companies are revealed, allowing the ultimate owners to remain anonymous to the South African public. International accounting standards are such that a company is regarded as a separate entity from its owner; and that the names of the owners need not appear in company financial reporting. This bipolarity means that companies can own multiple entities that cannot be traced back to them, enabling them to engage in aggressive tax avoidance practices.

Finally, inadequate transparency in the mining sector relates not only to tax avoidance but also to consultation with communities affected by mining. The secretive, confidential nature of some mining contracts does little to protect communities or regard them as legitimate partners in local development. Communities are not only kept in the dark about the specific payments being made to government by mining companies, but they are also often excluded from sufficiently participating in the Social and Labour Plans which companies are obliged to draw up in their project areas, a problem compounded by the fact that South African law does not require the free, prior and informed consent of communities to be secured in mining (or other) projects. The Promotion of Access to Information Act was promulgated to avoid the historically secretive nature of decision-making in South Africa and to promote instead a more transparent, democratic society. However, transparency under the Act is limited to information between government and citizen and it may not be applied to corporate information.

10 'Operating entities', http://www.petradiamonds.com/about-us/group-structure/operating-entities.aspx; *Annual Report 2012*, p.81

11 Petra Diamonds, *Annual Report 2012*, p.118

THE BENEFITS OF TRANSPARENCY

Improving transparency in the mining sector is in the interests of all actors. Overall, it would increase revenues to the government and help promote the 'social contract' between companies, government and citizens. Requiring multinational companies to provide more financial information would enable the government to assess potential tax avoidance schemes and close the loopholes, thus increasing revenues. It would enable Parliament to better scrutinise and oversee the mining sector, and to better hold to account the Executive, which has considerable discretionary powers and a crucial oversight, tax collection and tax administration role in the mining sector; this is necessary to deepen democracy in the country.

Improving financial transparency would also benefit communities affected by mining because it should enable them to assess exactly what companies are providing in each project area. The current lack of transparency can create unrealistic expectations by local populations of the economic benefits of projects, leading to dissatisfaction and protests. Marikana is a case in point. In addition, mining companies sometimes make payments to local governments to provide public services but these can disappear behind the veil of corruption. Transparency in these financial flows can ensure that communities and the broader public are empowered to hold mining companies and local governments to account for these payments and ensure that citizens are better able to demand improved public services.

Neither is greater transparency a danger to companies with nothing to hide. Indeed, the business case is clear. The provision of better financial information can demonstrate companies' contribution to the national budgets and to communities in the project area. The disclosure of project-level payments also acts as an important disincentive to corruption and therefore complements anti-bribery legislation targeting corrupt payments to government officials. For example, many companies operating in South Africa are covered by the U.S. Foreign Corrupt Practices Act (FCPA), which requires companies listed on US stock exchanges to disclose in their annual reports to investors any payment made to a foreign official that may be considered a bribe. The UK and China have adopted anti-briberty statues as well. Companies should see the FCPA requirement and other anti-bribery legislation as an insurance policy, and a rationale to refuse to provide a bribe.

Finally, transparency can benefit investors, who are bound by codes of ethics to invest in entities that respect the rights of host communities and comply with the laws of the land. The tax dodging activities of multinational corporations are a violation of the rights of states, workers and citizens, and improving transparency will enable institutional investors to avoid unethical actors including those likely to be hit with penalties for tax dodging or violation of legislation.

RECOMMENDATIONS

The government has an opportunity – and duty - to ensure that South Africa's natural resources benefit more people more widely and that companies operating in the country are acting according to ethical and legal standards. The government should review and revise a number of tax policies:

- Mining companies should not be allowed to completely write off their capital expenditure in the year of acquisition, and should not be permitted VAT refunds for mining exports.
- The formula used to calculate income tax for gold mines should be reviewed to ensure that companies are not able to reduce their taxable profits by cross-ownership of companies.
- There should be a progressive, flat rate for royalties, set at higher levels for each mineral than currently, instead of the current complex variable tax regime which results in lower revenues to the state.

The government should also take greater steps to increase financial transparency in the mining sector. This partly involves making greater efforts globally to clamp down on tax avoidance, but there are also domestic policies that need to be reformed:

- South Africa should, as the only African country member of the G20 grouping, take a lead in introducing mandatory reporting for mining companies of all payments (taxes, levies, licence fees, rates) to all levels of government and for all projects. This reporting should also extend to: the value and type of assets utilised in generating income; the number and category of employees in each division and the ownership structure of the company. All companies listed on the Johannesburg Stock Exchange and large private companies should be required to report this information.
- To clamp down on transfer pricing, the government should require all mining companies to provide relevant financial information to the tax authorities including the prices at which it trades with all subsidiaries.
- Since mining companies may use aggressive accounting methods to avoid paying tax, the interest on loans from tax havens should be treated as profits. Thus the Controlled Foreign Company regime should be reviewed in line with best practice jurisdictions in order to curtail these activities.
- Companies should be required to publish their beneficial owners and those of subsidiaries and provide a detailed organogram of the company structure as a part of normal reporting.
- In order to improve transparency at project level and community participation in mining projects, officials should be trained and deployed to ensure consultations between companies and communities proceed without coercion or corruption. The principle of free, prior and informed consent should be introduced into South African law.

The Policy Brief is a condensed version of submissions to the Davis Tax Committee on Base Erosion and Profit Shifting and Mining Taxation

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