South African Institute of Tax Professionals

22 May 2017

National Treasury
240 Madiba Street
PRETORIA
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The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
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BY EMAIL: [redacted]

RE: SAIT comments on the Discussion Document on the Review of the Diesel Fuel Tax Refund System

We refer to the Discussion Document on the Review of the Diesel Fuel Tax Refund System. We welcome the opportunity for public comment on the discussion document and for further public consultation during the review process. Our comments below build on our previous submissions to National Treasury and the South African Revenue Service (SARS) in relation to the diesel refund. In preparing our submissions we have obtained inputs from various stakeholders in the farming, fishing and mining sectors.

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THE ETHICS INSTITUTE

A. Background

In the 2001 Budget Review, it was estimated that almost 80 per cent of energy consumption in agriculture, forestry and mining was diesel-based. It was stated that the cost of diesel affects the competitive position of these industries as its use is relatively inelastic due to the nature of the production processes. The diesel refund for the primary production sector was introduced in recognition of the fact that liquid fuels are a primary source of energy in the sector. It was indicated that SARS would audit the diesel refunds regularly and that suppliers of diesel would be required to confirm all diesel sales to those eligible for the refund electronically.

The diesel refund system is aimed at protecting the international competitiveness of local industries and reducing the road-related tax burden of the Road Accident Fund (RAF) levy for certain non-road users. However, some potential diesel refund beneficiaries, who should also benefit, are effectively excluded from the diesel refund system for a variety of reasons. These reasons range from technical reasons, such as not being the holder of a fishing permit or mining right, to practical reasons, such as not being able to satisfy SARS that they are fully compliant with the logbook requirements.

We understand that widespread problems around logbook compliance, fishing permits and mining rights, contracting and joint ventures led over time to more focused diesel refund enforcement drives by SARS.

The scope of the current review is limited to streamlining the administration of the system, ensuring fair access and minimising any potential abuse and perverse incentives. Our comments take these objectives into account.

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B. Our perspective

Many South African taxpayers experience the requirements to qualify for diesel refunds as overly burdensome. Some taxpayers have even decided not to claim the diesel rebates that they should be entitled to as the downside exceed the upside. Ideally, the simplest possible way of ensuring that the diesel refund is only claimed on diesel acquired for use in qualifying primary production activities should be found. A suitable proxy for use should be considered, rather than relying on unnecessarily onerous logbooks and the e-filing of fixed asset registers. For example, the Australian diesel refund system appears to be much less burdensome with taxpayers in certain industries qualifying for the diesel refund without specific lists of qualifying and non-qualifying activities. On-road usage by LDVs are excluded but taxpayers are allowed to claim on litres used by LDVs on site. Logbooks are required to prove consumption rather than consumption for specific purposes.

It is important that the review of the diesel rebate system results in a system that achieves the objectives set out above. This would require that a balance be struck between ease of access to the system by the various big, small and emerging primary producers and controls to prevent and/or detect abuse.

C. Comments for consideration

1. Interim diesel refund amendments

The interim diesel refund amendments, that came into effect on 1 April 2016, are welcomed. One of these amendments was that the list of activities specifically included as own primary production activities in mining was expanded by the addition of mining rehabilitation (item (vv)). Unfortunately, the specific inclusion of mining rehabilitation in the list from 1 April 2016, has not provided certainty regarding the correct treatment of this item prior to that date.

Mining rehabilitation has been a contentious topic in the past, with SARS often arguing that it is not a primary production activity. On the other hand, taxpayers have held the view that mining

rehabilitation activities qualified, even though they were not specifically listed, because they are an integral part of mining, required by law. Although the legislation has been amended to specifically include mining rehabilitation, we find that SARS often only allows the mining rehabilitation activities from 1 April 2016. This continues to cause difficulties for taxpayers where SARS disallows diesel used for mining rehabilitation prior to the amendment, resulting in VAT underpayments, interest and penalties. We recommend that the effect of item (vv) be made retrospective to remove any uncertainty regarding whether or not rehabilitation activities qualified in the past, rather than leaving mining companies exposed to ongoing SARS audits.

2. Separate diesel refund administration

a. Advantages and disadvantages

A stand-alone diesel refund administration is proposed, which would address limitations around intended beneficiaries that cannot claim diesel refunds due to not being VAT registered. These include small and emerging primary producers and joint ventures that do not make taxable supplies. The delinking from the VAT system is generally supported, provided that the new system will not increase the administrative burden on taxpayers.

One of the main reasons for the support for the delinking is that taxpayers are experiencing significant problems arising from the linking between the VAT and diesel refund systems, arising from the way it works in practice. Vendors have to submit diesel refund claims on their VAT returns. The e-filing system automatically calculates a net amount payable by deducting the diesel refund from the VAT liability. However, SARS' account maintenance division often does not apply the same principle and fails to timeously set-off the diesel refund against the VAT liability. This often creates instances where a taxpayer is charged with penalties and interest on VAT as a result of a so-called underpayment of VAT. This is further exacerbated where diesel refunds are later set-off against older VAT liabilities artificially created as a result of the fact that diesel refunds are not set-off against VAT as provided for on the VAT return which creates a continuous cycle of "late payments" for which SARS unduly charges penalties

and interest. Taxpayers have to constantly monitor their accounts so that they can timeously object in order to ensure that the diesel refunds are correctly set-off against the VAT. This creates a significant administrative burden for taxpayers and SARS. Therefore, many large VAT registered taxpayers would prefer the delinking, simply from a pragmatic perspective, to mitigate the risk of VAT "late payments". Ironically, if the SARS systems were adequately integrated, the linking of the diesel refund to the VAT system would have been convenient to many taxpayers.

On the other hand, there is a concern about the impact that there may be on small and emerging operators should the diesel rebate and VAT returns be on different systems with different deadlines and re/payment criteria. Small farmers and fishermen typically sell produce (some vatable) on the local market and are able to deduct the diesel refund from VAT payments. Amending the system could place significant cash flow constraints on these operators if VAT becomes payable in full before the diesel refund is received, and assuming no offset will be permitted.

We recommend that extensive consultation should take place with various operators of different sizes in the various sectors to ensure that the solution, as implemented in practice, meets the policy objectives of the diesel refund system. Simply put, any cash-flow hardship caused by delays in the receipt of the diesel refund will be counter-productive.

b. Implementation

It is critical that the implementation of a new standalone diesel refund system should be done in a seamless way so that taxpayers will timeously receive the diesel refunds that they are entitled to. The separate diesel refund system registration process should be as simple as possible and should be explained clearly, both for new and re-registration. It should be clear how the system will work to avoid delays in the payment of diesel refunds.

The diesel refund system should be efficient. All communication should be available on e-filing including return submissions, statements of account, audit correspondence, etc. However, small and emerging producers should be accommodated.

The legislation should make specific provision for interest on delayed refunds and that such interest should start running automatically on delayed refunds and not only once the taxpayer has demanded payment.

3. Qualifying primary production activities and use

a. In principle support

We understand that the proposal to shift the basis of the diesel refund administration away from the current emphasis on allowed users to qualifying primary production activities is meant to achieve the overarching objective of the diesel refund and simultaneously resolve the identified shortcomings. These shortcomings include that qualifying fishing and mining operations that fall within the scope of the diesel refund system have in some instances been denied refunds where the activities were performed by contractors and joint ventures or the permits/licenses were not timeously issued. This has been criticised as unfair, especially for emerging primary producers. We welcome that these shortcomings are being addressed in the review.

b. Eligible activities

A shift in the basis of the diesel refund administration should be approached with caution to avoid unintended consequences and creating a trap for the unwary. At this stage, there is relative certainty amongst most primary producers of which of their activities qualify for diesel refunds. The definition of "eligible purchases" and the description of "primary production activities" in various industries contained in Part 3 of Schedule 6 to the Customs & Excise Act is relatively well settled. We note that the indicative list in Annexure 1, that is based on the

current allowed activities, will be used as a starting point for further consultation. All deviations from the current list should be comprehensively consulted on.

It appears that some of the interim amendments have inadvertently not been taken into account in the preparation of Annexure 1: Provisional indicative list of eligible activities and use by sector. Given that Annexure 1 will be used as a starting point for the public comment process, the interim amendments should also be incorporated.

Careful consideration should be given to the potential impact of the proposal to limit the delineation of activities to purely primary production, excluding all transport activities beyond the site where primary production occurs as well as any processing activities. In this regard, we note that the current allowed activities are already relatively limited.

c. Exclusion of off-site transport

We are aware that off-site transport could be subject to abuse and that the potential abuse needs to be addressed. However, it should be considered that the exclusion of all off-site transport will affect different sectors differently. Certain sub-sectors in the agricultural sector will be affected disproportionately more by the fact that the transport of farming products to the market or first point of delivery will no longer qualify. For example, vegetable farming where the fresh produce markets are far from the farms and the diesel used in transport is a relatively bigger portion of the total diesel used by the farmer.

Provision should be made to allow an element of off-site transport where primary production takes place at two sites. For example, where ore is transported from an open cast mine (in some cases crossing the public road) to the crushing plant where the mineral is extracted. It appears that item (tt) allowing the transport of ores or other substances containing minerals from the mining site to the nearest railway siding as well as item (uu)(I) locomotives for carriage by rail of minerals or equipment has been left off Annexure 1. This transport should be allowed, at least to the extent that it forms part of the winning of minerals.

d. Exclusion of processing activities

There is a concern with the proposal that all processing activities are to be excluded from the diesel refund system. It appears that processing activities that are incidental to the primary production activities of the agriculture, forestry and mining sectors may also be affected. When considering the current list of specifically included primary production activities of the agriculture, forestry and mining sectors it appears that the intention of the legislator was not to exclude all processing activities. Primary production and processing activities are not mutually exclusive, rather processing often forms part of primary production.

In **farming**, there will be operations that could conceivably be termed "processing", and that as a result could be excluded even though they form part of the primary production activity. For example, a livestock farmer who grows his own feed but must process the raw material into a form suitable for feed to the livestock, such as the de-husking and crushing of mealies. We suggest that processing on the farm of own produce for own consumption should be a qualifying activity.

In **mining**, SARS interpretation of what qualifies as "own primary production" continues to create doubt for taxpayers, especially with regard to processing type activities where SARS wants to draw a line in the sand at a certain point with litres used thereafter not qualifying. For example, in coal mining, some SARS officials have argued that once the coal has been taken out of the ground and stockpiled the further activities are non-qualifying post-recovery or post-mining processes. From the taxpayers' perspective, the further processes including grading and washing of the coal are also part of the primary production process in order to retrieve a saleable product. Therefore, as a result of differences in interpretation between various taxpayers and SARS teams, any list of qualifying activities would not give sufficient certainty, unless Treasury and SARS agrees on the interpretation and unless such a list is exhaustive enough to cater for all circumstances. The current list of qualifying activities could be expanded and fine-tuned to create an exhaustive list. In preparing such an exhaustive list, a thorough understanding of the different types of mining (depending on

the type of mineral and also between above and underground mining) needs to be taken into account.

The definition of "mining" in the Income Tax Act is defined to include every method or process by which any mineral is won from the soil or from any substance or constituent thereof. This definition, as pronounced on by our Courts, should be taken into consideration in determining what is involved in winning a mineral.

In **fishing**, the processing of fish while at sea currently qualify. Excluding all processing would not be justifiable. For example, squid fishers have to be Certified and Licenced "Fish Processing Establishments" in order to export their catch. After catching the squid, they are sorted into different sizes for different markets. They are then frozen on board the vessel. The squid are only saleable once they have been frozen. Diesel is consumed in this process from the same tanks that diesel is consumed for the process of landing the catch. The larger hake trawlers may even gut, fillet and package their catch on board. We recommend that the processing of fish while at sea should continue to qualify.

e. Linking of activities to a physical site

The person that conducts the qualifying primary production activity can claim the refund provided the logbook is linked to the physical site where such operations takes place. The concept appears fair, however practical issues may cause difficulties. For example, a farmer who owns 6 farms under a total of 21 title deeds with bulk storage on two of the farms but diesel used over all the farms. Practical solutions are needed.

f. Linking of activities to the legal sanction

The person that conducts the qualifying primary production activity can claim the refund provided the logbook is linked to the valid fishing permit or mining right, even if such person is not the holder of such legal sanction. Clarification is required on the method of linking to the legal sanction in such a manner that would not put the holder at risk.

g. Shift away from the current qualifying user to qualifying activities

This move to ensure that all producers, operators, contractors and joint ventures that perform qualifying primary production activities will be able to qualify for diesel refunds is welcomed. In addition, allowing contractors to register and claim the diesel refunds themselves could reduce the administrative burden of their clients.

Further consideration should be given to which party would be entitled to the diesel refund in the case of dry contracting, in other words where the contractor uses diesel provided by the client. It should be considered that the terms of the current contract between the client and the contractor would likely have taken into account that the client is entitled to the diesel refund. Perhaps the client should continue to be entitled to the diesel refund as it would have purchased the diesel. Clear guidance should be given on how the client and the contractor together should go about to meet the compliance requirements. For example, whether the client would have to include the contractor's vehicles and equipment in its diesel refund profile; keep a logbook of diesel use in those vehicles; and claim the diesel refund.

4. Administrative enforcement and taxpayer compliance

Many honest taxpayers are currently finding that the diesel rebate compliance requirements and audits are overly burdensome. Significant amounts of management time is tied-up in the process, from logbook maintenance, return submission, queries, audits and dispute resolution. Some large taxpayers have even stopped claiming the diesel refund to which they are entitled. Although we appreciate that SARS needs to audit and enforce the diesel rebate legislation, we respectfully request that National Treasury and SARS work with taxpayer representatives to reduce rather than increase this burden.

a. Diesel refund risk profiling

Placing bulk storage facilities and equipment/vehicles formally on record with SARS would be disproportionately burdensome. SARS could rely on the accounting records and systems of internal controls of the claimants which SARS can audit, where appropriate. Expecting taxpayers to place their bulk storage facilities and diesel using equipment/vehicles on record with SARS is analogous to requiring taxpayers to e-filing their fixed asset registers in real-time in order to support the capital allowances claimed in their income tax returns.

The document also states that claims outside the scope of the beneficiary's current registration profile will be denied. It is not clear whether this means that if a taxpayer acquires a diesel using asset subsequent to registration but before their annual update with SARS, that the rebate cannot be claimed, or that any changes must be updated in real-time. It appears clear that the compliance burden will increase dramatically.

The template for the agreement to be entered in between SARS and claimants needs to be consulted on. There will be an obligation for registrants to update their profile and conclude new agreements annually with SARS. It is not clear why new agreements will be required annually. It is currently being proposed that other customs registrations be renewed every 3 years, for example the importer/exporter registrations.

b. Logbook and recordkeeping obligations

We refer to our attached submissions dated 19 April 2013, 23 February 2016, 6 July 2016 and 24 November 2016 to National Treasury and SARS in which we raised our concerns regarding the onerous requirements to measure use and keep detailed logbooks. We have discussed some of the practical difficulties experienced in farming, fishing and mining of maintaining the "usage logbook" and made certain recommendations in our submission dated 6 July 2016.

In summary, we recommended that:

- From a practical perspective, the diesel refund compliance should as far as possible be focused on financial data as opposed to physical measurement of diesel used.
- Ideally, the diesel refund should become claimable as soon as the diesel has been purchased (with the purpose) to be used for qualifying activities.
- An alternative approach to overcome these difficulties in keeping the prescribed logbooks, would be that a distinction be made between the logbook requirements for vehicles/equipment that are only used for qualifying activities and for multi-purpose vehicles/equipment that are used for qualifying and non-qualifying activities.
- Once diesel has been dispensed into a vessel, vehicle, equipment or underground bowser that is used in a qualifying activity only, the associated diesel should be treated as having been properly "used" as required by the definition of "eligible purchases".
- In the case of taxpayers who are entitled to claim diesel refunds on multi-purpose vehicles (such as bakkies, trucks and SUV's), a different system may be required, unless a *de minimus* exclusion is applied. For this group, logbooks similar to the usage logbook proposed by SARS would be required to prove the split between eligible and ineligible purchases of diesel. In cases where these taxpayers are not able to measure the diesel in the tank at month-end, the diesel refund claim would have to be deferred until the next month.

The onerous logbook requirements remain a significant concern amongst taxpayers as they often make it impossible for valid claimants to satisfy SARS that they meet their burden of proof. Determining that the equipment will be used for a qualifying purpose and that the diesel has been dispensed into it should be a proxy for use. This may require that the bulk storage facilities should have logbooks but that the individual items of equipment/vehicles should not be required to have usage logbooks as it is often totally impractical. The large diesel consuming equipment can often only be used for one purpose which is qualifying and a usage logbook for it would be totally unnecessary. A number of taxpayers have indicated that they would be willing to accept a reduced refund percentage or even forego their diesel

refund on multi-purpose vehicles as long as they would be entitled to the diesel refund on diesel dispensed into qualifying single-purpose vehicles/equipment without having to keep a usage logbook.

Many large diesel users, such as the mines, implement sophisticated logbooks and/or fuel management systems to manage the mine's control over diesel use to ensure that the diesel asset is properly controlled. This is part of their system of controls to prevent financial losses. These systems often include the use of sophisticated and expensive technology such as GPS systems, security keys and fuel pumps that can only be used in large mining vehicles. Most of these logbooks and/or fuel management systems are not designed specifically for diesel refund purposes and need to be adjusted to provide the additional information required to meet the definition/s of "logbooks". This is often expensive.

Very careful consideration should be given to a more flexible approach to allow taxpayers to prove valid use with reference to their (adequate) financial controls and records, whichever format it might take. To expect taxpayers to maintain onerous logbooks purely to support their diesel refund claims is hard to justify. The logbook templates being developed by SARS in consultation with industry could serve as guidelines of the kind of information required but should not be a prerequisite. SARS accreditation of the taxpayer's logbooks or alternative records would be preferred.

c. Treatment of small and emerging primary producers

The possibility is raised of a diesel refund sectoral threshold being implemented. We support that special treatment will be considered for small and emerging producers that fall below the threshold. We support that the options of collective registration as a cooperative and a formula-based methodology should be explored. Alternatively, producers could be allowed an option whether or not to participate in the diesel refund system. Small producers could then have six monthly tax periods, similar to the VAT system.

We welcome the opportunity to comment on the discussion document and look forward to future engagements during the consultation process.

Yours sincerely

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Enclosures: Submissions to National Treasury and/or SARS dated:

- 19 April 2013
- 23 February 2016
- 6 July 2016
- 24 November 2016

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