Tax issues for Independent Power Producers

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Glossary of terms

COD	Commercial Operations Date
DoE	Department of Energy
DTA	double taxation agreement
FDI	foreign direct investment
IPP	Independent Power Producer
PPA	Power Purchase Agreement
REIPPPP	Renewable Energy Independent Power Producer Procurement Programme
SARS	South African Revenue Service
SED/ED	Socio-Economic Development / Enterprise Development

Background

The South African energy industry has been transformed by the DoE's REIPPPP. Renewable energy now costs 40% less than new coal and nuclear power.[1] Investment into South Africa's renewable energy industry accounted for 84% of all FDI in 2014.[2] However, the industry has been a source of controversy in recent years, which has put FDI in the sector on hold.[3] This was mainly due to Eskom and the Energy Ministry delaying the signing of new PPAs[4] due to an apparent preference to procure nuclear power. However, the Western Cape High Court has recently stopped the nuclear deal in its tracks[5], and Finance Minister Malusi Gigaba has said that government remains committed to its REIPPPP[6].

In addition to political hurdles, IPPs face unique tax challenges in South Africa. Interestingly, given the size of the green energy industry in South Africa, there is – other than specific asset allowances – no tax legislation dealing with IPPs specifically. This creates complexities since existing tax legislation, which was not written with this unique industry in mind, has to be applied to IPPs. Often there is not clarity on how the legislation should be applied to the IPPs, nor any guidance in the form of case law or interpretation notes issued by SARS. It is worth noting that, while most of the IPPs in South Africa are currently still trading with huge assessed tax losses, we expect significant audit activity from SARS in this industry once the Round 1 IPPs start moving into taxable income positions.

This publication highlights some of the major tax considerations for IPPs and their investors.

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[1]Martin, B. (2017, April). SA's IPP Programme a Badge of Excellence. Retrieved from http://www.fin24.com/Opinion/sas-ipp-programme-a-badge-of-excellence-20170409
[2]Le Cordeur, M. (2017, February). SONA: Zuma Commits SA to Renewable Energy. Retrieved from http://www.fin24.com/Economy/Eskom/sona-zuma-commits-sa-to-renewable-energy-20170209
[3]Ibid
[4]Omarjee, L. (2017, April). Gigaba Govt Committed to Renewable Power Despite Eskom's Cost Claims. Retrieved from http://www.fin24.com/Economy/gigaba-govt-committed-to-renewable-power-despite-eskoms-cost-claims-20170419
[5]Van Rensburg, D. (2017, April). Nuclear Deal Brought to its Knees. Retrieved from http://www.fin24.com/Economy/nuclear-deal-brought-to-its-knees-20170430-3
[6]Le Cordeur, M. (2017, February). SONA: Zuma Commits SA to Renewable Energy. Retrieved from http://www.fin24.com/Economy/Eskom/sona-zuma-commits-sa-to-renewable-energy-20170209

Pre-trade expenditure and revenue

Potential IPPs incur significant upfront costs in relation to setting up company structures, administration, professional advice and feasibility studies. They may also be charged management fees by investors or other sponsors. Once an IPP has reached financial close and signed a PPA with Eskom, the IPP then incurs huge capital costs to construct its power plant and to connect the plant to Eskom's grid.

In general terms, for expenditure to be deductible for tax purpose, it is a requirement that the taxpayer is trading in terms of the Income Tax Act. Conversely, income is taxable regardless of whether the taxpayer is trading or not. It is therefore important to establish at what point in time the IPP commences trading. In practice IPPs often take the view that trade commences once financial close was reached and the PPA was signed and, from that date, expenses are claimed as a tax deduction and a tax loss is created. However, in our view this is likely to be successfully challenged by SARS, who would argue that trade only commences when generation of electricity for sale to Eskom starts.

Pre-trade expenditure that was incurred but could not be deducted due to trade not yet having commenced, may however be carried forward and deducted in full, once trade commenced and all tax losses have been fully utilised. For example, costs in relation to salaries, security costs, bank charges, audit fees, tax compliance fees and interest can be carried forward and deducted for tax purposes at that time, as they are not of a capital nature. As a result of the carry-forward of qualifying pre-trade expenditure, a deferred tax asset is likely to be recognised and carried forward (usually together with the deferred tax asset in respect of an assessed tax loss) for a number of years, until the assessed loss has been fully utilised.

Development fees are generally payable by the IPP upon commencement of the project, or the IPP may be obliged to pay a success fee to investors, other sponsors or professional advisors on financial close. Costs such as these are incurred to set up the IPP's income-earning structure and are capital in nature. As a result, they do not qualify for any tax deduction.

Costs to construct the IPP's plant and connect it to the grid may be deductible through various capital allowances, but only once the asset is operational and has been brought into use. There are a number of requirements that must be met to qualify for these allowances, and each asset must be analysed individually in order to ascertain whether an allowance is claimable.

Capital allowances in respect of assets

There are a number of capital allowances available specifically to IPPs. With effect from 1 April 2016, a 100% deduction of costs incurred in respect of roads and fences used by IPPs is claimable.[7]

The Income Tax Act provides capital allowances in respect of assets used in the production of renewable energy[8], cables used to transmit electricity[9], and buildings used in commercial operations[10]. In order to qualify for these allowances, the taxpayer must satisfy a number of requirements, including ownership of the assets in question. In terms of common law, permanent works accede to the land on which they are constructed. This means that IPPs that construct permanent assets (such as buildings and transmission lines) on leased land will not have legal ownership thereof.

There is a provision for IPPs in the Income Tax Act[11] that, in certain circumstances, can deem the IPP to own assets it constructs on land in respect of which it has a "right of use". In these cases, the IPP will meet the ownership requirement in respect of the relevant capital allowances. In our experience, however, these provisions are generally not as beneficial to the IPPs as one may believe, because usually the type of permanent works that would benefit from deemed ownership, such as substation buildings or transmission lines, are legally owned by Eskom and are also constructed on land over which Eskom holds a servitude (ie Eskom holds the "right of use" of the land).

IPPs are usually required to construct and/or pay for certain "connection works" in order to connect to the grid and transfer the electricity produced from their facilities to Eskom's substations. It is important to establish which assets are owned by the IPP, and which are owned by Eskom. Where Eskom has ownership of the grid connection assets, there are usually no capital allowances available to the IPPs, despite the fact that the IPP incurred the costs to construct such assets.

Foundations and supporting structures, and various costs directly associated with acquiring/constructing the assets, may be included in the cost of the assets for purposes of calculating the capital allowances, provided they meet certain requirements. It is therefore essential for IPPs to componentise their tax asset registers in sufficient detail, so that the maximum benefit can be derived from the deductions and capital allowances available to them. Where uncertainty exists as to which assets are included in the base amount on which an allowance is claimed, SARS will be within its right to disallow all or a part of the allowance because of a lack of sufficient supporting information.

[7] Section 12U of the Income Tax Act
[8] Section 12B of the Income Tax Act
[9] Section 12D of the Income Tax Act
[10] Section 13quin of the Income Tax Act
[11] Section 12N of the Income Tax Act

Costs associated with funding

Equity – dividends

As of 22 February 2017, dividends withholding tax is charged at 20% (up to 21 February 2017 the rate was 15%). South African resident company shareholders are exempt from dividends withholding tax. Where a DTA is in place between South Africa and the jurisdiction in which the shareholder is tax resident, the withholding tax rate may be reduced for dividends paid to such foreign shareholder, subject to the required written declarations being in place. It is important to note that, should the IPP not have the required written declarations in place at the time the dividends withholding tax is due to SARS, it would not be allowed to withhold the tax at a reduced rate. Should the IPP do so in contravention of the provisions of the Income Tax Act, it will be liable for interest and penalties in respect of the amount of dividends withholding tax that was not withheld.

Debt – interest and related finance charges

Related finance charges

- Commitment fees are generally included in the definition of "interest" for tax purposes and are therefore usually deductible.
- Advisory fees in respect of compiling financial models, performing feasibility studies, and assistance in obtaining financing for construction (such as raising fees and guarantee fees), are generally capital in nature and therefore not deductible for tax purposes.

Interest

- Interest expenditure is deductible for income tax purposes by the IPP, subject to certain limitation rules:
- There is limited deductibility of interest paid to a creditor that has a 'controlling relationship' over the debtor, where the creditor is not subject to South African tax on the interest received.
- Interest paid to a cross-border related party in excess of a market-related amount, may be deemed to be a dividend in specie In this case, no deduction for the interest may be claimed, and a liability for payment of dividends withholding tax will arise in the hands of the IPP (plus interest and penalties).
- If interest is not incurred in the production of income, it will not be deductible. For example, if interest is incurred on a loan used to acquire shares, these shares will produce exempt income in the form of dividends. The interest on such a loan will therefore, subject to limited exceptions, not be deductible.
- Interest withholding tax is charged at 15% on interest paid (or interest which is due and payable) from a source in South Africa for the benefit of foreign persons. The Income Tax Act provides for certain exemptions from the withholding tax, as well as the reduction of the rate, in terms of the application of an applicable DTA, subject to obtaining a written declaration. Again, as is the case for dividends withholding tax, should the IPP not have the required written declarations in place at the time the withholding tax is due to SARS, it would not be allowed to withhold the tax at a reduced rate. Should the IPP do so in contravention of the provisions of the Income Tax Act, it will be liable for interest and penalties in respect of the amount of the interest withholding tax that was not withheld.

Hybrid debt instruments

A hybrid debt instrument would arise in the case of an instrument purporting to be debt in form, but which is equity in substance, and is commonly seen in IPPs' shareholder loans. If a loan agreement is in substance a hybrid debt instrument, or results in "hybrid interest" (a defined term), this will result in part or all of the interest paid being deemed to be a dividend in specie, on which dividends withholding tax is payable by the IPP (plus interest and penalties).

Swap agreements

Many of the investor loans to IPPs contain terms and conditions requiring the IPP to hedge various market risks, such as interest rate and foreign exchange risks. This is traditionally done through the use of swaps.

Gains and losses arising on interest rate swaps are taxable or deductible and calculated, for tax purposes, on a day-to-day basis.

There are two possible interpretations as to the treatment of cross currency swap arrangements in respect of foreign currency-denominated loans, depending on how the swap arrangement is structured. In certain instances, net amounts payable or receivable in terms of the swap arrangement are taxable or deductible as and when accrued or incurred. In most cases, however, in our experience, the structure of the swap arrangement results in a foreign currency denominated debt arising for tax purposes, on which deductible foreign exchange losses or taxable foreign exchange gains have to be calculated in accordance with the provisions of the Income Tax Act. It is therefore essential to thoroughly analyse loan agreements and related swap arrangements to ascertain the resulting tax consequences. The tax consequences differ from the way the derivatives were recognised for accounting purposes, and adjustments to the tax calculation are necessary in order to reflect the correct tax position.

Socio-Economic and Enterprise Development expenditure

IPPs are typically required, in terms of their implementation agreements with the DoE, to make contributions to SED/ED initiatives. In general, such contributions would be deductible expenditure for tax purposes. However, should the IPP construct or acquire assets (such as a school or clinic) and retain ownership thereof, a deduction may be disallowed. In this case, however, a capital allowance is usually claimable.

Contact us

If you would like to find out how these considerations impact your particular situation, please contact us.

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