

# Public Private Partnership's infrastructure is trading stock

By Johan Kotze

Public Private Partnerships (PPP) are some of the mechanisms whereby a government renders services to its citizens. There are a host of different PPPs and it seems that the common denominators among PPPs are the need for infrastructure and a lack of funds on the part of the State.

PPPs that the normal man encounters on a daily basis are toll roads, which the user pays a toll for. There are a number of PPPs in South Africa, among other two prisons, which the normal man hopefully does not encounter.

A PPP typically involves the effecting of improvements on land belonging to the State by a special purpose vehicle (SPV). The reason for a SPV seems to be that the State wishes to look at one entity for the performance of the obligations under a PPP.

In a recent case in the Tax Court, held in Pretoria, (case no 12576) Judge RD. Claassen had to consider and rule on the tax implications of a prison PPP.

The main question was whether the costs the SPV incurred in respect of building the prison for the State, on State land, are capital or revenue in nature.

The SPV entered into an agreement with the Government of South Africa, represented by the Department of Correctional Services (DCS), for the design, construction, finance, operation and maintenance of a maximum security prison. The duration of the contract was 25 years.

The concession agreement provide that DCS wishe to provide the public with cost-efficient effective prison services, and to provide Prisoners with proper care, treatment, rehabilitation and reformation in accordance with the provisions of the Correctional Services Act; and pursuant hereto, DCS has requested the SPV, who has agreed to provide the services, being the design, construction, finance, operation and maintenance.

The years of assessment applicable to the dispute were 2002, 2003 and 2004 and did not had to deal with any specific PPP provision in the Income Tax Act (the Act).

The actual costs incurred by the SPV in constructing the prison and bringing it into a ready-to-use condition were R511 million, which included the building, utensils, finance charges and further costs. The SPV contended that the R511 million is deductible in terms of section 11(a) of the Act, but that it is deemed to be trading stock in terms of section 22(2A) of the Act.

Section 11(a) provides that *'[for] the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature'*.

Section 22(2A)(a) provides that *'[where] any person carries on any construction, building, engineering or other trade in the course of which improvements are effected by him to fixed property owned by any other person, any such improvements effected by him and any materials delivered by him to such fixed property which are no longer owned by him shall, until the contract under which such improvements are effected has been completed, be deemed for the purposes of this section to be trading stock held and not disposed of by him'*.

The words '*or other trade*' in section 22(2A)(a) mean that the subsection does not apply only if the taxpayer carries on a construction, building or engineering trade. It also applies to any '*other trade*' as long as improvements are effected in the course of such trade to fixed property owned by any other person.

Judge Claassen accepted the interaction between section 11(a) and section 22(2A) and that section 22(2A) deems almost all expenses, if they fall within a contract as described in section 22(2A), to be revenue in nature.

Judge Claassen held that the prison falls squarely within the description / ambit of section 22(2A) for the following reasons:

- The SPV, although specially established for the concession agreement, entailed various trades, i.e. construction of a prison, providing accommodation, custodial and security services, catering, and other services
- The concession clearly stipulates that the land at all times remained the property of the State
- The useful building on the land cannot be anything but an improvement
- Construction materials, like cement, bricks, etc. accede to the land, but materials may also relate to utensils, which are used to operate the prison. It is a term of the contract that the whole prison, together with all utensils, becomes the property of the State on conclusion of the contract.

SARS argued that as a SPV the taxpayer never 'owned' any of the material brought onto the site for the purposes of constructing a prison therefore section 22(2A) is not applicable. It was submitted that because the SPV only operated through sub-contractors all materials brought onto site never became the ownership of the SPV, but went directly to the State. Judge Claassen rejected this argument on the basis that delivery can take many forms. It does not have to happen directly from vendor to buyer.

SARS even argued that because the SPV operated via sub-contractors it was itself not trading as such. Judge Claassen held that there was no merit in this argument, because the principle in our law is that: he who acts through agents, acts himself (*Qui facit per alium, facit per se*). Therefore, all the definitions regarding trader and trading stock must be viewed in the light that they apply to the SPV.

Judge Claassen then held that although the SPV falls squarely within of section 22(2A), as stated above, the true intention of section 22(2A) is to override section 11(a). Even though an expense may usually be capital in nature, it becomes revenue when it is trading stock via section 22(2A).

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