Like it or not, SARS; PPP's infrastructure may be trading stock

By Johan Kotze

The mini-Budget has heightened focus on Public Private Partnerships (PPPs); it is a focus that raises the issue of how, when and why PPPs incur tax. In particular, the age-old capital-versus-revenue argument has resurfaced in a PPP context.

In spite of the host of different PPPs, their common denominator is the State's need for infrastructure, for which there is usually insufficient funding.

PPPs most commonly encountered are toll roads. Prisons, too, are the subject of PPPs – though, hopefully, not as commonly encountered as toll roads.

A PPP typically involves improvements by a special purpose vehicle (SPV) to land belonging to the State. The State seemingly favours the SPV route because it wishes to interact with a single entity for the performance of the PPP's obligations.

In a recent Tax Court case in Pretoria, Judge RD Claassen considered the tax implications of a prison PPP: the main question being whether the costs the SPV-taxpayer incurred in building a prison for the State, on State land, were capital or revenue in nature.

DCS wished to provide the public with cost-efficient, effective prison services, and to provide prisoners with proper care, treatment, rehabilitation and reformation. DCS then entered into a 25-year agreement, in terms of which the SPV-taxpayer agreed to provide the relevant design, construction, finance, operation and maintenance for a maximum security prison.

The costs incurred by the SPV-taxpayer in bringing the prison into a ready-to-use condition were R511 million, which included the building, utensils, finance charges and further costs. The SPV-taxpayer contended that the R511 million was deductible in terms of section 11(a) of the Act, read with the deeming trading stock provision of section 22(2A).

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) means that it did not only apply to construction, building or engineering trades. It also applicable to '*any other trade*' as long as improvements were effected to fixed property owned by any other person in the course of the taxpayer's trade.

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

The Judge held that the prison fell squarely within the description and ambit of section 22(2A) because the SPV-taxpayer, although specifically established for the concession agreement, entailed various trades, among them the construction of a prison, and the concession clearly stipulated that the land at all times remained the property of the State.

SARS argued that in an SPV context, the SPV-taxpayer never 'owned' any of the material brought onto the site for purposes of constructing the prison and that because the SPV-taxpayer only operated through sub-contractors, all materials brought onto site had never been owned by the SPV-taxpayer but went directly to the State.

Judge Claassen rejected these argument on the basis that delivery could take many forms and were not restricted to delivery directly from vendor to buyer.

He held that section 22(2A)'s true intention was to override section 11(a). In short, even though an expense might usually be capital in nature, it became revenue when it was trading stock via section 22(2A).

Interesting to see what is going to happen on appeal.

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