

**(REPORTABLE)**

**(Currently on appeal to SCA)**

**IN THE TAX COURT OF SOUTH AFRICA  
(HELD AT PRETORIA)**

**CASE NO: 12576**

In the matter between:

**A (PTY) LTD**

Appellant

and

**THE COMMISSIONER FOR THE SOUTH AFRICAN  
REVENUE SERVICE**

Respondent

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**JUDGMENT**

**Delivered on: 21 October 2010**

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**R D CLAASSEN J**

1.

Two main questions arise for determination in this case:

- 1.1 Are the costs to the Appellant for building a prison for the State (Department of Correctional Services “DCS”) on State land and thereafter running and maintaining it for 25 years

before handing it back to the State, expenditure of a capital or a revenue nature?

- 1.2 Similarly, are various financial expenditures of capital or revenue nature?

2.

The factual background to this case was succinctly (although not necessarily briefly) set out by the Respondent in its Statement of Grounds of Assessments. They were not disputed and it is convenient to repeat them here. (The issue of prescription which was argued *in limine* have already been decided and I do not intend repeating it here):

- “1. *The Appellant is A (Pty) Ltd, a company with limited liability, which is duly registered and incorporated according to the laws of the Republic of South Africa.*
  
2. *The Appellant is a joint venture between K Consortium (Pty) Ltd (“K”) and G Group. That is, K and the G Group are the ultimate equity owners of the Appellant. Whilst K is a South African company, G Group is an American based corporation*

*specialising in the operation of correctional, detention and health facilities throughout the world.*

3. *The Respondent is the Commissioner for the South African Revenue Service.*

**B. MATERIAL FACTS**

4. *On 3 August 2000, the Appellant entered into an agreement with the Government of the Republic of South Africa (“the Government”), represented by the Department of Correctional Services (“the Department”), for the design, construction, operation and maintenance of a maximum security prison at T Town (“the concession contract”). The duration of the contract is 25 years (twenty five) years.*
5. *The preamble to the concession contract reads as follows:*

*‘Whereas:*

- 5.1 *The Department wishes to provide the public with cost-efficient effective prison services, and to provide Prisoners with a proper care, treatment, rehabilitation and reformation in accordance with the provisions of*

*the Correctional Services Acts, No. 8 of 1959 and No. 111 of 1998;*

*5.2 Pursuant thereto, the Department has requested, and the contractor has agreed to provide, the services on the terms and conditions set out herein.’ [In the concession contract the Appellant is referred to as the ‘contractor’]*

*6. Clause 13.1 of the concession contract stipulates that ‘the Contractor shall design and construct the prison and the road subject to and in accordance with the terms of Schedule A and Part 1 of schedule B. Schedule A of the concession contract deals with the Design and Construction Specifications and Schedule B deals with the Equipment.*

*7. Clause 11 of the concession contract stipulates, inter alia, as follows:*

*7.1 The land upon which the contractor shall provide the prison shall be the land marked upon the diagram attached hereto as Schedule L. The Department shall give full an unencumbered access to and possession of*

*the site to the contractor from the effective date to the expiry of the contract term. (Clause 11.1).*

7.2 *The contractor shall have the right of occupation of the site from effective date until the expiry of the contract term without undue interference by any third party and shall have no title to, or ownership interest in, or liens, or leasehold rights or any other rights in the land on which the prison is or is to be constructed pursuant to the contract. The State shall at all times remain the owner of the land. (Clause 11.2)*

7.3 *At the end of the contract term or at such earlier time as may be provided herein, the contractor shall hand over the site to the Department free of charges, liens, claims or encumbrances whatsoever, and free of liabilities except for those in respect of which the Department has given its written approval.*

8. *Clause 14 of the concession contract stipulates, inter alia, that:*

- 8.1 *Prior to the contractual opening date, the contractor shall supply and install at the prison all the fixtures, fittings, furnishings, and other equipment specified as being required in the prison prior to the contractual opening date in Part 1 of Schedule B. All equipment, referred to in Part 1 of Schedule B, shall be the property of the Contractor and such equipment shall be in good and serviceable condition. (Clause 14.1(a)).*
- 8.2 *At the end of the contract term or upon early termination, ownership in such fixtures, fittings, furnishings and other equipment referred to in Clause 14.1 (including replacement property or equipment) or which is otherwise used or present in the prison or on site (other than personal possessions of staff or prisoners) shall pass to the Department by delivery and the contractor shall use all reasonable endeavours to procure that the benefit of all guarantees, warranties, documentation and service agreements relating to the said fixtures, fittings, furniture, movable property, and other equipment is assigned to the Department (Clause 14.2).*

9. *The agreement embodied in the concession contract qualifies as a 'public private partnership' as defined in Regulation 16 of the Treasury Regulations.*
  
10. *For purposes of financing the construction of the prison and the performance of other obligations in terms of the contract, the Appellant entered into a lending agreement with the BOE Merchant Bank and First Rand Bank ('the lenders'), the terms of which are recorded in the 'Common Terms Agreement' and in the 'specific facility agreements'.*
  
11. *The lending arrangement in terms of the Common Terms Agreement is structured, essentially, as follows:*
  - 11.1 *Tranche A Base Facility Agreement in terms of which the financiers advanced to the Appellant fixed rate loan facilities for a maximum of aggregate principal amount of R284 million;*
  
  - 11.2 *Tranche B Base Facility Agreement in terms of which the financiers advanced to the Appellant fixed rate loan facilities for a maximum of aggregate principal amount of R70 million;*

11.3 *Tranche A Standby Facility Agreement in terms of which the financiers advanced to the Appellant standby loan facilities for a maximum of aggregate principal amount of R24 million; and*

11.4 *Tranche B Standby Facility Agreement in terms of which the financiers advanced to the Appellant standby loan facilities for a maximum of aggregate principal amount of R6 million.*

(The facilities in 11.3 and 11.4 were not utilized).

12. *As security for the funds advanced to the Appellant, the Lenders required guarantees which were to be provided by the Government and the shareholders of the Appellant.*

13. *The Government guaranteed 80% of the lender liabilities and the remaining 20% of the lenders' liabilities was to be guaranteed by the shareholders of the Appellant, equally.*

14. *This 80-20 split in the guarantees resulted in the loan facility of initially R354 million also being structured in an 80-20 split*



*of R284 million (tranche A guaranteed by Government) and R70 million (tranche B guaranteed by the shareholders).*

15. *The G Group's share of the guarantee was provided by W Corporation ("W USA"), a US company and a member of the G Group. In terms of a Guarantee and Put Agreement, W USA bound itself as a principal debtor to pay the Lenders all the amounts payable by the Appellant in terms of Tranche B. [Clause 4 of the Guarantee and Put Agreement].*
  
16. *In terms of Clause 18 of the Guarantee and Put Agreement, the Appellant is required to pay W USA a 'guarantee fee'.*
  
17. *As K was unable to provide the guarantee in the same fashion as the G Group, instead of providing the guarantee, it advanced a loan to the Appellant equivalent to the liability guaranteed by W USA.*
  
18. *As a condition for the Lenders providing the funds to the Appellant, the shareholders of the Appellant had to enter into a Sponsorship Agreement in terms of which the shareholders undertook, inter alia:*

- 18.1 *to maintain control of the Appellant during the duration of the Concession Contract;*
- 18.2 *not to reduce their individual shareholding in the Appellant;*
- 18.3 *to subordinate any liabilities owed by the Appellant to the shareholders to the Appellant's liabilities to the Lenders.*
19. *Clause 5.7.1 of the Sponsorship Agreement provides that in consideration for K agreeing to become a lender, the Appellant has agreed to pay K the "Introduction Fee".*
20. *African Merchant Bank ('AMB') was the financial advisor to the Appellant in respect of the project. In consideration for the services rendered by AMB in this regard, the Appellant undertook to pay AMB a financial advisory fee of R6,209,274.*
21. *The Appellant also agreed to pay AMB a margin fee if AMB managed to negotiate the Tranche A base facility with the lenders at a margin less than 275 basis points. As the margin that was finally agreed with the lenders was 250 basis*

*points, the Appellant became liable to pay AMB the margin fee of R2, 545,077.*

22. *Clause 15 of the Tranche B a Base Facility Agreement provided that the Appellant shall pay to each Tranche A Lender a commitment fee in proportion to its Tranche A Commitment, which shall be calculated as a percentage of the total Tranche A commitments.*

23. *In terms of Clause 27.1.2 of the Common Terms Agreement, the Appellant agreed to pay an initial fee of R750.000 (excluding VAT) to each of the lenders on financial close.*

24. *During tendering stage, in order to comply with requirements of the tender, AMB was requested to provide the necessary guarantee for the Appellant's tender for the concession contract. As a consideration for providing such a guarantee, a bid guarantee fee was payable in the sum of R77, 333.*

25. *For convenience, the following fees referred to above, are collectively referred to as 'the raising fees:*

- 25.1 The financial advisory fee referred to in paragraph 20;
- 25.2 The margin fee referred to in paragraph 21;
- 25.3 The commitment fee referred to in paragraph 22;
- 25.4 The initial fee referred to in paragraph 23; and
- 25.5 The bid guarantee fee referred to in paragraph 24.
26. As the loan facilities obtained by the Appellant were interest-bearing, the Appellant incurs interest expenses on the outstanding amounts of the loan facilities.
27. The Appellant also incurred the following legal fees in connection with the project:

<b>Description of legal service rendered</b>	<b>2003</b>	<b>2004</b>
Deneys Reitz – Merger of WCC & Group 4	8,500	
Edward Nathan – Cancellation of lending facility	1,750	
Edward Nathan – Negotiation on existing contract	68,306	
Edward Nathan – Opinion on sub- contractors	32,200	
Edward Nathan – Opinion on repayment of loan		10,000
Edward Nathan – Opinion on accrual		10,000

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*facility management*

*Edward Nathan – Advice on sale of debt  
by K* 10,000

*Edward Nathan – Advice on change of  
control of K* 10,000

*Reversal of a fee* (1,253)

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**TOTAL** 110,556 38,747

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28. *The Appellant incurred administration fees payable to Rand Merchant Bank for the administration of the facilities and the commitment of the standby facility.*

29. *The actual cost incurred by the Appellant in constructing the prison and bringing it into a ready-to-use condition are as follows:*

*Buildings* R 228,821,436

*Utensils* R 95,558,256

*Introduction fees* R 47,484,608

*Guarantee fees* R 16,638,464

*Raising fees* R 12,527,232

*Further costs* R 64,346,528

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**TOTAL** R 464,376,824

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30. *As a consideration to the Appellant for performing its obligations under the concession contract, clause 38.1 stipulates that the Department shall pay to the contractor the 'contract fee' which shall accrue from day to day as payable in accordance with the provisions of 'Schedule E'.*

30.1 *'Contract fee' is defined in the concession contract as "a fee payable under clause 38 by the Department to the contractor for the performance of its obligations under the concession contract, including any amounts payable in respect of the prisoner escort service".*

30.2 *Paragraph 1 of Schedule E to the concession contract reads as follows: "The contract fee is based on the daily available prisoner places. This fee split into two component parts, the fixed component and the indexed component for each year"*

30.3 *Paragraph 2 of Schedule E to the concession contract reads as follows: 'Subject to Clauses 9 (Changes to Services required) and 39 (Variation of Price), the fixed component shall be R [to be determined at the fixing of the rate pursuant to the Finance Direct Agreement and*

*the Common Terms Agreement] per Available Prisoner Place per Day as at 1 January 1998 (the 'Base Fixed Component'), escalated by the Consumer Price Index between 1 January 1998 and the Contractual Opening Date by using the following formula....'*

30.4 *Paragraph 3 of Schedule E to the concession contract reads as follows: 'Subject to Clauses 9 (Changes to Service Required) and 39 (Variation of Price), the indexed component shall be R64.09 (VAT inclusive) per Available Prisoner Place per Day as at 1 January 1998 (the 'Base Indexed Component'), escalated by the Consumer Price Index between 1 January 1998 and the Contractual Opening Date by using the following formula ...'*

31. *The Appellant sub-contracted its operational obligations to certain sub-contractors as follows:*

31.1 *South African Custodial Management (Pty) Ltd was sub-contracted to provide the security, administration and overall management including utilities and insurance;*

31.2 *K Corrections Management (Pty) Ltd was sub-contracted to provide routine management, inmate programs and purchasing services;*

31.3 *Royal Food Correctional Services (Pty) Ltd was sub-contracted to provide food services.*

32. *On 5 June 2006, the Appellant wrote to the Respondent requesting a reduced assessment in terms of Section 79A on the basis that certain expenses that qualified for deduction had not been claimed as deductions in its tax returns for the 2001 to 2004 years of assessment.*

33. *On 8 November 2006, in a further letter regarding the request for reduced assessment, the Appellant requested that fixed portion of the contract fee receivable by it from the Department be excluded from gross income as constituting a capital receipt. This, it was argued, was in accordance with the true nature of the concession contract which effectively entailed the Appellant, by building the prison on the Department's land, advancing a loan to the Department. It is*



*this loan that the fixed portion of the contract fee seeks to repay.*

34. *On 16 February 2007, in a further letter regarding the request for reduced assessment, the Appellant argued that it must be taxed as a construction contractor on the basis that the concession contract provides for a typical construction contractor scenario: building a prison on the Department's land; supplying and installing all the fixtures, fittings, furniture and other equipment ('construction costs'). On this basis, the Appellant sought to deduct the construction costs in terms of section 11(a) and treating them as trading stock in terms of section 22(2A) of the Income Tax Act 58 of 1962.*

35. *Pursuant to its disagreement with the representations made by the Appellant in the letters referred to above as well as in meetings held to discuss this matter, the Respondent raised revised assessments for the 2003 and the 2004 years of assessment disallowing the following expenses on the basis that they are of a capital nature and therefore non-deductible:*

35.1 *Prison building costs;*

35.2 *Utensils cost;*

- 35.3 *Guarantee fee;*
- 35.4 *Introduction fee;*
- 35.5 *Consultant's fees;*
- 35.6 *Legal fees;*
- 35.7 *Raising fees; and*
- 35.8 *Administration fees*

36. *In the revised assessment, the Respondent also disallowed certain portions of interest on the basis that it relates to exempt income.*

37. *On 19 September 2007, the Appellant objected to the revised assessment for the 2003 and the 2004 years of assessment as well as the 2002 assessment."*

3.

For ease of reference the following relevant parts of sections of the Income Tax Act, No. 58 of 1962 are set out as well as Section 103 (1) of The Correctional Services Act, No. 111 of 1998.

*"INCOME TAX ACT Sections*

1 (DEFINITIONS)

**“trade”** includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any other property which is of a similar nature;

**“trading stock”** includes—

(a) anything—

(i) produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by him or on his behalf, or

[Sub-para. (i) substituted by s. 17 (1) (e) of Act No. 60 of 2001.]

*Wording of Sections*

(ii) the proceeds from the disposal of which forms or will form part of his gross income, otherwise than in terms of paragraph (j) or (m) of the definition of “gross income”, or as a recovery or recoupment contemplated in section 8 (4) which is included in gross income in terms of paragraph (n) of that definition; or

[Sub-para. (ii) substituted by s. 6 (1) (t) of Act No. 74 of 2002 deemed to have come into operation on 19 July, 2000.]

*Wording of Sections*

(b) any consumable stores and spare parts acquired by him to be used or consumed in the course of his trade,

but does not include a foreign currency option contract and a forward exchange contract as defined in section 24I (1);

**11. General deductions allowed in determination of taxable income.**—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—

**(a)** expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

**(g)** an allowance in respect of any expenditure actually incurred by the taxpayer, in pursuance of an obligation to effect improvements on land or to buildings, incurred under an agreement whereby the right of use or occupation of the land or buildings is granted by any other person, where the land or buildings are used or occupied for the production of income or income is derived therefrom: Provided that—

**(vi)** the provisions of this paragraph shall not apply in relation to any such expenditure incurred under an agreement concluded on or after 1 July 1983, if the value of such improvements or the amount to be expended on such improvements, as contemplated in paragraph (h) of the definition of “gross income” in section 1, does not for the purposes of this Act constitute income of the person to whom the right to have such improvements effected has accrued, unless the expenditure was incurred pursuant to an obligation to effect improvements in terms of a Public Private Partnership;

**(x)** Any amendments which in terms of any other provision in this part are allowed to be deducted from the income of the tax payer;

**22. Amounts to be taken into account in respect of values of trading stocks.**— **(1)** The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held

*and not disposed of by him at the end of such year of assessment, shall be—*

*(a) in the case of trading stock other than trading stock contemplated in paragraph (b), the cost price to such person of such trading stock, less such amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, not being shares held by any company in any other company, has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner; and*

*(b) in the case of any trading stock which consists of any instrument, interest rate agreement or option contract in respect of which a company has made an election which has taken effect as contemplated in section 24J (9), the market value of such trading stock as contemplated in such section.*

**(2)** *The amount which shall in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the beginning of any year of assessment, shall—*

*(a) if such trading stock formed part of the trading stock of such person at the end of the immediately preceding year of assessment be the amount which was, in the determination of the taxable income of such person for such preceding year of assessment, taken into account in respect of the value of such trading stock at the end of such preceding year of assessment; or*

*(b) if such trading stock did not form part of the trading stock of such person at the end of the immediately preceding year of assessment, be the cost price to such person of such trading stock.*

**(2A)** (a) *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.*

(b) *For the purposes of paragraph (a), a contract shall be deemed to have been completed when the taxpayer has carried out all the obligations imposed upon him under the contract and has become entitled to claim payment of all amounts due to him under the contract.*

**(3A)** *For the purposes of this section the cost price of trading stock referred to in subsection (2A) shall be the sum of the cost to the taxpayer of material used by him in effecting the relevant improvements, and such further costs incurred by him as in accordance with generally accepted accounting practice are to be regarded as having been incurred directly in connection with the relevant contract, and such portion of any other costs incurred by him in connection with the relevant contract and other contracts as in accordance with generally accepted accounting practice are to be regarded as having been incurred in connection with the relevant contract, less a deduction of so much of—*

(a) *any income received by or accrued to the taxpayer in respect of the relevant contract;*

(b) any portion of an amount payable to the taxpayer under the relevant contract (but not exceeding 15 per cent of the total amount payable to him under such contract) the payment of which has been withheld as a retention; and

(c) any of the said costs included under this subsection as exceed that portion of the contract price which relates to the improvements actually effected by him, as does not exceed the said sum.

(3) (a) For the purposes of this section the cost price at any date of any trading stock in relation to any person shall—

(i) subject to subparagraphs (iA) and (ii), be the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus, subject to the provisions of paragraph (b), any further costs incurred by him up to and including the said date in getting such trading stock into its then existing condition and location, but excluding any exchange difference as defined in section 24I (1) relating to the acquisition of such trading stock;

(3A) For the purposes of this section the cost price of trading stock referred to in subsection (2A) shall be the sum of the cost to the taxpayer of material used by him in effecting the relevant improvements, and such further costs incurred by him as in accordance with generally accepted accounting practice are to be regarded as having been incurred directly in connection with the relevant contract, and such portion of any other costs incurred by him in connection with the relevant contract and other contracts as in accordance with generally accepted accounting practice are to be regarded as having been incurred in connection with the relevant contract, less a deduction of so much of—

(a) any income received by or accrued to the taxpayer in respect of the relevant contract;

(b) any portion of an amount payable to the taxpayer under the relevant contract (but not exceeding 15 per cent of the total amount payable to him under such contract) the payment of which has been withheld as a retention; and

(c) any of the said costs included under this subsection as exceed that portion of the contract price which relates to the improvements actually effected by him, as does not exceed the said sum.

(4) If any trading stock has been acquired by any person for no consideration or for a consideration which is not measurable in terms of money, such person shall for the purposes of subsection (3), unless subsection (3) (a) (iA) applies, be deemed to have acquired such trading stock at a cost equal to the current market price of such trading stock on the date on which it was acquired by such person: Provided that any capitalization shares awarded by any company to shareholders of that company on or after 1 July 1957 shall have no value as trading stock in the hands of such shareholders: Provided further that options or any other rights to acquire shares in any company which have been acquired as aforesaid shall have no value.

### **83**

#### **(17) Where—**

(a) the claim of the Commissioner is held to be unreasonable;

(b) the grounds of appeal of the appellant are held to be frivolous;

(c) the decision of the tax board contemplated in section 83A is substantially confirmed;



(d) *the hearing of the appeal is postponed at the request of one of the parties; or*

(e) *the appeal has been withdrawn or conceded by one of the parties after a date of hearing has been allocated by the registrar,*

*the tax court may, on application by the aggrieved party, grant an order for costs in favour of that aggrieved party, which costs shall be determined in accordance with the fees prescribed by the rules of the High Court.*

### **CORRECTIONAL SERVICES ACT 111/98**

**103.** *Contracts for joint venture prisons.—(1) The Minister may, subject to any law governing the award of contracts by the State, with the concurrence of the Minister of Finance and the Minister of Public Works, enter into a contract with any party to design, construct, finance and operate any prison or part of a prison established or to be established in terms of section 5.*

*(2) The contract period in respect of the operation of a prison may not be for more than 25 years.”*

4.

The parties at the start of the proceedings also sought certain amendments which were granted.

4.1 The Appellant substituted the words “2002 to 2004 years of assessment” in the heading of paragraph 22 of its Grounds of Appeal for “2003 to 2004 years of assessment”.

4.2 Respondent amended its grounds of assessment as follows:

4.2.1 The heading below paragraph 58 of the Grounds of Assessment are hereby replaced by the following:

**“MAIN ISSUES: DEDUCTABILITY OF VARIOUS AMOUNTS (2002 TO 2004):”**

4.2.2 Paragraph 59 is deleted and replaced with the following:

*“59. Respondent contends that the construction costs incurred by the Appellant in building the prison, constructing the roads, supplying and installing fixtures, fittings, furniture and other equipment to the prison do not qualify for deduction in terms of Section 11(a) of the Act on the basis that the requirements of Section 11(a) read with Section 23 of the Act are not met.”*

4.2.3 Paragraph 60 is deleted and replaced with the following:

*“60. Section 11(a) allows for deduction of expenditure actually incurred in the production of income during the year of assessment provided that such expenditure is not of a capital nature.”*

4.3 Appellant also argued that certain “*preproduction costs*” ought to be included as part of the total construction costs of about R464 million (see paragraph 29 quoted above) bringing the total to R511 196 332.00. There was no issue with the principle of adding it, but the nature thereof remained in dispute.

## 5.

Four people testified on behalf of the Appellant and the Respondent called no witnesses. The evidence added very little to this case.

5.1 The first witness was Mr S C P Jordaan who is now Managing Director of South African Custodial Management which is a company that manages the prison as such. At the time of the negotiation of the contract he was in the employ of the

Government and had a lot to do with the contract as such. He basically gave a breakdown of what the contract entails and how it is supposed to work.

5.2 The next witness was Mr Dennis McCarthy. He is currently the Financial Manager of South African Custodial Management. He assists Mr Jordaan in implementing the contract. He also gave a breakdown of what the various financial fees were intended for and how they were obtained.

5.3 The next witness was Mr Mark Pinington who gave evidence as an expert and is a qualified Chartered Accountant. The essence of his evidence is that in terms of Section 22 of the Act and more specifically 22(2A) and (3A) where the principles of "*general accepted accounting practices*" apply like in this case, it boils down to the fact that all these construction costs and financial expenditures should be treated as part of trading stock.

5.4 The last witness was Mr Justus Stols. He is also a Chartered Accountant and is currently employed by Kagiso Financial Services, one of the partners of the Appellant. He gave an overview of how the public private partnerships started and

why they are employed. His evidence was basically to the effect that the purpose of a PPP and a special purpose vehicle was to put all the eggs in one basket, as it were, so that the Government only has to deal with one single entity, although many disciplines are involved in such a project. It takes care of the risk factor and is therefore convenient to all parties. That was the gist of the evidence.

6.

**THE COST OF THE CONSTRUCTION OF THE PRISON: CAPITAL OR REVENUE?:**

This question is the main issue in this case. In that regard mainly Sections 11(a) and 22(2A) are relevant. In terms of Section 11(a) an expense is deductible if it is of the nature of revenue and not capital. That entails that the expense must firstly be analysed to establish its true nature. Obviously all circumstances must be looked into, for example the purpose of the expense, how it was treated in the financial statements, etc. There is no *numerus clausus*.

7.

As opposed to Section 11(a) stands 22(2A). This section deems almost all expenses as revenue, if it falls within a contract as defined/described in Section 22(2A). The Respondent's attitude is that however one reads Section 22(2A), the nature of the expense must still be first established to decide whether Section 22(2A) applies at all. *A contrario* Mr Emslie submitted that 22(2A) is an overriding provision to 11(a) and all costs are then automatically deemed to be revenue.

8.

I agree with Appellant's submissions:

8.1 Carrying on a trade:

It is common cause that the Appellant is a special purpose vehicle (SPV) established specifically for the purposes of the concession contract. The contract entailed various *trades* i.e. construction of a prison, providing accommodation, custodial and security services, catering, and other services. It is therefore a "*multi faceted trader*".

8.2 Property owned by another:

The contract clearly stipulates that the land at all times remained the *property* of the Department/State. In terms of the common law all permanent fixtures to land then also becomes the property of the land owner. Applicant thus qualifies under this heading.

8.3 The improvements:

A useful building on land cannot be anything but an *improvement* on that other person's land.

8.4 Materials delivered:

As far as construction materials go, like cement, bricks, etc. they obviously accede to the land. Materials may of course also relate to utensils, etc. which are used to operate the prison. It is a term of the contract that the whole prison, together with all utensils, etc. becomes the property of the

State on conclusion of the contract. To my mind that then must also be included under this heading.

9.

In my view from the above it is abundantly clear that the prison falls squarely within the description/ambit of Section 22(2A). All such costs are then deemed to be trading stock.

10.

At this time a few preliminary points can and should be clarified.

10.1 Firstly it was argued by the Respondent that because the Appellant was an SPV it never “*owned*” any of the material brought onto the site for the purposes of constructing a prison. It was submitted that because the Appellant only operated through sub-contractors, therefore all the materials brought onto site never became the ownership of the Appellant but went directly to the Department. It was contended that a type of tripartite agreement existed whereby the sub-contractors delivered directly to the Department. It was further submitted that a purchasing contract does not by itself and of itself give ownership to the purchaser. Something else must also happen, i.e. delivery thereof. It was therefore submitted that



because the Appellant never became owner of the materials, and it did not “deliver” it to the Department, it can thus not claim those expenses as being tax deductible. There is, of course, a fatal flaw in this argument in the sense that delivery can take many forms. It does not have to happen directly from vendor to the buyer. This argument therefore cannot succeed.

10.2 The second question is the submission by the Respondent that because it operated through sub-contractors it was itself not really *trading* as such and therefore could not become a *trader* as per the definition thereof in the Act. There is no merit in this argument either. “*Qui facit per alium, facit per se*”. This principle is part of our law. It simply means that he who acts through agents, acts himself. It is thus clear that whatever the Applicant really is and however it might have operated whatever it did, it did by and through itself. Therefore all the definitions regarding trader and trading stock, etc. must be viewed in the light that they apply to the Appellant directly and not to any of its sub-contractors.

The true nature of the prison specifically must then be analysed. Firstly, looking at the requirements of Section 22(2A) as stated above the Appellant falls squarely within its ambit. However, there is another side to it as well. In normal accounting practice, improvements are usually considered to be of a capital nature as opposed to “*repairs*”, which are trading expenses. Viewed from this angle the intention of Section 22(2A) becomes clear: even expenses that are usually treated as capital now become trading stock. Therein lies the clear intention, namely that Section 22(2A) overrides Section 11(a). This view is further strengthened by the terms of Section 11(x). Thus whether it is “*deductible*” in terms of Section 11(a) read with 11(x) or to be treated as trading stock in terms of Section 22(2A) it boils down to the same basic principle, i.e. that it is revenue in nature and not capital.

12.

That really puts to bed the whole issue of the prison, as such. This makes any reference to cases dealing with the difference between revenue and capital irrelevant because they all are decided for the purposes of Section 11(a) only. However, viewed as stated above, the Appellant then in any event qualifies as a trader and the material qualifies as deemed trading

stock in terms of the definition thereof because it was acquired by the Appellant for purposes of manufacturing the prison and selling or exchanging it to the Department at the end of the contract period.

13.

There is, however, one other aspect relating to this that must be dealt with. Mr Nxumalo raised the point that R390 odd million of expenses were incurred in the 2001 tax year, and were not claimed as trading stock. In fact, in the financials it is reflected as capital (a loan). Since we were only dealing in this case with the 2002-2004 tax years, and no variation of the 2001 tax year assessment is requested, he submitted that it cannot be varied because of the 3-year period which has already prescribed. This would mean that the R390 odd million must be deducted from the R511 odd million for purposes of a re-assessment.

13.1 As Mr Emslie clearly pointed out in argument, sections 22(3) and (4) specifically caters for this situation in that it does not matter in what year the costs were incurred. The purpose is that tax on trading stock should be delayed until the stock is disposed of. In this case it means at the end of the contract period of 25 years. Cf **MEYEROWITZ, Income Tax, par 12.190**, where the following is stated:

*Although the section speaks of trading stock held and not disposed of at the beginning of the year of assessment, it seems to be implicit from the*

provisions of [section 22(2) read with sec 22(3), which refers to the cost incurred in the current or any previous year of assessment in acquiring the stock, that any trading stock acquired during the year of assessment should be regarded as trading stock held and not disposed of at the beginning of the year of assessment. [Footnote: otherwise trading stock acquired during the current year for no consideration would go to increase gross income, whether such stock is sold during the year or is included in stock on hand at the end of the year, without deduction of the cost ascertained in terms of sec 22(4).] This leads to the conclusion that the expenditure in acquiring the stock, to the extent of its cost as ascertained above, is not to be regarded as an expense incurred in the production of income, for otherwise the taxpayer would obtain a double deduction, namely the actual expenditure in acquiring the stock plus the value of the stock purchased. In effect there is no practical difference whether the cost of trading stock purchased during the year is deductible or whether the value of the trading stock so purchased is regarded as being held and not disposed of at the beginning of the year; the same result is reached in either case. But on the construction suggested above a legal basis is given for taking into account in the determination of taxable income of the cost incurred in a previous year of assessment, in respect of an asset which the taxpayer regarded as a capital investment, but the proceeds of which in a subsequent year are to be held to be of a revenue nature. It also provides

*a legal basis for allowing the deduction of the value of nay stock acquired by the taxpayer at no cost to him (eg by gift or inheritance).*

(Quoted from Mr Emslie's Heads of Argument)

13.2 I agree with Mr Emslie's argument and the authority of Meyerowitz.

That means that the whole of the R390 million must be treated as trading stock in the 2002 year of assessment.

#### **FINANCIAL CLAIMS:**

14.

In argument Mr Nxumalo, for the Respondent, stated that he "*discards*" (not "concede") any argument relating to the following financial claims: legal fees; administration fees; the initial fee and portion of the interest in terms of Section 23(f) in terms of the Act. Previously in the papers the commitment fee was also conceded. The following fees remained in issue: introduction fee; guarantee fees; consultation fees; financial advisory fee; margin fee; bid guarantee fee.

15.

The basis of the Respondent's objection to the claims in regard to these latter fees is that they were expended to obtain capital assets. Once the asset, however, becomes trading stock that argument cannot obtain any

more and therefore they must also all be classified as revenue expenses. The evidence on behalf of the Plaintiff was in any event that in terms of GAAP, these expenses would be considered as expenses for revenue purposes and in any event that they were necessarily incurred to obtain a contract in the first place.

16.

**THE COSTS:**

Section 83 of the Act provides that where the claim of the Commissioner is held to be unreasonable, the Court may grant costs in favour of the aggrieved party. The question here is whether the Respondent's attitude is or was unreasonable. Both counsel agreed that this case will become the *locus classicus* on the issues herein. It is clear that there are no relevant cases dealing directly in point with the issues here at stake. Furthermore, this whole concept of a public private partnership (PPP) is a new animal in the tax world. Section 22(2A) has not specifically been the subject of any binding decision that could be found. To our minds the attitude of the Respondent was therefore not unreasonable and therefore no costs will be ordered.

17.

The Appellant made one concession regarding certain depreciations which were allowed in the 2002 tax year. The point was made that if the Court upholds the submission that the prison is stock in trade, that deduction should not have been allowed. There was obviously no objection to this attitude by the Respondent and it will be so reflected in the order. We therefore make the following order:

1. The prison constitutes Appellant's trading stock in terms of Section 22(2A) of the Act.
2. The amount of R120,330,332.00 (being R511,196,332.00 less R390,866,000.00) as contemplated in Section 22(3A) is deductible as opening stock in the Appellant's 2002 year of assessment in terms of Section 22(2) and must thereafter be dealt with in terms of Section 22(3A) read with Section 22(1) and (2) of the Act.
3. The Section 11(e) depreciation granted to the Appellant in its 2002 year of assessment must be reversed as it would give rise to double accounting.
4. All the financial fees and expenses and the legal fees are fully deductible.

It is to be noted that this is a majority decision of myself and one assessor.

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**R D CLAASSEN**  
**Judge of the High Court**