The impact of CSARS v South African Custodial Services (Pty) Ltd on the income tax position of construction contractors

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DECLARATION

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'*Giving thanks always for all things unto God and the Father in the name of our Lord Jesus Christ*' (Ephesians 5:20)

Foremost, I would like to express my gratitude to my study leader, Mr Herman Viviers, for his guidance, motivation and contribution to this study. I would also like to thank my family for their support and continuous motivation to reach for my dreams.

ABSTRACT

The impact of CSARS v South African Custodial Services (Pty) Ltd on the income tax position of construction contractors

Infrastructure is one of the top priorities of the South African Government. Substantial amounts will be invested by the Government in infrastructure between 2014 and 2016 as good infrastructure plays a pivotal role in the growth of the South African economy. Government does not have sufficient resources to meet its infrastructure goals and is therefore dependent on the private construction sector to provide assistance. Discrepancies were noted between the judgment laid down in CSARS v South African Custodial Services (Pty) Ltd (SACS) and the interpretations from the relevant sections contained within the Income Tax Act governing the normal tax treatment of construction contractors. The aim of this study was to determine whether reliance could be placed on the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd in order to determine the nature and deductibility of expenditure incurred by construction contractors in future. It is crucial that tax legislation should be correctly interpreted and applied in determining the taxable income of taxpayers as it is evident that tax consequences influence the behaviour of South African taxpayers. A literature study of prior case law, sections of the Income Tax Act governing the normal tax treatment of construction contractors as well as other relevant literature was performed in order to determine the correct application of sections governing the normal tax position of construction contractors. The negative tax consequences suffered by SACS as a main contractor due to judgement laid down in CSARS v South African Custodial Services (Pty) Ltd could influence the willingness of the private construction sector to provide assistance to Government in future. Based on the literature study performed it was found that the court's application of Section 22(2A) of the Income Tax Act was correct. It was further found that the Court erroneously applied Section 11(*a*), and as a result incorrectly determined the normal tax position of SACS. In response to this it is recommended that no reliance should be placed on the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd in respect of determining the nature and deductibility of fees paid to sub-contractors by construction contractors, as this could result in negative tax planning consequences.

KEYWORDS: Agent, concession agreement, construction contract, , contractor, CSARS v South African Custodial Services (Pty) Ltd, Public Private Partnership, sub-contractor, tax deductible, trade, trading stock.

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LIST OF ABBREVIATIONS

Act	-	Income Tax Act (58 of 1962)
BPR	-	Binding Private Ruling
PFMA	-	Public Finance Management Act
PICC	-	Presidential Infrastructure Coordinating Commission
PPP	-	Public Private Partnership
SACS	-	South African Custodial Services (Pty) Ltd
SARS	-	South African Revenue Service

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CHAPTER 1: INTRODUCTION

1.1 INTRODUCTION

South Africa remains in a state of poverty and unemployment twenty years into democracy. Infrastructure development is therefore a top priority for the South African Government in order to create jobs (KPMG, 2013). To meet the infrastructure goals as set out in the National Development Plan, the Cabinet established the Presidential Infrastructure Coordinating Commission, hereafter referred to as 'PICC'.

In his State of Nation address in 2012, President Jacob Zuma invited the nation to join Government in a massive development drive. The importance of infrastructure was again reinforced when President Jacob Zuma indicated in his State of Nation address in 2014 that Government plans to invest a further R847 billion in national infrastructure between 2014 and 2016. From this it is clear that infrastructure is a long term priority for the South African Government.

Although infrastructure development is good news to all South Africans, it is not always certain whether the Government will be able to meet its infrastructure targets as it requires specific expertise, knowledge and manpower which it does not necessarily possess (Groenewald, 2009:19). In order to assist Government in this regard, an inter-departmental task team was commissioned during 1997 to develop policies and legislation to enable an environment in which Government could liaise with the private sector by means of a Public Private Partnership (hereafter referred to as a PPP) (Department of National Treasury, 2014).

Treasury Regulation 16 issued in terms of Section 76 of the Public Finance Management Act (PFMA) (1 of 1999) defines a PPP as:

'*an agreement between an institution and a private party in terms of which –*

(a) the private party undertakes to perform an institutional function on behalf of the institution for a specified or indefinite time;

(b) the private party receives a benefit for performing the function, either by way of:

(i) compensation from a revenue fund;

(ii) charges or fees collected by the private party from users or customers of a service provided to them; or

(iii) a combination of such compensation and such charges or fees;

(c) the private party is generally liable for the risks arising from the performance of the function, subject to paragraph 16.13.1; and

(d) depending on the specifics of the agreement, state facilities, equipment or other state resources may be transferred or made available to the private party.'

Examples of major PPPs in South Africa include: National Toll Roads, the Gautrain project, the construction of offices for National Government Departments, as well as the construction of private prisons like Mangaung Correctional Centre and Kutama Sinthumule Maximum Prison located in Louis Trichardt (Makhado) (Department of National Treasury, 2014).

From the perspective of private parties (with specific reference to contractors in the construction industry) who are required to contract with public sector institutions (Government) by means of PPPs, it is vital to consider the tax implications and tax consequences that a PPP agreement encapsulates.

Relevant sections that will impact the determination of the taxable income of construction contractors in terms of the Income Tax Act (58 of 1962) (hereafter referred to as the Act) are Sections 11(*a*), 22, 22(2A), 22(3A) and 24C.

Section 11(*a*) governs the deductibility of general expenditure of a non-capital nature, while Section 22 regulates the tax treatment of the cost of opening and closing trading stock. Improvements effected by a construction contractor, including any materials delivered by the contractor to its client's fixed property, will be deemed in terms of Section 22(2A) to be trading stock held and not disposed of by the construction contractor until the contact is completed. The purpose of Section 22(3A) is to determine the value (cost) of the trading stock that is deemed to be held by the construction contractor. Section 24C aims at deferring the income of a construction contractor in order to match the expenditure incurred by the contractor in future.

The importance of the correct interpretation and actual meaning of the latter sections are prevalent as highlighted in recent judgement laid down in CSARS v South African Custodial Services (Pty) Ltd (hereafter referred to as SACS) by the Supreme Court of Appeal of South Africa on 30 November 2011. From this case it is clear that private parties (contractors) that make use of sub-contractors should carefully consider the terms and conditions agreed upon with sub-contractors, as this could result in unforeseen tax consequences for the contactor (Van der Zwan & Lubbe, 2012:1).

1.2 BACKGROUND OF THE CASE CSARS V SOUTH AFRICAN CUSTODIAL SERVICES (PTY) LTD

SACS entered into a concession agreement with the Department of Correctional Services on 3 August 2000 in terms of which SACS would design, construct and operate a maximum security prison based in Louis Trichardt (Makhado) that would have capacity

for 3 024 inmates (Department of Public Works, 2002). The agreement constituted a PPP in terms of Treasury regulations contained in the PFMA (1 of 1999). The agreement stipulated that SACS had the right to operate the prison for the period of the concession (25 years), but that ownership of the property would never pass on to SACS.

SACS appointed a sub-contractor, CGM (a joint venture), to design and construct the prison. The construction contract concluded between SACS and the sub-contractor determined that the sub-contractor had to build and equip a prison on land owned by the State (the Department of Correctional Services) for which SACS undertook to pay a set price. The sub-contractor was responsible for all construction services and activities that would be necessary to erect a prison. The uncertainty surrounding the deductibility of the fixed fee paid to the sub-contractor, with specific reference to the component relating to the cost of constructing and equipping the prison, was one of the main reasons why this case was heard by both the Tax Court and the Supreme Court of Appeal.

The deductibility of the expenditure incurred (the cost of acquiring materials and equipment that were used to construct the prison forming part of the fixed fee paid to CGM) should be primarily determined in terms of Section 11(*a*), the general deduction formula, of the Act. However, due to the nature of a building contractor's expenditure being work in progress, Section 22(2A) of the Act should also be considered.

Section 22(2A)(*a*) of the Act determines the following:

'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 the materials delivered by him to such fixed property which are no longer owned by him shall, until the contract under which 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.'

From the latter it is clear that Section 22(2A) does not primarily deal with or regulate the deductibility of expenditure, but rather acts as a deeming provision. It is however questionable what the true purpose of the deeming provision entails. Is the purpose of Section 22(2A) to deem what is not trading stock to be trading stock, or is the purpose to deem trading stock no longer held to still be 'held and not disposed of'?

It could be argued that Section 22(2A) of the Act deems what may not be trading stock (expenditure of a capital nature) to be trading stock (expenditure of a non-capital nature) in order to allow a deduction for trading stock that would override Section 11(*a*) which primarily deals with the deductibility of expenditure (such as the acquisition of trading stock) which is not of a capital nature. The latter statement was also argued for on

behalf of SACS. However, the Supreme Court of Appeal held that this interpretation is not correct and that consideration should be given to the true purpose of section 22(2A).

It was held that the true purpose of Section 22(2A) is to deem an item that is in fact trading stock in the hands of a person to be still 'held and not disposed of' by that person to enable the deduction in terms of Section 11(*a*). As a result, the Court was of the opinion that Section 22(2A) does not override Section 11(*a*) by deeming expenditure of a capital nature to be expenditure of a revenue nature.

Therefore, the issue that had to be decided on in CSARS v South African Custodial Services (Pty) Ltd was whether the activities of SACS did in fact fall within the scope of section 22(2A) of the Act? In order to address this, the relationship between SACS and the sub-contractor was of particular importance in the formulation of the verdicts by both the Tax Court and the Supreme Court of Appeal. SACS contended that the sub-contractor it appointed acted as its agent and that the principle '*Qui facit per alium, facit per se'* meaning that '*he who acts through agents, acts himself*' (ITC 1855, 2010) should be applicable.

The Tax Court found that the sub-contractor was indeed acting as an agent on SACS's behalf (ITC 1855, 2010) and ruled that the expenditure incurred was deductible for normal income tax purposes by SACS. The Tax Court found that Section 22(2A) of the Act deems almost all expenditure to be revenue in nature and indicated that the expenditure incurred by SACS fell within the scope of Section 22(2A). It was further held that if expenditure falls within the scope of Section 22(2A), it is not necessary to determine the nature of the expenditure for purposes of deducting it in terms of Section 11(*a*).

The Supreme Court of Appeal (after the SARS appealed on the ruling of the Tax Court) found it not to be necessary to determine whether the expenditure incurred by SACS for the construction of the prison was of a capital nature for purposes of Section 11(*a*). It found it to be irrelevant as the case rather turned to Section 22(2A), read with Section 11(a), of the Act to determine the deductibility of the cost of constructing and equipping the prison that formed part of the fixed fee paid to the sub-contractor (CGM).

The Supreme Court of Appeal concluded that no deduction will be available to SACS in respect of the fixed fee paid to the sub-contractor that related to the construction of the prison by stating the following: '*I conclude accordingly, that SACS is not entitled to* ***the deduction contended for by it in terms of Section 22(2A)****, read with s 11(a)*' (Own emphasis added) (CSARS v South African Custodial Services (Pty) Ltd, 2011:16).

From the words '*...the deduction contended for by it in terms of Section 22(2A)...*' it remains questionable whether the Supreme Court of Appeal considered SACS' deductibility primarily in terms of Section 22(2A), while it should have considered deductibility primarily in the context Section 11(*a*), but only after it is established that the context of the issue under review falls within the scope and ambit of Section 22(2A).

1.3 RESEARCH QUESTION

As a result of the discrepancies noted between the judgment laid down in CSARS v South African Custodial Services (Pty) Ltd and the interpretations from the relevant sections contained within the Act governing the income tax treatment of construction contractors, the aim of the study is to answer the following research question:

- Should reliance be placed on the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd in order to determine the nature and deductibility of expenditure incurred by construction contractors in future?

1.4 RESEARCH OBJECTIVES

In order to answer the research question, the following key research objectives will be addressed in the study:

- To determine how taxation on construction contractors is currently governed in terms of the current Act. Specific reference will be made to Section 11(*a*) and Section 22. The true purpose of Section 11(*a*) and specifically Section 22(2A) will be analysed.
- To critically analyse the interpretation and application of Section 11(*a*), Section 22 and Section 22(2A) of the Act and to compare this analysis to the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd.
- To determine whether a contractor who appoints a sub-contractor will be regarded as carrying on of a trade for normal income tax purposes, considering the terms and conditions of the appointment as well as the requirements to be met. The impact of the use of a sub-contractor on the tax position of a main contractor will be determined.
- To provide guidance on the steps to be taken by the main contractor to ensure that the manner in which a sub-contractor is appointed will not result in negative normal income tax consequences for the main contractor.

1.5 RESEARCH METHODOLOGY

A paradigm refers to the world view of an individual. The world view of an individual is formed by a set of beliefs about fundamental aspects of reality. Observations are all relative to an individual's beliefs, background and perceptions of the world, or in other words, the paradigm that the researcher views the world in (Niewenhuis, 2010:47-48). There are two main paradigms, namely the interpretative paradigm and the positivist paradigm, which is discussed further below.

Research methodology is dependent on the philosophical paradigm that it resorts under, since the paradigm will influence the manner in which data is obtained (Van der Westhuizen, 2010:33). There are two types of research methodologies, namely the scientific method and the emerging world view method. The scientific method, under the positivist paradigm, implies that the researcher has no impact on the findings of the object being researched. The researcher merely investigates the research object without influencing the outcome of the study (Niewenhuis, 2010:53). This research method is objective and quantitative in nature. Knowledge is obtained or discovered through the use of scientific methods.

The emerging world view method under the interpretivist paradigm, on the other hand, is impacted by the researcher's beliefs. The findings are therefore based on what the researcher believes to be reality. It is qualitative in nature and focuses on the social construction of ideas and concepts (Niewenhuis, 2010:53). This research methodology is based on the investigation of behaviour, intentions and beliefs of others. The research methodology attempts to determine how others have constructed reality through asking questions (Niewenhuis, 2010:54). Where the researcher therefore investigates the experiences of others, the study is subjective.

Interpretivism is the study of theory and the interpretation thereof. The researcher therefore reconstructs the original intention of the author of the literature under review.

This study will resort under the interpretivist paradigm. This paradigm consists of the interpretation of literature which is affected by the beliefs of the researcher. This study will follow a doctrinal research approach. Doctrinal research is described as a systematic exposition of the rules governing a particular legal category, an analysis of the relationship between rules that will explain areas of difficulty in an attempt to predict future developments (McKerchar, 2008; Hutchinson & Duncan, 2010).

The method followed in this study comprises a literature review, an analysis of relevant provisions in the Act and case law regarding the deductibility and nature of expenditure incurred by contractors in the construction industry. The findings from the analysis will

be compared to the findings of the Supreme Court case CSARS v South African Custodial Services (Pty) Ltd.

The study resorts under the interpretivist paradigm since existing theory, which is the CSARS v South African Custodial Services (Pty) Ltd case and its findings, will be critically analysed. Grounded theory, based on the Act and additional case law, will then be formed and compared to the findings of the CSARS v South African Custodial Services (Pty) Ltd case. Discussions will mainly focus on the important elements arising from CSARS v South African Custodial Services (Pty) Ltd and its related tax implications. The rules of interpretation will also be discussed as this will play an important role in evaluating what should take precedence, income tax legislation as opposed to rulings by the Supreme Court of Appeal, for future tax planning purposes.

1.6 LIMITATION OF SCOPE

The case of CSARS v South African Custodial Services (Pty) Ltd deals with three issues, namely:

- The validity of SACS's objection against its 2002 assessment;
- The deductibility of the cost incurred to construct and to equip the prison; and
- The deductibility of interest and various other fees.

However, this research study is limited to only include an investigation into and a critical analysis of the judgement laid down relating to the nature and deductibility of the cost incurred to construct and equip the prison. These costs comprise the acquisition of material and equipment to construct the prison that formed part of the fixed fee paid by SACS to its sub-contractor (CGM).

The study is further limited to the field of normal income tax applicable to residents only. No Value-Added Tax (VAT) implications or other relevant tax types were considered. Only the impact on the normal income tax position of the contractor is considered and not the tax impact on any other person that could also be a possible party to a construction contract.

Section 22(3A) of the Act refers to the generally accepted accounting practice in order to determine the cost of trading stock. The generally accepted accounting practice will however not be discussed or analysed in this study.

1.7 CHAPTER OUTLINE

Chapter 2 consists of a critical analysis of the South African income tax legislation that governs construction contractors. Focus is placed on specific sections of the Act, namely Sections 10(1)(*zl*), 11(*a*), 22, 22(2A), 22(3A) and 24C to determine the interpretation and application thereof. The meaning and purpose of each of the aforementioned sections is determined by means of analysing specific Court cases as well as other relevant literature supporting the principles contained within these various sections. The judgment laid down in CSARS v South African Custodial Services (Pty) Ltd is compared to the current interpretation and application of the relevant sections to determine the normal income tax liability based on the profits of a construction contractor.

In Chapter 3, the differences between an agent and an independent contractor are identified and guidelines are provided in order to ensure that a contractor will not suffer negative tax consequences when appointing a sub-contractor.

Chapter 4 concludes the study with a summary of the findings and conclusions reached. A final conclusion is made on whether any reliance should be placed on the judgment laid down in CSARS v South African Custodial Services (Pty) Ltd in future to determine the deductibility for normal income tax purposes of construction expenditure incurred by contractors. Finally recommendations are made and possible areas for future research are identified.

CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION

In order to be able to conclude whether or not the judgment laid down in CSARS v South African Custodial Services (Pty) Ltd is in contradiction with the Act, it is important in the first place to understand and determine the interpretation of the provisions governing the normal income tax of constructing contractors as well as the general practice applied by the South African Revenue Service (SARS) to the construction industry. This will be achieved in this Chapter through addressing the first three research objectives namely:

- To determine how taxation on construction contractors is currently governed in terms of the current Act. Specific reference will be made to Section 11(*a*) and Section 22. The true purpose of Section 11*(a)* and specifically Section 22(2A) will be analysed.
- To critically analyse the interpretation and application of Section 11(*a*), Section 22 and Section 22(2A) of the Act and to compare this analysis to the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd.
- To determine whether a contractor who appoints a sub-contractor will be regarded as carrying on of a trade for normal income tax purposes, considering the terms and conditions of the appointment as well as the requirements to be met. The impact of the use of a sub-contractor on the tax position of a main contractor will be determined.

The Supreme Court of Appeal found in CSARS v South African Custodial Services (Pty) Ltd (2011:16) that no deduction will be available to SACS in respect of the fee paid to the sub-contractor relating to the construction of the prison by stating the following: 'I conclude accordingly, that SACS is not entitled to *the deduction contended for by it in terms of Section 22(2A)*, read with s 11(a)" *(Own emphasis added).*

From the words '*...the deduction contended for by it in terms of Section 22(2A)...*' it is questionable whether the Supreme Court of Appeal considered SACS' deductibility primarily in terms of Section 22(2A), while it should have considered deductibility primarily in the context Section 11(*a*), but only after it was established that the context of the issue under review falls within the scope and ambit of Section 22(2A).

The judgment of the Supreme Court of Appeal was based on the following aspects:

- The Court found it irrelevant to determine whether the expenditure incurred by SACS to construct the prison was capital in nature for purposes of section 11(a),

as it instead turned to section 22(2A), read with section 11(a), to the determine its deductibility.

- The Court deemed the trading stock applied to effect improvements to the Government property to be the property of the sub-contractor and therefore SACS did not qualify for a deduction in terms of Section 22(2A) of the Act.
- The Court did not believe that SACS effected the improvements to the property of the Government due to the fact that it made use of sub-contractors.

A short summary of the background and the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd will be provided in this chapter. A short discussion on the steps to be taken in order to interpret income tax legislation will also be provided. This will assist in future evaluations of what need to take precedence, income tax legislation as opposed to rulings by the Supreme Court of Appeal and also on the authority of subsequent rulings by the Supreme Court of Appeal. Hereafter the provisions of the Act governing the tax treatment of construction contractors will be thoroughly analysed and examined by way of a literature study in order to understand the true purpose of Section 22 (including Section 22(2A)) and to obtain a better understanding of the criteria of Section 11(*a*). The findings will then be compared to the judgment laid down in CSARS v South African Custodial Services (Pty) Ltd in an attempt to clarify the uncertainty pertaining to the application of Section 22(2A), read with Section 11(*a*), of the Act applied by the Court to determine the deductibility of expenditure incurred by SACS.

2.2 BACKGROUND AND JUDGEMENT LAID DOWN IN CSARS v SOUTH AFRICAN CUSTODIAL SERVICES (PTY) LTD

SACS entered into a concession agreement with the Department of Correctional Services. The agreement stipulated that SACS had the right to operate the prison for the period of the concession (25 years), but ownership of the property would never pass on to SACS.

SACS appointed a sub-contractor, CGM (a joint venture), to design and construct the prison. The construction contract concluded between SACS and the sub-contractor determined that the sub-contractor had to build and equip a prison on land owned by the State (the Department of Correctional Services) for which SACS undertook to pay a set price. The sub-contractor was responsible for all construction services and activities necessary to erect a prison.

The Supreme Court of Appeal considered the nature of the fee paid to the sub-contractor, and regarded it to be capital in nature; they therefore rejected the application of Section 11(*a*) of the Act. The Court turned to Section 22(2A), read with Section 11(*a*), of the Act to determine the deductibility of the expenditure incurred by the sub-contractor for the acquisition of trading stock in the hands of SACS.

The relationship between SACS and the sub-contractor was scrutinised in determining whether Section 22(2A) was applicable. Should the sub-contractor qualify as an agent, the principle '*Qui facit per alium, facit per se*' meaning that '*he who acts through agents, acts himself*' (ITC 12756, 2010) would be applicable. It was however held that the activities of SACS did not fall within the scope of Section 22(2A) since improvements were effected to the property by the independent sub-contractor and not by SACS or an agent of SACS; consequently SACS did not qualify for a deduction in terms of Section 22(2A).

2.3 RULES OF INTERPRETATION

The interpretation of income tax legislation and applying the rules of interpretation is no simple matter. Taxpayers often find themselves in a position where the letter of the law is applied by the Commissioner when they are assessed for tax (Van der Zwan, 2015:22). Also, this position could be turned around where the taxpayer might plan around and complete a tax return where the letter of the law provides a taxpayer with an outcome that could clearly not have been the intention of the legislator.

Legislation is generally interpreted based on the grammatical and ordinary meaning of the words of law. This is commonly referred to as the literal or textual approach of interpretation. In Cape Brandy Syndicate v IRC the literal approach to interpretation was described as follows:

'*In a taxing Act one has to look merely at what is clearly said. There is no equity about tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used*'.

This approach was however to some extent qualified in R Koster & Son (Pty) Ltd & another v CIR where it was held that the plain meaning of a provision's language must be adopted unless it leads to some absurdity, inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended.

In Venter v Rex it was indicated that the court may depart from the ordinary effect of the words to the extent necessary to remove the absurdity and to give effect to the true intention of the legislature.

In contrast to the literal or textual approach is the contextual or purposive approach where surrounding circumstances and resources are taken into account to derive at the purpose of specific legislation. In the South African context Section 39(1) and (2) of the Constitution (1996) indicates that the contextual approach should be followed (Stiglingh *et al.*, 2015:10). The contextual approach supports the *contra fiscum* rule which determines that where a provision of the Act is open to more than one meaning, the court must follow the interpretation which favours the taxpayer even if it means that it is to the disadvantage of the fiscus. The true intention or the purposive construction in the interpretation of legislation requires that legislation should be interpreted within the context of its overall purpose (Van der Zwan, 2015:22).

Judicial decisions are an integral part of the process of interpreting and clarifying Income Tax legislation in cases of uncertainty. In South Africa the English *stare decisis* rule applies which encapsulates the principle of legal precedence indicating that where a rule of law has been established within previous judgment it will be binding upon a lower court. Therefore, all subordinate courts in South Africa are bound by the decisions of the Supreme Court of Appeal as the highest authority, while the Supreme Court of Appeal is bound by its own decisions and will generally follow any previous decision it has given. (Stiglingh *et al.*, 2015:9).

2.4 ANALYSIS OF SOUTH AFRICAN INCOME TAX LEGISLATION PERTAINING TO CONSTRUCTION CONTRACTORS

The following table provides a list of the sections relevant to determine the taxable income of construction contractors and provides a brief description of the content of the sections that need to be analysed within the context of this study:

Table 2.1: List of sections in the Income Tax Act governing construction contractors

Relevant section	Description
Section 10(1)(*zl*) Discussed in 2.4.1	Section 10(1)(*zl*) provides an exemption to a Public Private Partnerships if certain criteria are met.

Section 11(*a*) Discussed in 2.4.2	Section 11(*a*), also referred to as 'the general deduction formula', regulates the deductibility of general expenditure incurred by taxpayers.
Section 22 Discussed in 2.5.2	Section 22 and its sub-sections regulate the tax treatment of trading stock, specifically with reference to the tax treatment of closing stock and opening stock.
Section 24C Discussed in 2.4.2.3	Section 24C regulates the conditions that have to be met in order to qualify for an allowance for future expenditure to be incurred for the completion of a contract.
Fourth Schedule to the Act Discussed in 3.3	This schedule provides regulations for the classification of an independent contractor versus an employee.
Additional literature: Discussed in 2.4.2.4	Case law will assist in the correct interpretation of tax legislation. Other relevant sources will provide guidance as to the interpretation of Court cases and tax legislation. (The rules of interpretation have been discussed under 2.3)

2.4.1 Impact of Section 10(1)(zl) *on the normal income tax position of a construction contractor*

Government embarks on various construction projects and calls upon private entities to provide assistance. Therefore, private construction companies often enter into transactions with the Government to provide services in relation to the construction of infrastructure. If a construction company can classify its relationship with Government as a PPP the construction company could qualify for an exemption of its income received from government in terms of Section 10(1)(*zl*).

Section 10(1)(*zl*) applies to all taxpayers who qualifies as a PPP. In CSARS v South African Custodial Services (Pty) Ltd it was pointed out that *'the concession contract that SACS concluded with the Minister is a public private partnership – a PPP – for purposes of the Treasury Regulations.'* It therefore seems possible that SACS possibly could have qualified for the exemption.

Section 10(1)(*zl*) is therefore important to analyse as it will have an impact on the tax consequences of construction contractors who enter into construction agreements with the Government. No deduction in terms of the Act will be allowed if the income is exempted.

The Section 10(1)(*zl*) exemption states that it will be applicable to:

'...any amount received by or accrued to or in favour of any person from the Government, where that amount is granted for the performance by that person of its obligations pursuant to a Public Private Partnership; and that person is required in terms of that Public Private Partnership ***to expend an amount at least equal to that amount in respect of any improvements on land or to buildings owned by any sphere of government*** *or over which any sphere of government holds a servitude.' (Own emphasis added)*

It should however be noted that the exemption is limited to the amount which is required in terms of the PPP agreement to be expended on the improvements on the land or buildings owned by Government. It is therefore vital that the improvements should be effected by the taxpayer (contractor) in order to qualify for the exemption. The fact that the Court ruled that the sub-contractor appointed by SACS made the improvements to the land of Government, and not SACS, makes it highly doubtful that SACS would qualify for the exemption provided.

Construction companies entering into a transaction with Government and making use of sub-contractors should be extra vigilant to ensure that the SARS will deem the contractor to effect the improvements and not the sub-contractor in order to qualify for the exemption in terms of Section 10(1)(*zl*). Interpretation Note: No. 59 (SARS, 2010) interprets the function of Section 10(1)(*zl*) of the Act to exempt any amount received from the Government if the recipient is required to expend it as part of its obligations in terms of a PPP.

Section 11(*a*) will only allow a deduction for expenditure incurred from income. The term 'income' is defined in Section 1 of the Act as:

'...the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax...'

The amount received from the Government will therefore not meet the definition of 'income' if it constitutes exempt income. Consequently, if there is no income, no deduction in terms of Section 11(*a*) will be available. For the purposes of the discussion to follow under part 2.4.2, it will be assumed that SACS did not qualify for the exemption and that Section 11(*a*) might be applicable.

2.4.2 The general deduction formula

Section 11(*a*) of the Act, generally referred to as the general deduction formula, is analysed in the context of CSARS v South African Custodial Services (Pty) Ltd to determine whether or not it was applicable in the tax treatment of the expenditure incurred by SACS. Also, this will support whether or not the Supreme Court of Appeal erroneously labelled the determination of the capital nature of the expense to be irrelevant by primarily turning onto Section 22(2A), read with Section 11(*a*), of the Act to determine deductibility of the expenditure incurred by SACS.

Contractors incur various costs in order to complete a construction contract. These expenditures could qualify for a general deduction in terms of Section 11(*a*) if all of the relevant criteria of the section are met.

Section 11(*a*) of the Act states 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 that such expenditure and losses are* ***not of a capital nature***' *(Own emphasis added).*

It is clear that a general deduction in terms of Section 11(*a*) for expenditure incurred will only be allowed if the following requirements are met:

i) A ***trade*** should be carried on.

ii) Expenditure and losses should be ***actually*** incurred.

iii) Expenditure should be incurred in the ***production*** **of income**.

iv) Expenditure and losses are ***not of a capital nature.***

The listed criteria will be discussed in more detail below.

2.4.2.1 A trade should be carried on

Expenditure can only be deducted in terms of Section 11(*a*) if a trade is carried on. A taxpayer should therefore be engaged in the carrying on of a trade before any of the other requirements of Section 11(*a*) could be considered.

The term 'trade' is defined in Section 1 of the Act as follows:

'...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.....or any design.....or any trade mark...or any copyright...or any other property which is of a similar nature'

The definition of a trade should be widely interpreted and includes a variety of profit making schemes. The definition of a trade also includes a venture. A venture is a transaction in which a person takes a risk in order to make a profit. A venture will constitute a trade if there is some degree of risk involved (Burgess v CIR, 1993). It was also held in the ITC 1529 (1991) that the degree of continuity, regularity in operations and whether operations are being performed with the long-term objective to generate profit will also indicate that a trade is being carried on. Activities of the taxpayer should however be examined as a whole to determine whether these activities would be regarded as carrying on a trade, irrespective of whether there was a motive to realise a profit or not (Estate G v COT, 1964).

In the case CSARS v Megs Investments (Pty) Ltd (2005), it was held that a trade requires a degree of activity in the production of income. Passive income, such as interest and dividends, therefore do not constitute a trade. It is clear that any profit making scheme comprising active operations will constitute a trade and would therefore include the manufacturing of goods in order to sell, purchasing and reselling of a product as well as services being provided.

The importance of the requirement: '*carrying on of a trade*', in order to qualify for a deduction is further substantiated by Section 23(*g*). Section 11(*a*) and Section 23(*g*) should always be read together (KBI v Van Der Walt 1986 (4) SA 303 (T)).

Section 11(*a*) and Section 23(*g*) are often referred to as the positive and negative test. Section 11(*a*) determines the deductibility of expenditure, hence the positive test; whilst Section 23(*g*) specifies the type of expenditure which may not be deducted (Van Coller, 2011:118), hence the negative test. Section 23(*g*) prohibits a deduction for expenditure to the extent that it is not incurred for the purpose of a trade.

The Supreme Court of Appeal determined that SACS never carried on any construction, building, engineering or other trade in the course of which improvements were effected by it to the fixed property of the Government (CSARS v South African Custodial Services (Pty) Ltd, 2011:16). SACS was therefore not entitled to a deduction for the trading stock acquired by the sub-contractor in terms of Section 22(2A), read with Section 11(*a*), of the Act.

This decision was based on the fact that the Court did not believe the sub-contractor to be an agent of SACS and therefore believed that the sub-contractor did not act on behalf of SACS. The Court determined that the sub-contractor acted independently and that the sub-contractor delivered the trading stock and effected the improvements to the property of the Government independent from SACS (CSARS v South African Custodial Services (Pty) Ltd, 2011:16).

If the improvements were effected by an agent, the principle of '*he who acts through agents, acts himself*' would have applied. This means that if the sub-contractor (CGM) had qualified as an agent, all acts performed by the sub-contractor, such as the purchasing of trading stock and improvements effected, would have been regarded to have been the acts of SACS, and SACS would then have been carrying on a trade.

From a review of the aforementioned literature it has been identified that, in order to meet the requirements for 'carrying on a trade', the taxpayer should have active operations, take a certain degree of risk, exercise a profit making scheme and there should be a degree of continuity involved in the operations. It is also clear that the definition of a trade includes a wide range of activities. The activities of SACS should therefore be investigated in order to determine whether SACS was in fact carrying on a trade.

The following extracts from the CSARS v South African Custodial Services (Pty) Ltd case are extremely important in order to establish whether SACS was indeed carrying on a trade, and will be analysed in detail.

'*The preamble of the concession contract states that the object of the contract is to give effect to the Department's wish 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 Acts, No. 8 of 1959 and No. 111 of 1998.' (Own emphasis added)*

Clause 7.3 provides that SACS is *'directly responsible for the* ***management and supervision*** *of approved Sub-contractors'. (Own emphasis added)*

SACS entered into a concession contract with Government determining that it would design and construct a prison and a road on the land provided by Government. From the above extracts from the CSARS v South African Custodial Services (Pty) Ltd case, it is clear that SACS was solely responsible to provide a prison and services to the Government.

It was agreed that SACS was allowed to appoint sub-contractors with the approval of the Government. SACS appointed an approved sub-contractor. The responsibilities of the sub-contractor were set out in clause 8.3.14 of the contract between SACS and CGM.

Clause 8.3.14 of the contract between SACS and CGM states that '*CGM accepted responsibility 'for the provision of' and bore 'all risks in relation to all goods, materials and labour necessary for the provision of the works*'. Paragraph 43 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:15) indicated that '*in terms of the construction contract, CGM undertook to build and equip a prison – to perform 'all the construction services and activities associated with or necessary to provide the prison' – on land owned by the State, for which SACS undertook to pay a set price'*.

CGM was responsible for the provision of the goods, labour and material and carried all risks in relation to goods, labour and material used to effect the improvements to the property of the Government. A fixed fee of R303 000 000 was to be paid to the sub-contractor for these services. CGM therefore delivered the materials and effected the improvements to the fixed property of the Government. SACS was therefore never involved in the physical construction of the prison and never physically held the trading stock.

A range of warrantees was also provided to the Government by SACS with regards to the quality of goods and services. From the above extracts, it is evident that SACS was still directly responsible for the provision of the prison to the Government, despite using sub-contractors. SACS was solely responsible for supervision and management of any sub-contractor. The government agreed to pay fees to SACS for the design and construction of the prison. Since SACS received fees for the construction of the prison, it could be argued that SACS exercised a trade. SACS took active steps in order to ensure that a prison was provided to the Government. SACS actively identified, appointed and supervised the sub-contractor in order to ensure that the prison was erected based on the requirements of Government. SACS was responsible for the delivery of the prison to the Government and therefore carried all risks relating to the construction of the prison. Even though the prison had been erected through the means of a sub-contractor, SACS actively managed the construction and ensured that the product required by their client

had been delivered in the requested condition and time as per the contract with Government. SACS therefore actively managed the construction, delivered the prison and did carry on a trade.

The fact that the relationship between SACS and the sub-contractor was not that of an agency is irrelevant when considering whether a trade had been carried on. The issue of whether SACS was carrying on a trade was dealt with in the Tax Court. The Supreme Court of Appeal however had to decide whether SACS owned the trading stock and provided the materials by means of an agent in which case a deduction in terms of Section 22(2A) would have been granted to SACS and not to its sub-contractor.

The terms and conditions between SACS and the sub-contractor did not influence SACS's 'trading' status as SACS was actively involved in the construction of the prison through the supervision and management of the sub-contractor. SACS also carried all risks in relation to the construction of the prison. The relationship would have changed SACS's 'trading' status to 'not trading' if SACS had not been actively involved in the construction, and if the contract between SACS and the sub-contractor had indemnified SACS and all risks had been transferred to the sub-contractor.

The Court ruled that the improvements effected by the sub-contractor to the property of the Government were not deemed to be the actions of SACS. The fact that the improvements were effected by the sub-contractor did however not influence the trading status of SACS. SACS was carrying on a trade independently from the sub-contractor and could possibly deduct expenditure in terms of Section 11(*a*) which SACS incurred as it was carrying on a trade.

From the above discussion, it is clear that the appointment of a sub-contractor will not influence the 'trading' status of the contractor if the contractor carries the risks associated to the venture and remains actively involved in the project.

It could therefore be concluded that SACS did in fact carry on a trade. Therefore, the relevance of Section 11(*a*) cannot be eliminated due to the absence of the carrying on of a trade. The first requirement has therefore been met.

2.4.2.2 Expenditure and losses actually incurred

Non-capital expenditure must be actually incurred in the production of income for a deduction to be allowed in terms of Section 11(*a*). Expenditure actually incurred does not only mean actually paid but also includes all liabilities incurred (ITC 542, 13 SATC 116). In order for expenditure to be actually incurred there should be no degree of contingency. The taxpayer should therefore be legally obligated to pay the expenditure

(Edgars Stores Ltd v CIR (1986)(4) SA 312 (T)). An expense is actually incurred when the taxpayer has an unconditional obligation to perform (CIR v Golden Dumps (Pty) Ltd (1993 A)).

It was further held in Labat Africa Ltd v C: SARS (2011) that for expenditure to be actually incurred there should be a movement in assets of the taxpayer which leads to a diminishment of assets.

From the above discussion it is evident that for an expense to be regarded as actually incurred, the taxpayer must have an unconditional obligation to perform. The obligation should lead to a diminishment in the assets of the taxpayer.

In the contract concluded with the sub-contractor, SACS agreed to pay the amount of R303 000 000 for all the construction services and activities associated with the provision of the prison. Therefore, SACS had a legal obligation to pay an amount to the sub-contractor. A legal obligation is defined in IAS 37 of IFRS as an obligation that derives from a contract, legislation or other operation of law. SACS was legally bound to the contract and fulfilment of the contract will therefore lead to an outflow of assets.

Therefore, the expenditure has actually been incurred and the second requirement of Section 11(*a*) has been met.

2.4.2.3 In the production of income

In Port Elizabeth Electric Tramway Co Ltd v CIR (1936) it was established that expenditure is incurred '*in the production of income*' if expenses are attached to the performance of the business operations, but provided that it is so closely connected to the business operations that it may be regarded as part of the cost of performing it. Expenditure incurred should therefore be a reasonable business expense (Van Coller, 2011:119).

As discussed earlier (under 2.4.1), income is defined in Section 1 of the Act as '*the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax…*'

This requirement for the Section 11(*a*) deduction can therefore only be met if the payment received from the Government for the delivery of the prison has been included in the gross income of SACS and no exemption in terms of Section 10 of the Act was available.

To determine whether the amount received from the Government would be included in the gross income of SACS, the definition of gross income has to be analysed.

The term 'gross income" is defined in Section 1 of the Act as:

'in relation to any year or period of assessment, means in the case of any resident, the total amount, in cash or otherwise, ***received by or accrued*** *to or in favour of such resident; or in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic during such year or period of assessment, excluding receipts or accruals of a* ***capital nature.'*** *(Own emphasis added)*

The proceeds received from the Government will therefore only be included into the gross income of SACS if it is not capital in nature. The nature of the proceeds received has to be investigated.

The 'nature' of the proceeds refers to how these are classified. Proceeds could either be classified as income or capital in nature. The classification is relevant for the normal income tax treatment in respect of the proceeds as well as the related expenditure. If the proceeds are classified as income in nature, then the amount will have to be included in the gross income of the taxpayer in terms of Section 1 of the Act. If they are included in the gross income of the taxpayer, then all expenditure incurred in the production of income will be deductible in terms of Section 11(*a*), provided that the other three requirements of the general deduction formula are also met.

It is important to note that if an amount is classified as gross income, the full amount will be included in gross income during the year of assessment in which the amount has been received by or accrued to the taxpayer. An amount accrues to a taxpayer when the taxpayer becomes entitled to a payment, irrespective of whether the amount is received in the year of assessment or not (Lategan v CIR, 1926). An amount accrues the taxpayer when the taxpayer becomes unconditionally entitled to the amount (Mooi v SIR, 1972). It is common practice for contractors to receive advance payments from clients in order to finance future expenditure. The period of construction contracts often span over more than one year which results in the contractor not incurring all expenditure necessary for the construction contract in the same year of assessment in which the advance (income) is received. Since the contractor did not actually incur expenditure in the year of assessment in which the advance was received, no deduction will be allowed in terms of Section 11(*a*) for that specific year of assessment. Income and expenditure are therefore mismatched and will lead to the taxpayer being taxed on pure income (the advance payment received). Section 24C has been enacted in order to prevent taxation on pure income.

Before the introduction of Section 24C, taxpayers often had to pay tax on income received in advance without being allowed to provide a deduction for expenditure to be incurred in future (Cliffe Dekker Hofmeyr, 2012). From the manner in which the Act governs construction contract transactions, it is evident that it is not the intention of the SARS to tax the taxpayer (contractor) on pure income but merely on its profit.

Section 24C applies to all taxpayers who receive proceeds in advance before the commencement of work which constitutes finance for further expenditure, for example acquisition of material, that has to be incurred in terms of the contract. Contractors generally receive advance payments in order to finance future expenditure relating to a specific construction contract. Therefore, Section 24C is relevant to consider when analysing the tax position of construction contractors.

Section 24C allows an allowance for future expenditure to be incurred in order to overcome the mismatch of timing differences between income and expenditure. The allowance is determined as cost as a percentage of the contract price multiplied by the advance income received, less the actual expenditure incurred in the current year of assessment. It is general practice to base the allowance on the gross profit percentage of the contract. The allowance allowed in the previous year of assessment should be added back to taxable income in the current year of assessment.

Binding Private Ruling: No. 106 (SARS, 2011) specifically deals with the provisions of Section 24C of the Act and requires expenditure to be contingent in nature and deductible in terms of Section 11(*a*).

It would generally seem that all expenditure not yet incurred will qualify as contingent in nature. However, to determine whether expenditure is contingent or not is no simple matter. It is therefore necessary to refer to relevant case law. In ITC 1601 (1995) it was established that there must be a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable.

It seems of utmost importance that the taxpayer should be able to provide an accurate estimate of the future expenditure to be incurred in order to qualify for an allowance in terms of Section 24C. This is clearly proved in ITC 1697 (1999). The taxpayer was able to provide the Court with a clear budget prediction, based on the expertise of the taxpayer, exactly in which year and which item would need maintenance. The Court determined that the expenditure was therefore unconditional and quantifiable (Cliffe Dekker Hofmeyr, 2012).

It is evident that a contractor will have to include the full amount received into gross income since the amount would meet the definition of gross income, but if accurate

predictions of expenditure are made, an allowance in terms of Section 24C will be granted, ensuring that the income and expenditure are matched, therefore relieving the tax burden.

As SACS earned a fixed fee over a period of eighteen years for payment of the construction of the prison, SACS did not receive an advance payment and correctly did not qualify for an allowance in terms of Section 24C.The Act does not provide a definition for 'capital in nature'; relevant case law pertaining to the determination of the nature of the proceeds should therefore be considered. Court cases provide subjective and objective tests as a guideline for the determination of the nature of proceeds or expenditure incurred.

The most important test to determine the nature of proceeds is the intention of the taxpayer. It should be determined with what intention (i.e. was the transaction a profit making scheme or purely a once-off transaction) the taxpayer acquired the asset in order to determine the nature of the proceeds of the sale of the asset. Section 102 of the Tax Administration Act (28 of 2011) states that the onus rests on the taxpayer to establish the intention with which the asset was acquired.

The intention of the taxpayer with regard to a specific transaction is a key indicator of the nature of the proceeds, but other factors may contradict the intention of the taxpayer and can override the intention of the taxpayer (Stott v CIR, 1928).

The intention of the taxpayer is subjective and therefore a subjective factor, the intention of the taxpayer is therefore established through evaluating objective factors. Objective factors are facts and circumstances surrounding the transaction and taxpayer. Objective factors considered by the Court include the nature of the taxpayer's business or occupation, how frequently the taxpayer enters into similar transactions, whether asset was used in profit making scheme, period which the asset was held and, in the case of a company, the Court would consider the director's objectives as documented in the minutes of meetings. (Stiglingh *et al.*, 2014:33)

An example of the application of objective factors in order to determine the intention of the taxpayer is illustrated in the Elandsheuwel Farming (Pty) Ltd v CIR (1978) case. The taxpayer contended that proceeds from the sale of a property were capital in nature; the shareholders, however, had a history of property speculation. The past activities of the holders of shares (an objective factor) had established the intention of the taxpayer and the proceeds were considered by the Court to be income in nature.

The Court also often considers the occupation of the taxpayer as an objective factor. The occupation of the taxpayer includes the taxpayer's profession or daily income

generating activities. For example, in the African Life Investment Corporation (Pty) Ltd v SIR (1969), the company operated as an investment company. The company traded in shares and other securities. The Court ruled the nature of the proceeds from the sale of shares to be income due to the normal course of the company's operations which served as the deciding factor in order to establish the intention of the taxpayer. The occupation of the taxpayer therefore serves as a deciding factor.

SACS is a joint venture between Kensani Consortium (Pty) Ltd and the GEO group. The normal operations of Kensani Consortium (Pty) Ltd are to make investments in correctional facilities (Anon., 2014a) and the GEO group specialises in the operation of correctional facilities throughout the world. Services provided by the GEO group also include the design, construction and financing of prisons (Anon., 2014b). From the operations of the holders of shares of SACS, it is clear that the intention of the holders of shares was that the transaction would be a trade.

SACS had been formed with the intention to design, construct and operate the prison in Louis Trichardt. The transaction with the Government was therefore part of the normal business activities of SACS and constitutes a trade. As a result the proceeds received from the Government should therefore be included in the gross income of SACS. Expenditure incurred by SACS is therefore incurred in the production of income. The third requirement has therefore been met.

Furthermore it is important to note that expenditure will still be deductible even if a loss was realised. Thus, the purpose behind incurring the expenditure should be the production of income and not necessarily be based on the outcome of the expenditure, hence profit or loss (Allied Building Society, 1963). Expenditure is deductible regardless of the year of assessment in which the taxpayer becomes entitled to or receives the revenue. In Sub-Nigel Ltd v CIR (1948) it was held that expenditure will be deductible if the main purpose of the expenditure incurred is for the production of income, even if the impact of the expenditure is not immediately seen on the income for the year of assessment in which the expenditure was incurred. Expenditure can only be deducted in the year of assessment in which it was incurred. In Concentra (Pty) Ltd v CIR (1942) it was established that if the taxpayer fails to claim the expenditure in the year it was incurred, the deduction will be forfeited.

2.4.2.4 Expenditure and losses are not of a capital nature

This requirement could be regarded as the most controversial of all the requirements due to the subjectivity attached to the determination of the nature of the expenses incurred, and has led to countless Court cases. Even if the aforementioned three

requirements have been met, a deduction in terms of Section 11(*a*) will not be granted if the expense is classified as capital in nature. Section 11(*a*) requires that the expenditure incurred should not be capital in nature.

Paragraph 38 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:12) makes it clear that the expenditure incurred by SACS, thus fee paid to the sub-contractor, was considered to be capital in nature. SACS therefore did not qualify for a deduction in terms of Section 11(*a*). No explanation for why this fee was deemed to be capital in nature was provided. The classification of the expenditure as capital in nature is questionable.

Case law provides useful guidelines to determine the nature of the expense incurred and will be further investigated below.

The relationship between capital and income in nature can be illustrated by the famous metaphor used in the Visser v CIR (1937) case of the tree and its fruit. The tree (capital) is the taxpayer's income earning permanent structure which produces fruit (income) on a regular basis. The tree therefore refers to all assets used in order to generate income. The fruit produced by the tree refers to income generated by the income earning structure of the taxpayer. It should however be noted that this case was used to determine whether an amount received was income or capital in nature in the context of gross income, but it is submitted that the principles can also be applied to determine the nature of the expenditure incurred by the taxpayer.

It was held in New State Areas Ltd v CIR (1946) that costs incurred which added to the income operating structure would be capital in nature and not deductible in terms of Section 11(*a*). For example, if a taxpayer makes use of machinery in order to manufacture shoes, the machinery will be the permanent income earning structure which makes it possible for the taxpayer to manufacture shoes. The shoes will therefore be the 'fruit' produced. All proceeds generated from the sale of shoes will be income in nature and have to be included in gross income. If the taxpayer, however, decides to sell the machinery used to manufacture the shoes, the taxpayer will be selling his tree and the proceeds will be subject to capital gains tax. Therefore, it is clear that an asset acquired to produce income will be classified as being capital in nature.

It was further held in Cadac Engineering Works (Pty) Ltd v SIR (1965) that if the expenditure incurred creates a permanent benefit, it would be indicative that the costs are more closely related to the income operating structure.

The principle explained above seems simple, but the classification between income and capital in nature has proven to be much more complex. David Joubert (2009:381) has

substantiated the complexity of the classification by stating that it has vexed Courts, legal minds and tax advisors for years. There is not a set of rules to determine the nature of proceeds or assets or expenses and the classification has to be determined in each separate case (New State Areas Ltd v CIR, 1945).

It was held in BP Southern Africa (Pty) Ltd v C: SARS (2007) that a good criterion in the determination of the nature of expenditure is whether the expenditure is recurring or a once-off expense. If the expenditure is recurring, it would be a good indicator that the expense is not capital in nature and possibly deductible.

The 'permanent benefit test' as provided in African Oxygen Ltd v CIR (1963) does, however, hold more value than the 'once-off' test (Williams, 2009:211). In order to determine if an enduring benefit is acquired, there has to be considered if a right or asset has been acquired which will be enduringly beneficial to the taxpayer. An enduring benefit is not only acquired when a once-off payment is made, but also if there are recurring expenditures in order to protect the enduring benefit. The term 'enduring benefit' is subjective and the facts of each case should be considered separately. The duration for which the asset is held or right is received will however have to be taken into consideration. Expenditure will not be considered to be capital in nature if the benefit acquired is soon exhausted (Palabora Mining Co Ltd v SIR, 1973).

All expenditure incurred with the intention of a profit making scheme would therefore be closely linked in the production of income. Expenditure can however be incurred to create a permanent benefit to the taxpayer, hence fixed capital or be floating capital, and not be considered to be capital in nature.

In George Forest Timber Company v CIR (1924) it was determined that a distinction should be made between floating capital and fixed capital. If capital is consumed in the production of income it would constitute floating capital, whereas fixed capital remains intact. Floating capital is regularly converted into cash. It was also held in George Forest Timber Company v CIR (1924) that if expenditure was incurred in order to acquire floating capital, that expenditure would be deductible in terms of Section 11(*a*) for normal income tax purposes. It is clear from the above that not all expenditure incurred is automatically income in nature but could be capital in nature.

In order for expenditure not to be classified as capital in nature, the following characteristics of expenditure have been identified in the review of the literature above:

- Expenditure incurred must be closely linked to the production of income and incurred in the income earning activities.
- Expenditure does not add to the income producing structure.

- Expenditure is recurring and does not create a permanent benefit.

These characteristics will now be applied to the expenditure incurred by SACS.

SACS received two benefits for the expenditure incurred (i.e. the amount paid to the sub-contractor) in order to provide the prison, namely: a fixed fee (for the construction of the prison) and a variable fee (arising from the right to operate the prison for 25 years).

In the English case British Insulated and Helsby Cables Ltd v Atherton (1926 AC) it was stated that it should be enquired whether expenditure was incurred with the view to bring an asset or advantage for the enduring benefit of the trade into existence. The fixed fee that was paid to the sub-contractor (in order to provide the physical prison to the Government) is closely connected to the income earning activities of SACS. The transaction with the Government was part of the normal business activities of SACS. Refer to 2.4.2.3 in which the income earning activities of SACS has been discussed. The prison had been constructed for an agreed upon amount, and ownership was transferred by SACS to the Government upon completion. As per paragraph 6 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:3), SACS '*would have 'no title to, or ownership interest in, or liens, or leasehold rights or any other rights in the land' and the State would 'at all times remain the owner of the land*'. The prison therefore did not form part of SACS's income generating structure and the expenditure incurred to erect the prison did not create a permanent benefit and appears to be income in nature. It should however be noted that the degree of longevity of a right of an asset remains a question of fact, and each case should be considered in its own merits (Stiglingh *et al.*, 2014:145).

The fourth and final requirement of Section 11(*a*) has been met. From the analysis performed, it is clear that SACS should have qualified for a deduction in terms of Section 11(*a*) for the fee paid to the sub-contractor.

It should be noted that if a provision providing a specific deduction is available in terms of the Act, that the specific deduction will override Section 11(*a*). A double deduction in terms of both a specific provision and Section 11(*a*) is prohibited in terms of Section 23B of the Act.

2.5 TRADING STOCK

Often, in the ordinary course of business, taxpayers purchase trading stock in order to generate a profit in the future. However, without the regulations of Section 22, there will be an immediate deduction of expenditure available in terms of Section 11(*a*) providing

an opportunity for taxpayers to plan a tax deduction to their best advantage. For example, if a taxpayer had received substantial revenue in the current year of assessment, a taxpayer could purchase large amounts of trading stock which would lead to a tax deduction, in turn lowering the taxpayer's tax liability. This tax planning scheme has been prevented through the introduction of Section 22 into the Act.

2.5.1 Opening and closing stock

Section 22 only applies to trading stock which has been acquired by the taxpayer in the current year of assessment or prior year of assessment and not yet disposed of at the end of the year of assessment.

In order to avoid manipulation for the best tax position, Section 22(1) provides that the cost of trading stock still on hand, thus closing stock, should be added back to the taxable income of the taxpayer at the end of the year of assessment.

Opening stock, in terms of Section 22(2), has to be deducted from the taxpayer's taxable income. The deduction will be equal to the amount which has been added back to the taxpayer's taxable income in the preceding year of assessment. The opening and closing stock adjustments therefore ensure that the benefit of the Section 11(*a*) deduction will be matched with the proceeds of the sale. This leads to a fair matching of revenue and expenditure, resulting in the taxpayer only to be liable for tax on the profit from the disposal of the stock during the year of assessment that the profit is realised.

It was held in Richards Bay Iron & Titanium (Pty) Ltd and Another v CIR (1996) that the purpose of Section 22 is to defer the deduction of the costs incurred to acquire trading stock until the year of assessment in which it is disposed of (Swart, 1997:191). It was also held that work in progress should be included into closing stock in accordance with generally accepted accounting practice (Williams, 2009:364). It appears that the general consensus is that the function of Section 22 is to determine the cost of opening and closing stock, and to defer the deduction.

The improvements effected by construction contractors to the property owned by their clients becomes the property of the clients once the materials are delivered and affixed to the premises of the clients. The client becomes the legal owner of the trading stock and it would seem that the trading stock will be disposed of as soon as the improvements are effected. Even though a construction is usually for a period longer than a year, the trading stock applied in improvements would be disposed before the end of the year of assessment as it has already been effected to the property of the client and therefore disposed of in terms of Section 22(1).

Section 22 only applies to trading stock which is held and not disposed of. From the above mentioned, it would seem that Section 22 does not apply to construction contractors for trading stock which has already been applied in improvements at the end of the year of assessment. Section 22(2A) was therefore enacted in order to deem trading stock applied in improvements at the end of the year of assessment to be held and not disposed of until the fulfilment of the construction contract.

2.5.2 The application of Section 22(2A)

Section 22(2A)(*a*) applies exclusively to taxpayers carrying on any construction, building, engineering or other trade in the course of which improvements are effected to fixed property owned by another person. Normally, as indicated above, ownership transfers from the contractor to the client once the improvements have been affected to the property. Section 22(2A)(*a*) provides that the ownership of the material and improvements will only be transferred once the obligations of the contract have been met. Section 22(2A)(*b*) states that the contract will be deemed completed once 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. The trading stock is therefore to be held and not disposed of until the end of the contract for tax purposes. Section 22 will therefore be applicable to the deemed trading stock held. (De Koker & Williams, 2014)

Section 22(2A)(*a*) was specifically implemented in order to place the trading stock, i.e. improvements effected and materials delivered, as described above, within the scope of Section 22. Section 22 determines the cost of opening and closing stock. The deemed trading stock will be included in opening and closing stock for the normal tax calculation of the taxpayer until all obligations are fulfilled and the contract expires.

Section 22 and Section 22(2A) are only applicable to trading stock and only defer the deduction of cost. They do not determine the deductibility of expenditure, nor override the nature of an asset. The nature of the asset should be determined with reference to the Eighth Schedule and relevant case law principles. Section 11(*a*), read with Section 23(*g*), has to be applied to determine the deductibility of expenditure incurred.

The application of Section 22(2A) by the Court in the CSARS v South African Custodial Services (Pty) Ltd case seems to be in line with the above findings. The Supreme Court of Appeal referred to Section 22(2A), read with Section 11(*a*), of the Act to determine whether a deduction for the expenditure of materials used in the construction of the prison by the sub-contractor, hence trading stock, would be available to SACS. It was

held that a deduction for the trading stock would therefore only be available if the activities of SACS fell within the scope of Section 22(2A).

SACS contended that the construction of the prison was its trade and the materials used constituted its trading stock. However, this trading stock became the property of the Government as soon as it was built into the prison resulting in SACS no longer holding it as trading stock. It was argued on behalf of SACS that Section 22(2A) deems what may no longer be trading stock (now expenditure of a capital nature due to the loss of ownership) to be trading stock (expenditure of a non-capital nature) in order to still allow a deduction for trading stock that would override Section 11(*a*) which actually primarily deals with the deductibility of expenditure (such as the acquisition of trading stock) that is not of a capital nature. SACS therefore argued for a deduction of its expenditure (in the form of the payment made to the sub-contractor) that related to the acquisition of materials and equipment used in the construction of the prison.

It is therefore submitted that in paragraph 41 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:14), the Supreme Court of Appeal correctly determined the true purpose of Section 22(2A). The true purpose is to deem an item that was in fact trading stock in the hands of a taxpayer to still be 'held and not disposed of by that person' in order to enable the deduction in terms of Section 11(*a*). Thus, the application of Section 22(2A) is in agreement to the findings of the literature study above.

The Court turned to Section 22(2A), read with Section 11(*a*), of the Act to determine the deductibility by SACS of the expenditure incurred by the sub-contractor (CGM) relating to the materials acquired. It was held that the activities of SACS did not fall within the scope of Section 22(2A) since the improvements were effected to the property by the independent sub-contractor, and not by SACS or an agent of SACS. In the opinion of the Court, SACS therefore did not qualify for a deduction in terms of Section 22(2A).

Section 22(2A) was correctly applied to the tax position of the sub-contractor and not to the tax position of SACS as the main contractor. In paragraph 45 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:16), the Supreme Court of Appeal correctly determined that sub-contractor's activities fell squarely into Section 22(2A) as it effected the improvements and delivered materials to the Government's fixed property The sub-contractor held the trading stock for purposes of Section 22(2A) and could be deemed to be trading stock that was 'held and not disposed of' by it.

The true purpose of Section 22(2A) is to deem trading stock which has been effected to the property of a third party to be held and not disposed of by the contractor until the end of the contract for tax purposes, and to place it within the scope of Section 22.

Therefore, it is concluded that the Court correctly applied Section 22 and Section 22(2A), read with Section 11(*a*), in deciding whether the expenditure incurred was deductible in the hands of SACS.

2.5.3 Valuation of trading stock

In terms of Section 22(3) of the Act, the value of closing stock will be the cost of the trading stock less any amount which the Commissioner deems reasonable due to damage or loss in value. The cost of financial instruments held as trading stock will however not be diminished due to the market value and has to be included at cost price.

Reference to Section 22(3) has to be made in order to determine the value of trading stock.

The 'cost price' of trading stock in terms of Section 22(3), includes all cost incurred by the taxpayer in the acquisition of trading stock as well as any additional costs incurred in order to get the trading stock in its current condition and location, excluding exchange differences.

The cost price of the improvements effected to the property of the construction contractor's client is deemed in terms of Section 22(3A) to be equal to the cost incurred by the taxpayer for material used to effect the improvements, and any additional costs directly incurred in connection with the contract in accordance with generally accepted accounting practice, less any amounts received and payment which has been withheld as retention. The portion of costs incurred in connection with the contract can be apportioned among the contract and other contracts which can be allocated to the contract, in accordance with generally accepted accounting practice (which falls outside the scope of this study, refer to 1.6).

Section 22(3A) supplies a method for the valuation of the costs incurred for the deemed trading stock if progress payments are received by the contractor and states that:

'(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.' (Own emphasis added)*

This valuation of the deemed trading stock ensures that the amount included into closing stock diminishes in line with the income received, therefore matching the deduction allowed with the income received. Section 22(3A) only applies to the valuation of deemed trading stock as per Section 22(2A).

It is clear from the discussion that the purpose of Section 22(2A) is to deem trading stock which has already been delivered to a client's premises to be the property of the contractor so that the deemed trading stock is included in opening and closing stock. This ensures that the deduction for expenditure in respect of the fee payable to the sub-contractor is deferred in order to match with the income received. Section 22(2A) does not provide a special deduction and therefore does not override Section 11(*a*).

The fee paid to the sub-contractor was still incurred in the production of income: a deduction in terms of Section 11(*a*), the general deduction formula, should have been granted to SACS for this fee and the decision of the Supreme Court of Appeal led to negative tax consequences for SACS.

As discussed above, taxpayers made use of Section 11(*a*) in the past to perform tax planning and to make use of this tax deduction to their best advantage. Section 22 was enacted in order to prevent the manipulation of the tax deduction and to match the expenditure incurred with the proceeds, but not to determine the deductibility of the expenditure and does not override the deductibility provided for under Section 11(*a*).

The Supreme Court of Appeal correctly ruled that SACS never owned the trading stock and correctly denied a deduction for the trading stock in terms of Section 22(2A). As a result Section 22 has been correctly applied by the Supreme Court of Appeal.

2.6 CONCLUSION

A better understanding of the sections of the Act which governs the tax treatment of construction contractors has been obtained in this chapter through the literature study performed. The findings were applied to the tax position of SACS and compared to the judgement laid down in the CSARS v South African Custodial Services (Pty) Ltd case. It was established that the Court erroneously determined the fee paid to the sub-contractor to be capital in nature and should have granted a deduction in terms of s Section 11(*a*).

It is clear from the analysis performed that Section 11(*a*) allows deductions for expenditure incurred by a taxpayer if all four criteria of Section 11(*a*) have been met. The Court erroneously found that Section 11(*a*) should not be applied in order to determine the deductibility of the fee paid to the sub-contractor, as it held that the expenditure incurred did not meet one of the criteria of the general deduction formula. The Court held that the expenditure was capital in nature and therefore no deduction was allowed.

It has been established from the analysis performed that the definition of a trade must be broadly interpreted and includes a variety of profit making schemes. A scheme will constitute a trade if there is some degree of risk involved. It has been established that the relationship with the sub-contractor would not have influenced SACS's trading status as SACS was actively involved in the construction of the prison through the supervision and management of the sub-contractor and carried the risks associated with the profit making scheme. Therefore, it is clear that the criteria of the carrying on of a trade have been met by SACS.

SACS had been formed with the intention to design, construct and operate a prison in Louis Trichardt. The transaction with the Government was therefore part of the normal business activities of SACS and constituted a profit making scheme. The proceeds received from the Government were included in the gross income of SACS. Therefore, the fee paid to the sub-contractor was actually incurred by SACS in the production of income.

Various Case Law were analysed in order to identify general indicators to determine the nature of expenditure incurred. It has become clear that the classification depends on whether expenditure incurred contributes to the income-operating structure of the taxpayer and whether an enduring benefit has been obtained, or whether the expenditure was incurred as part of a profit making scheme. The intention of the taxpayer is also an important indicator to determine the nature of the expenditure

incurred. Intention is, however, subjective and therefore objective factors need to be evaluated in order to determine a taxpayer's true intention.

The objective factors surrounding SACS have been evaluated to determine SACS's true intention. The fact that the holders of shares in SACS were involved in the construction of prisons and that the sole purpose of the incorporation of SACS was to construct and operate a prison in Louis Trichardt indicates that it was the intention of SACS to carry on a trade.

It has been established that the purpose of Section 22 is to defer the deduction of the costs incurred to acquire trading stock until the year of assessment in which it is disposed of. Section 22(2A) requires trading stock which has been effected to the property of a third party to be held and not disposed of by the contractor until the end of the contract for tax purposes. Therefore, Section 22 and Section 22(2A) do not determine the deductibility of expenditure incurred. The Supreme Court of Appeal turned to Section 22(2A), read with Section 11(*a*), of the Act in order to determine whether SACS could deduct expenditure incurred by the sub-contractor for materials used in the construction of the prison. It correctly held that Section 22(2A) does not override section 11(*a*). It correctly determined that the improvements were never effected by SACS to the property of the Government and correctly granted the deduction to the sub-contractor in terms of Section 22(2A), read with Section 11(*a*), of the Act.

CHAPTER 3: CLASSIFICATION OF SUB-CONTRACTOR AND TAX PLANNING

3.1 INTRODUCTION

Since case law is often referred to in the judgment of later Court cases, it is essential for contractors to take the principles laid down in this Court case into consideration for tax planning purposes. It is essential for the contractor to take the necessary steps in order to ensure that the principles laid down in the CSARS v South African Custodial Services (Pty) Ltd case will not negatively affect its future tax position.

This chapter will attempt to address the fourth research objective, namely to provide guidance on the steps to be taken by the main contractor to ensure that the appointment of a sub-contractor will not result in negative tax consequences for the main contractor.

In order to meet the research objective the following will be discussed, analysed and evaluated in this chapter:

- Factors considered by the Court in determining the nature of the relationship between SACS and the sub-contractor in the SACS Court case.
- The meaning of a principal-agent relationship.
- Characteristics of an agent.
- Characteristics of an independent contractor.

The facts of the CSARS v South African Custodial Services (Pty) Ltd case will now be analysed in order to determine why the Court found the relationship between SACS and the sub-contractor to be that of an independent contractor.

3.2 FACTORS CONSIDERED BY THE COURT IN THE CSARS v SOUTH AFRICAN CUSTODIAL SERVICES (PTY) LTD CASE

SACS appointed a sub-contractor (CGM) to design and construct a prison. The construction contract concluded between SACS and its sub-contractor determined that the sub-contractor had to build and equip a prison on land owned by the Government (the Department of Correctional Services) for which SACS undertook to pay a set price. The sub-contractor was responsible for all construction services and activities that were necessary to erect the prison. SACS claimed a deduction in terms of Section 11(*a*) for the fee paid to the sub-contractor. The Supreme Court of Appeal however ruled that the fee was capital in nature and therefore did not qualify for a deduction in terms of Section 11(*a*).

The Tax Court (ITC 1855, 2010) granted a deduction in terms of Section 22(2A) for the trading stock acquired by the sub-contractor in the hands of SACS as the Tax Court was of opinion that the relationship between SACS and the sub-contractor was that of an agency and that the sub-contractor acted on behalf of its principal, SACS.

The Tax Court (ITC 1855, 2010) stated 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.'*

In paragraph 44 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:16), SACS is contended that '*SACS was entitled to the benefits of the deductibility of the cost of the trading stock acquired by CGM and built into the prison because it had built the prison through the agency of CGM.'* From the latter extract it is evident that SACS was of opinion that CGM, the sub-contractor, was an agent acting on behalf of its principal, namely SACS.

The Supreme Court of Appeal agreed with the principle that the acts of an agent would be deemed to be the acts of its principal, but questioned whether the relationship between SACS and the sub-contractor have been one of an agency. The Supreme Court of Appeal would however have granted a deduction for SACS if it considered the relationship between SACS and the sub-contractor to be that of a principal-agent relationship.

The Supreme Court of Appeal however ruled that the sub-contractor acted in his own capacity and that SACS therefore did not effect the improvements to the property of the Government, but that the sub-contractor did. A deduction in terms of Section 11(*a*) and Section 22(2A) was therefore not available since it was determined that SACS did not fall within the scope of Section 22(2A).

The Supreme Court of Appeal further substantiated its classification of the relationship in paragraph 43 of the CSARS v South African Custodial Services (Pty) Ltd case (2011:15) through inspecting the construction contract where the following is stated:

'...it is necessary to have regard to the essential features of the construction contract between SACS and CGM. In terms of the construction contract, CGM undertook to build and equip a prison – to perform 'all the construction services and activities associated with or necessary to provide the prison' – on land owned by the State, for which SACS undertook to pay a set price. The relationship between SACS and CGM was expressly stated not to be an employment relationship. Although not expressly stated, it is evident

that CGM was not SACS's agent either. It acted as an independent contractor and it gave a range of warranties as to the quality of its work and of the materials that it was to use that are incompatible with a relationship of principal and agent. It stood in relation to SACS as any construction company would in relation to a client for whom it had undertaken to construct a building. In terms of clause 8.3.14, CGM undertook to provide 'all goods, materials and labour necessary for the provision of the works'. From this it can be concluded that SACS never provided the materials or the equipment that were built into the prison, and never owned them at any stage. CGM did.'

Clause 48 of the construction contract between SACS and the sub-contractor defined the relationship between the parties as follows:

'...an independent contractor and nothing in the contract shall be construed as creating a relationship of the employer and employee between the contractor and construction sub-contractor or any of the sub-contractor's employees.'

From this clause, it is evident that the sub-contractor is not an employee of SACS and therefore not an agent of SACS.

The Supreme Court of Appeal ruled that the relationship between SACS and it's sub-contractor to be incompatible with that of a principal-agent relationship based on the wording of the construction contract between SACS and CGM and the range of warrantees provided to SACS by CGM with regards to the quality of the works performed.

The wording used within a construction contract between a contractor and a sub-contractor is critical as it could significantly impact on how a sub-contractor would be classified for normal income tax purposes and could lead to advantageous deductions for the main contractors.

From the above, it is evident that the deciding factors in the classification of the nature of the relationship considered in the Court case were the range of warrantees provided by the sub-contractor, indicating that the sub-contractor carried all the risk, and the fact that the contract stipulated that the relationship was not that of an employment contract.

3.3 THE MEANING OF PRINCIPAL AGENT RELATIONSHIP

An 'agency' describes a relationship where one person, the principal, gives power to a second person, the agent, to deal with a third person on the principal's behalf. The principal is responsible for any losses suffered by a third party which his agent causes

while dealing with the third person. (Anon., 2014c) It is evident that the actions of the agent would be deemed to be those of the principal.

An 'agent' is defined in Section 1 of the Act as:

'*...includes any partnership or company or any other body of persons corporate or incorporate acting as an agent*'

The definition is vague and could include numerous relationships. It does not express whether a contract is required or whether subjective factors would be sufficient to classify the relationship as that of an agency. In order to clarify the classification of the nature of the sub-contractor in its capacity as an 'agent' additional relevant definitions and interpretations need to be considered.

The definition of an agent in Section 1 of the Occupational Health and Safety Act of 1993 is as followed:

'"agent" means any person who acts as a representative for a client in the managing the overall construction work.'

This definition provides more insight as to the relationship of an agent. From this definition an agent is someone who represents another in the matters of the other person.

The implications for a principal appointing an agent are described in Section 97 of the Customs and Excise Act No 91 of 1964 as:

'Master, container operator or pilot may appoint agent.—

Notwithstanding anything to the contrary in this Act contained, the master of a ship, a container operator or the pilot of an aircraft, ***instead of himself performing any act****, including the answering of questions required by or under any provision of this Act to be performed by him, may at his own risk,* ***appoint an agent to perform any such act****, and any such act performed by such agent shall in all respects and for all purposes be* ***deemed to be the act of the master****, container operator or pilot, as the case may be: Provided that the personal attendance of the master or pilot may be demanded by the Controller.' (Own emphasis added)*

It is very clear from these Sections as mentioned above that a principal appoints an agent to act on behalf of the principal. All actions of the agent are deemed to be that of the principal.

The relationship is easily defined as a principal agent relationship if there is a contractual agreement between the two parties. The classification of the relationship is however

more difficult if there is no contract expressly stating that the relationship is that of an agency and subjective factors would have to be considered.

The Court indicated in the CSARS v South African Custodial Services (Pty) Ltd case that an employee would be considered to be an agent. Paragraph 1 in the Fourth Schedule to the Act defines an 'employee' as:

'(a) any person (other than a company) who receives any ***remuneration*** *or to whom any remuneration accrues;*

(b) any person who receives any remuneration or to whom any remuneration accrues by reason of any services rendered by such person to or on behalf of a labour broker;

(c) any labour broker; and

(d) any person or class or category of person whom the Minister of Finance by notice in the Gazette declares to be an employee for the purposes of this definition; and

(e) any personal service provider; and

(g) any director of a private company who is not otherwise included in terms of paragraph' (Own emphasis added)

Only paragraph (*a*) of the definition of an 'employee' as indicated above is relevant to this discussion and no further reference will be made to paragraph (*b*) – (*g*) of the definition.

The first requirement is that the person should receive remuneration. The term 'remuneration' is also defined in Paragraph 1 of the Fourth Schedule to the Act as:

'any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered.'

'Remuneration' however excludes:

'any amount paid or payable in respect of services rendered or to be rendered by any person in the course of any ***trade carried on by him independently*** *of the person by whom such amount is paid or payable and of the person to whom such services have been or are to be rendered: Provided that for the purposes of this paragraph a* ***person shall not be deemed to carry on a trade independently as aforesaid if the services are required to be performed mainly at the premises of the person by whom such amount is paid or payable or of the person to whom such services were or are to***

be rendered *and the person who rendered or will render the* ***services is subject to the control or supervision*** *of any other person as to the manner in which his or her duties are performed or to be performed or* ***as to his hours of work****: Provided further that* ***a person will be deemed to be carrying on a trade independently as aforesaid if he throughout the year of assessment employs three or more employees who are on a full time basis*** *engaged in the business of such person of rendering any such service, other than any employee who is a connected person in relation to such person.' (Own emphasis added)*

The characteristics of an agent or employee in terms of the Fourth Schedule of the Act for employees' tax purposes can therefore be summarised as follows:

- A person who receives remuneration in the form of wages or salary; or
- A person who does not trade independently from its employer or principal; or
- A person who renders services at the premises of its employer and who is subject to the control of such an employer.

3.4 CHARACTERISTICS OF AN INDEPENDENT CONTRACTOR

The SARS issued Interpretation Note: No. 17 (SARS, 2010) which provides a list of specific characteristics of an independent contractor for employees' tax purposes and will prove valuable to analyse the content of this document.

3.4.1 Interpretation Note: No. 17

Interpretation Note: No. 17 (SARS, 2010) provides two tests in order to determine whether a person will be classified as an employee or as an independent contractor. These two tests are the statutory test and the dominant impression test. The statutory test is conclusive in nature and should be considered first in order to determine whether a person should be classified as independent or not. The second test, should the statutory test prove to be inconclusive, is the common law dominant impression test. A dominant impression of the relationship should be formed when the common law dominant impression test is applied. Interpretation Note: No. 17 (SARS, 2010) provides a grid with a significant amount of indicators and circumstances which would indicate employee or contractor status.

3.4.1.1 Statutory test

The statutory test is provided in the exclusionary criteria of subparagraph (ii) of the definition of remuneration. The statutory test consists of three criteria. Only one of the

three criteria has to be met in order for a person to be deemed an employee. The criteria are:

- Whether the person is subject to the control of any other person as to the manner in which duties are performed or hours of work; or
- Whether the person is subject to supervision of any other as to the manner in which duties are performed; and
- Whether the person delivers services mainly at the premises of the employer

If any of these criteria apply positively, the person will be deemed an employee. The criteria will be positive if the person is subject to control or supervision, or amounts are paid on a regular basis, which would indicate that the person is paid for his time and not for a product. Should one of the aforementioned criteria be met, the common law dominant impression test will not be applied.

It should however be noted that a person will be deemed to be carrying on a trade independently and therefore an independent contractor if the person employees three or more full time employees who is not connected persons to him or her. The full time employees must also be engaged in his or business throughout the year of assessment.

3.4.1.2 Common law dominant impression test

The common law dominant impression test provides near-conclusive, persuasive and relevant indicators in order to determine the classification of the person as an independent contractor or as an employee. These indicators are only considered if the application of the statutory test has failed. The indicators should be considered in order to obtain a dominant impression of the status of a person.

The common law dominant impression test has various indicators to consider. Certain of these indicators could impact the contractor negatively from a business perspective; for example, warrantees from the sub-contractor are preferable as these protect the contractor against poor workmanship and qualities. Warrantees can, however, in terms of the common law dominant impression test, indicate that an independent contractor status is present.

It is recommended that the contractor ensures that at least one of the statutory tests is met by the sub-contractor. The sub-contractor will then be considered to be an agent of the main contractor and all actions performed by the sub-contractor will be deemed to be actions performed by the main contractor in terms of the Fourth Schedule of the Act for employees' tax purposes. Reference will not be made to the common law dominant

impression test and there will be no risk of being classified as an independent contractor based on the common law dominant impression test.

3.5 GUIDELINES FOR THE CONTRACTOR TO ENSURE MOST FAVOURABLE TAX TREATMENT

The following guidelines are provided to be considered by main contractors in order to ensure the most favourable normal income tax treatment for the main contractor when appointing sub-contractors:

- Special attention must be given to the wording used within the construction contract. It is recommended that there should not be referred to the sub-contractor as an independent contractor within the construction contract, unless it is the intention of the parties that the sub-contractor should be classified as an independent contractor.
- Ensure that at least one of the statutory tests as provided by Interpretation Note: No. 17 (SARS, 2010) is met. This would ensure that the sub-contractor is deemed to be an agent of the main contractor. This will secure a tax deduction in respect of costs incurred for the trading stock used to effect improvements to the property of the client, should the Court apply the principles as laid down in the SACS Court case. In order to meet one of the statutory tests:
    - Ensure that the sub-contractor is under the control of the contractor. This effectively means that it is the productive capacity of the sub-contractor, and not a result, that is obtained. This could be achieved by providing detailed instructions of the task to be performed. All acts by the sub-contractor, such as the appointment of staff or the application of certain equipment or trading stock, should be approved by the contractor. Control over the working hours of the sub-contractor will also be a strong indicator of an employer-employee relationship. It should however be noted that it would be sufficient to control only a portion of the productive hours.
    - The sub-contractor should be subject to a significant degree of supervision. Mere monitoring without the right to intervene would not indicate an employer-employee relationship. An element of supervision must be contained within the contract. A requirement of regular reporting to the contractor would be an indicator that supervision exists.
    - Ensure that the sub-contractor delivers the services mainly at the premises of the main contractor.

- Additional common law dominant impression test factors could also be incorporated in order that, should the statutory test be unclear, the sub-contractor would be considered to be an employee. These include that the payment or consideration for work performed is not based on a result, but based on the actual number of hours worked. This would indicate that the sub-contractor's productive capacity has been obtained and not only a mere service; hence a result. Payment by time periods, for example monthly, would be an indicator of an employer-employee relationship. Whether these amounts fluctuate does not impact the regularity of payments.

Through applying these guidelines, the main contractor would ensure that the sub-contractor would qualify as an agent. The agent would be deemed to be acting on behalf of its principal, the main contractor, and the costs incurred by the sub-contractor for the construction of the prison would be deductible in the hands of the main contractor.

3.6 CONCLUSION

The Court stated in the CSARS v South African Custodial Services (Pty) Ltd case that if the improvements had been effected by an agent, the principle *'Qui facit per alium, facit per se'*, which is part of the law, would have applied. It means that he, who acts through agents, acts himself. If the sub-contractor had qualified as an agent, all acts performed by the sub-contractor, including purchasing of trading stock and improvements effected, would have been regarded to have been the acts of SACS and as a result SACS would have been regarded as the owner of the trading stock. SACS would have qualified for a deduction in terms of Section 22(2A), since it would have been considered that SACS had effected the improvements itself.

Chapter 3 clarified guidelines that can be followed in order to ensure that the sub-contractor appointed by a main contractor will be considered to be an agent of the main contractor. All acts performed by the agent will then be regarded as having been performed by the main contractor itself, ensuring the most beneficial tax consequences for the main contractor. The main contractor will be considered to be carrying on a trade, the improvements effected by the sub-contractor will be deemed to have been performed by the main contractor and a deduction in terms of Section 22(2A) will be allowed in the hands of the main contractor. The sub-contractor would therefore not qualify for the deduction for the construction costs in terms of Section 22(2A).

CHAPTER 4: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

4.1 INTRODUCTION

It is common practice for Courts to refer to principles laid down in previous Court rulings. Since reference is often made to the prior rulings, it is important that the principles laid down are in agreement with the Act. The Act may lose its authority if rulings in future Court cases are based on past Court rulings which are contradictory to the rules and principles contained within the Act itself. This highlights the importance of analysing Court rulings to determine whether reliance should be placed on the ruling for future tax planning purposes.

The research question of this study was to determine whether any reliance should be placed on the judgement laid down in CSARS v South African Custodial Services (Pty) Ltd in order to determine the nature and deductibility of expenditure incurred by construction contractors in future.

In order to answer the research question the research objectives were addressed through a doctrinal research approach whereby the income tax legislation governing construction contractors were analysed and evaluated against the rulings made within the CSARS v South African Custodial Services (Pty) Ltd case.

4.2. SUMMARY OF FINDINGS

The findings relating to the research objectives could be summarised as follows:

Firstly the sections governing the normal income tax treatment of construction contractors were analysed in order to determine the application of these sections as intended by the Act. Hereafter it was considered how the Court interpreted and applied these sections within the context of the CSARS v South African Custodial Services (Pty) Ltd case.

4.2.1 Section 11(a)

A general deduction in terms of Section 11(*a*) is available for any taxpayer who carries on any trade and actually incurs expenditure in the production of income not of a capital nature. There is no definition for 'capital in nature' and each case should be considered independently and on its own merit. Each of the criteria has been analysed in order to be able to determine when a deduction in terms of Section 11(*a*) will be allowed. A summary of the findings per criteria is provided below.

4.2.1.1 The meaning of a 'trade'

A deduction in terms of Section 11(*a*) will only be allowed if 'the carrying on of any trade' is present. From the analysis performed, it has been established that the definition of a trade could be widely interpreted and that a trade includes a variety of profit making schemes. A profit making scheme will only constitute a trade if some degree of risk is involved. A trade has to involve a certain degree of activity in the process of producing income. Passive income, such as interest and dividends, will therefore not constitute the carrying on of a trade.

From the case under review, it is evident that the use of a sub-contractor, and the classification of the sub-contractor as an independent contractor, did not impact the 'trading' status of SACS, the main contractor.

It is concluded that the use of a sub-contractor does not impact whether a main contractor is carrying on a trade or not. Factors such as the level of risk that the main contractor is exposed to as well as the degree of activities undertaken by the main contractor in the production of income should be the deciding factors to conclude whether or not a main contractor is in fact 'carrying on a trade.'

4.2.1.2 The meaning of 'actually incurred'

From the analysis performed, it has been determined that actually incurred does not necessarily mean that expenditure should actually be paid. Furthermore, for expenditure to be actually incurred there should be no degree of contingency involved. The taxpayer should therefore be legally obliged to pay the expenditure. Expenditure is actually incurred once there is an unconditional obligation to perform. Once expenditure is actually incurred, there should be a diminishment in the assets of the taxpayer.

The Court did not dispute the fact that costs were actually incurred by SACS. SACS did pay a set price for the services delivered by the sub-contractors and did in fact actually incur expenditure.

4.2.1.3 The meaning of 'in the production of income'

As income is defined in the Act as gross income less any amounts exempt from normal tax, it is clear that expenditure will only be deductible if its related income is included into the gross income of the taxpayer. Income will be included into the gross income of the taxpayer if the amount is not capital in nature.

Expenditure will be regarded as incurred 'in the production of income' if it is attached to the performance of the business operations, provided that it is so closely connected to the business operations that it may be regarded as part of the cost of performing it.

It was held in the SACS Court case that SACS did not operate a trade; the Court therefore did not consider the rest of the criteria for a deduction in terms of Section 11(*a*). It is, however, clear from the study performed that SACS did indeed carry on a trade and that expenditure incurred in order to deliver the prison to the Government was part of a profit making scheme and was therefore closely connected to the performance of the business operations. Expenditure relating to the delivery of the prison was in the production of income.

4.2.1.4 The meaning of 'not of a capital nature'

It is a very contentious issue whether expenditure incurred is capital or income in nature. The answer will vary from case to case, based on the unique circumstances of each case. Through the analysis of various case laws, the following guidelines have been identified to be considered in order to determine the nature of expenditure incurred.

Once it is established what the intention was when the expenditure was incurred, whether it was incurred in order to create an enduring benefit which adds to the income earning structure of the taxpayer or whether it was incurred in the production of income, the nature of the expenditure can be determined. If the expenditure adds on to the income generating structure of the entity, it will be classified as capital in nature, but if the expenditure was incurred in the production of income, it will be classified as income in nature.

From the inspection of case law and Section 11(*a*), it has been established that a deduction for the fee paid to the sub-contractor should have been granted to SACS in terms of Section 11(*a*). It was found from the analysis performed that the fee paid was not capital in nature but income in nature.

The Court ruled in the CSARS v South African Custodial Services (Pty) Ltd case that the fee paid to the sub-contractor by SACS in order effect improvements was capital in nature. The Court should have considered the nature of the fee paid to the sub-contractor with relation to the prior Court cases which forms part of the South African lase law.

4.2.2 Section 22

From the analysis performed, it was established that the purpose of Section 22 and its related sub-sections of the Act is to defer a deduction of the expenditure incurred in order to obtain trading stock. The deferral will match the income to the expenditure. Therefore it is concluded that the purpose of Section 22 is not to determine the

deductibility of expenditure. These sections further determine what amounts should be taken into consideration in determining the cost of trading stock.

Furthermore, it was determined that the true purpose of Section 22(2A) is to include trading stock which has been effected to the property of a third party, into the scope of Section 22. The trading stock will be deemed to be held and not disposed of by the contractor until the end of the contract for normal income tax purposes.

Based on this, it is concluded that the Court correctly applied Section 22(2A) in determining whether or not the expenditure incurred by the sub-contractor was deductible by SACS. The Court stated that a deduction in terms of Section 22(2A) would not be allowed since SACS had not effected the improvements, and as a result the deduction was granted to the sub-contractor who had effected the improvements. This is in line with the findings of the study performed.

Therefore it is held that reference should be made the CSARS v South African Custodial Services (Pty) Ltd case in future court cases to determine the function and requirements of Section 22 and its' sub-sections.

4.2.3 Guidelines for main contractors in appointing sub-contractors in order to avoid negative tax consequences

From the Court case under review, it is clear that the classification of sub-contractors appointed by the main contractors can have an adverse impact on the deductibility of expenditure incurred to obtain trading stock for normal income tax purposes. Due to the judgement laid down in the CSARS v South African Custodial Services (Pty) Ltd case, there is a significant risk that main contractors will not qualify for a deduction of inventory should the sub-contractor not qualify as an agent or employee of such a main contractor. It is therefore recommended that the necessary steps should be taken by the main contractor to ensure that the sub-contractor will qualify as an agent of the main contractor.

Guidelines have been determined through analysing the requirements to be classified as an independent contractor versus an employee in terms of Interpretation Note: No. 17 (SARS, 2010) issued by the SARS as well as the factors considered within the CSARS v South African Custodial Services (Pty) Ltd case.

The following is a summary of the guidelines established in order to ensure the most favourable tax position for the main contractor who appoints sub-contractors:

- Special attention should be given to the wording used within the construction contract. It is recommended that there should not be referred to the sub-contractor

as an independent contractor within the construction contract, unless the sub-contractor is in fact an independent contractor. It would decrease the possibility of the sub-contractor to be viewed as an agent of the main contractor if the sub-contractor is classified as an independent contractor within the contract.

- It must be ensured that at least one of the statutory tests as provided by Interpretation Note: No. 17 (SARS, 2010) is met. This would ensure that the sub-contractor is deemed an agent of the main contractor and would secure a deduction for normal income tax purposes should the Court apply Section 22(2A) in determining the deductibility of expenditure incurred. In order to meet one of the statutory tests it must be ensured that the following are adhered to:
    - The sub-contractor must be under the control of the main contractor.
    - The sub-contractor should be subject to a significant degree of supervision of the main contractor.
    - The sub-contractor should deliver services mainly at the premises of the main contractor.

Through applying these guidelines, the contractor would ensure that the sub-contractor would qualify as an agent. The principle of *'Qui facit per alium, facit per se'* would then be applicable as all the acts performed by the sub-contractor would be deemed to have been performed by the main contractor itself.

4.3. FINAL CONCLUSION

From the analysis and comparative evaluation performed, it is submitted that SACS did in fact adhere to all the criteria required by Section 11(*a*) and that the fee paid to the sub-contractor should have been deductible. Based on the findings, it is concluded that the possible application of Section 11(*a*) should have been given more consideration by the Court in the CSARS v South African Custodial Services (Pty) Ltd case.

Section 22 and its sub-sections of the Act governing the tax treatment of trading stock and therefore also the expenditure incurred by sub-contractors in order to acquire trading stock were correctly applied by the Court in the CSARS v South African Custodial Services (Pty) Ltd case. Future reference can be made to the case in order to determine the correct application of Section 22 and specifically Section 22(2A) read with Section 11(*a*) in order to determine the deductibility of materials i.e. trading stock acquired by the sub-contractor in the hands of the main contractor.

The fact that SACS could not deduct a significant fee paid to the sub-contractor caused negative tax consequences for SACS. This could negatively impact the private sector's

willingness and attitude towards entering into PPPs with Government in future. It is vital for the development of the country and for the South Africa to meet its infrastructure targets as contained in the National Development Plan that the private sector is prepared to continue rendering construction services to the Government. The application of Section 22(2A), read with Section 11(*a*), does however provide an opportunity for main contractors to do more efficient tax planning. A substantial deduction in terms of Section 22(2A) and Section 11(*a*) could be obtained for cost incurred by the sub-contractor for the acquisition of trading stock if the relationship between the parties is classified as that of an agency. Subsequently it is recommended that construction contractors should ensure that its relationship with the sub-contractor will place it in the most beneficial tax position through ensuring that the sub-contractor is classified as its agent. The steps provided in this study will ensure that the most beneficial tax position will be obtained by the main contractor.

4.4 RECOMMENDATIONS AND AREAS FOR FUTURE RESEARCH

The impact of structuring the relationship between a main contractor and a sub-contractor as that of a Principal-Agent relationship could result in additional tax and business implications which was not considered in this study. It is suggested that further research could be conducted in order to explore these tax consequences from the perspective of both these parties in an attempt to establish the best contractual structure that would be most beneficial from a tax perspective.

Examples of these consequences for the main contractor could be the fact that all actions taken by the sub-contractor could be deemed to be that of the main contractor. The legal responsibility for the actions taken by the sub-contractor falling upon the main contractor also needs to be considered. It would be interesting to explore whether the possible tax savings could outweigh the additional risk taken on by the main contractor.

Further research could also be conducted in order to determine the effect of the Principal-Agent relationship on that of the sub-contractor. For example, the main contractor would possibly have to withhold Pay As You Earn (PAYE) from the sub-contractor's fees which could have a negative impact on the sub-contractor's cash flow. This possibility would have to be determined in terms of the Fourth Schedule to the Act. Also, the sub-contractor would most likely require some form of compensation for the tax deduction forfeited in terms of Section 22(2A) read with Section 11(*a*). Furthermore it would be questionable whether such compensation would be deductible in terms of

Section 11(*a*) in the hands of the main contractor and whether it will be taxable in the hands of the sub-contractor.

A cause and effect analysis could be performed to determine the various tax consequences that would result from the manner in which the contractual agreement or relationship is established between the parties in order to ensure the most beneficial tax position for both the main contractor and the sub-contractor.

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