



Public Private Partnership
Comhpháirtíocht Phoiblí Phríomháideach

Central Guidelines 1

**Corporation tax treatment of Public Private Partnership
Agreements**

02/07/2003

For further details please contact:

Central PPP Unit
Department of Finance,
15 Lwr. Hatch St.
Dublin 2

T: +353-1-6396211

F: +353-1-6396203

E: pppinfo@finance.gov.ie

W: www.ppp.gov.ie

CG1: Central Guidelines on Corporation tax treatment of Public/Private Partnership Agreements:

Note re Terminology: For convenience the Government Department, local authority etc. which is awarding the contracts is referred to as the **Awarding Authority** (“AA”) and the tenderer/prospective operator is referred to as the “**operator**” below.

We have set out below the corporation tax treatment for a generic PPP model. Any variants in a particular case would need to be examined and judged separately.

I. Trade:

The Design-Build-Finance-Operate-Maintain (DBFOM), Design-Build-Finance-Operate (DBFO), Design-Build-Operate (DBO) and Operate-and Maintain (O&M) models are all agreed as being trading activities within the Case I. The DBFO of a premise by an operator is regarded as the carrying on of a single trade;

II. Unitary charge/payment:

Where unitary payments made over the life of a project represent compensation to the operator for designing, building, financing and maintaining the relevant properties then such payments will be in the nature of trading income in the operator’s hands and accordingly would not be regarded as capital or as rental income, provided the licence or lease entered into with the operator does not confer an interest in the property on the operator but is solely for the purpose of enabling the operator to fulfil its obligations under the project agreement and also provided that the AA takes the premises in charge at no extra cost at the end of the contract period;

III. Lease:

Where there is a lease agreement between the operator and the AA in respect of the project, e.g. the educational institution, the mere existence of a lease will not render the sums payable under the lease taxable as rent where:

- a. the operator is not free to pass on the leasehold interest to another;
- b. the operator is responsible for the provision of a wide range of services to the AA beyond what would be provided in a normal landlord/tenant situation; and,
- c. where the unitary charge is composed of the elements outlined above then no part of it can be construed as “rent” as such.

It follows that it will be seen as Case I (i.e. trading) rather than Case V (i.e. rental) income.

IV.Sub-contracting:

Where the operator has the responsibility for providing a range of facilities such as cleaning, catering etc. the activity of providing those services in the context of the DBFO and DBFOM models is regarded as a trading activity (assessable Case I) notwithstanding that the bulk of the activities such as cleaning etc may be sub-contracted out by the operator.

V.Third party income:

Where surplus capacity is used to generate a user charge from third parties such income would usually be assessable Case I also, it is considered unlikely to have the characteristics of rent.

VI.Case V:

However the entitlement of the operator to rent out excess property might give rise to Case V income where a landlord/tenant relationship existed: the example given was of social housing constructed, operated and managed on a DBFOM model where the operator was entitled to retain and let a specified number of houses in excess of the houses constructed and managed for the AA, such letting income would be assessable Case V in the hands of the operator.

VII.Revenue sharing provisions:

Where there is agreement that the operator will share third party income with the AA then payments to the AA would be assessable Case IV in its hands and a deduction would be given against the gross third party income to the operator for payments to the AA out of the third party income.

VIII.Distribution:

However such revenue sharing could attract distribution treatment if it were between a company and its members, for example, if the AA was a shareholder in the operator.

The consequence of distribution treatment would be non-deductibility against the profits of the operator.

IX. CT rate:

The CT rate applicable to Case I is 12.5% (2003).

X.Early repayment of debt:

Where the AA pays a lump sum to the financing body (e.g. the bank) after a period to reduce the unitary charge by way of reducing the operator debt, some of the lump sum will be interest and some capital. Early repayment of the loan on the operator's behalf by the AA would result in the financial institution which had advanced the loan being taxable in the year of receipt on the full revenue element (interest) of the amount repaid; the capital element (balance of the loan amount) would not be taxable.

Penalty payments, if any, arising from early repayment of the loan would also be taxable as income in the hands of the lender financial institution. In any particular case regard would also be had to the accounting treatment adopted by the financial institutions advisors but this would not necessarily be decisive;

XI. Calculation of profits for tax:

The profits or gains of a trade for taxation purposes are ascertained in accordance with the ordinary principles of commercial accountancy unless there is a specific tax rule to the contrary. The amendment to FRS 5 "Reporting the Substance of Transactions": 'Private Finance Initiatives and Similar Contracts – September 1998' provides the specific guidance for the recognition of profits and assets in the case of Public Private Partnership transactions.

Application Note F of the amended FRS assists in the determination of whether the operator has a financial asset, being a debt due from the AA for the fair value of the property, or whether the operator has an asset of the property which is the subject of the DBFO contract.

XII.Repayment of debt by operator:

Operator debt repaid out of the unitary charge: the repayment of debt is deductible against Case I income. Bank borrowings could be seen as being on capital account but in practice Revenue do not seek to disallow interest which satisfies the test of being "wholly and exclusively for the purposes of the trade".

XIII.Pre-commencement events: e.g. pre-trading expenditure:

Expenditure incurred not more than three years prior to the commencement of the trade and which would have been allowable had it been incurred after the trade commenced is allowable in accordance with **Section 82 Taxes Consolidation Act 1997** (available on www.revenue.ie under publications: legislation).

For the deductibility of bid/tender costs see the Article in Tax Briefing issue 39, available on revenue website www.ppp.gov.ie , text also attached Appendix A for convenience.

XIV. Date of commencement:

The date of commencement is a matter of fact in each case but in general the trade would be seen as commencing whenever payments begin to be made under an agreement.

XV. Sale of surplus sites:

With respect to the tax treatment of the sub-sale of surplus sites: see Tax Briefing Issue 39, text attached at Appendix A.

XVI. Post-cessation events:

Compensation payments for loss of income are treated as revenue and hence as receipts of a Case I trade, otherwise they are treated as capital.

XVII. Compensation payments:

By way of asset transfer, it was noted that there might be a Capital Gains tax issue, to be considered on a case by case basis.

XVIII. Capital Allowances:

Where no leasehold or freehold interest is created in respect of the property Revenue considers that notwithstanding the accounting treatment, the entire contract is a revenue transaction in the hands of the operator. Therefore the question of capital allowances will not arise in respect of the property or any plant and machinery provided under the terms of the contract. The profits as disclosed by the accounts prepared in accordance with FRS 5 as amended in 1998 will be regarded as a true measure of the profits for tax purposes. Therefore the amortisation charge for the property, plant and machinery included in the profit and loss account will be allowed as a deduction in arriving at the taxable profits.

Revenue: TAX BRIEFING

Issue 39 - March 2000

Pages 7-9 Reproduced here for ease of reference only. Also available from www.revenue.ie

Treatment of Bid/Tender Costs and Surplus Land

Introduction

One of the ways in which the public sector can arrange for projects such as roads, public transport, waste management and water services to be undertaken, is by entering into a Public Private Partnership (PPP) arrangement. These arrangements often involve a private sector company (or consortium) agreeing to design, build and, possibly, operate the project in return for annual service charges which are paid by the public sector body. The contracts are usually for quite lengthy periods, typically 25-30 years. In the National Development plan for 2000-2006 provision has been included for £1.85 billion in PPP funding. The legal contracts which underlie such projects are invariably complex and may give rise to difficult tax issues. The purpose of this article is to consider the tax implications of two such issues:

- The question of the deductibility of bid/tender costs
- The tax treatment of surplus land (or cash) where it is introduced by the public sector body.

Background - Accounting Treatment

Before looking at the tax issues in detail, it is hoped that the following paragraphs, which contain a brief review of the relevant accounting treatment, will provide a useful overview for readers.

The Accounting Standards Board issued "Amendment to FRS5: Reporting the substance of Transactions Private Finance Initiative" and similar contracts in September 1998, which gives guidance on the accounting treatment to be used when dealing with Private Finance Initiative contracts (UK equivalent of PPP contracts). The amendment, which inserts Application Note F into FRS5 refers to the entity which acquires the services, (e.g. a Government Department) as the "purchaser", and the entity which supplies the services under the PPP contract to the Government

Department as the "operator"; the same terminology is used in this article.

The accounting by the operator is governed by Application Note F to FRS5 and the application of FRS5 involves those that prepare and audit financial statements taking a view on the substance of transactions, so that their commercial effects are properly reflected therein. In general, this involves taking a view on whether the property used in providing PPP contracted services is on or off balance sheet. In general, the operator has an interest in the property (e.g. a lease) and in most PPP schemes, significant risk rests with, or is transferred to, the operator. In such circumstances, the property is shown under FRS5 as the physical asset of the operator.

However, if the degree of risk transfer is low, the property may be on the balance sheet of the public sector purchaser. In such circumstances, the transaction is often termed "off balance sheet to the Operator", but more accurately, what this means is that the operator is viewed for accounting purposes as having a financial asset, reflected in its accounts as a debt due from the purchaser (similar to a finance lease receivable), rather than a physical asset of the property.

This article is only concerned with the position regarding the financial statements of the operator.

NB Although "Application Note F" of FRS5 specifically applies to UK Private Finance Initiative (PFI) contracts (UK equivalent of PPP contracts), in preparing the financial statements of an operator involved in Irish based PPP projects, the terms of the "Application Note" would normally be followed by the auditors and accountants of Irish companies.

Deductibility of Bid/Tender Costs

As part of the PPP process, a private sector company or typically, a number of companies who intend to form a consortium, will make a bid or an offer to the public body promoting the development of the project. Consortium members will incur certain expenditure in preparing their bid. Examples of this type of expenditure include architects, engineers, legal and other professional fees, salary and administration costs and financing costs.

Appendix A

A company making a bid/offer will either be successful or unsuccessful when the time comes to award the contract. If the bid succeeds, the members of a consortium generally carry out their commitments in relation to the project through a specially formed Special Purpose Company (SPC).

Costs incurred in making an unsuccessful bid

Where a company incurs expenditure in putting together an unsuccessful bid, provided that the expenditure is revenue in nature and would otherwise have been deductible as an expense of its trade, the bidding company can claim the costs as a deduction against the profits of its trade.

Costs incurred in making a successful bid

Where a bid made by a company succeeds, there is a potential issue as to whether the expenditure has been incurred by the bidding company for the purposes of its trade, given that that company, in conjunction with other members of the consortium, will form an SPC to carry out the terms of the agreement.

In the particular context of PPP projects, a deduction for costs incurred in a successful bid will not be disallowed by reason only of the fact that the project will be undertaken by a separate entity in the form of an SPC. If the expenditure is revenue in nature and would otherwise have been deductible as an expense of its own trade, the consortium company incurring the expenditure can claim a deduction for successful bid costs notwithstanding that the PPP project will be undertaken by an SPC. It should be noted that this treatment is specific to PPP projects and should not be regarded as having general application.

Tax Treatment of Surplus Land introduced into PPP contracts

Public sector organisations will often wish to minimise the annual service charge (referred to as the unitary charge) to be paid for the supply of services procured under a PPP contract, and where the purchaser has land surplus to its own requirements, it may decide to introduce that land into the PPP contract, in order to reduce the unitary charge. The purchaser and the operator will generally determine the price of the unitary charge on the basis of a discounted cash flow

model, which is produced by using a set of assumptions negotiated by the parties. The introduction of land as a contribution towards the project costs (in order to reduce the unitary charge), and the timing of the realisation of the value of the land, will have an impact on the cash flow of the operator and, therefore, on the price to be charged to the purchaser. The value of the land for tax purposes will be the price agreed between the parties which is specified in the documentation, being in accordance with the facts and intentions of the parties.

As has been previously stated, PPP transactions are by their very nature complex. When considering the correct tax treatment where surplus land of the purchaser is introduced into a particular contract, the terms of the relevant documentation, *providing this accord with the facts*, will be an important indicator. Another important indicator will also be the purpose of the payment from the point of view of the purchaser (as opposed to the purpose of the receipt from the operator's perspective) as evidenced by the documentation itself. For example, land can be introduced into a PPP project by the purchaser, in one of the following ways:

- The purchaser has land surplus to its requirements and introduces that land as a payment (in money's worth) on account of future unitary receipts
- The purchaser has previously identified land which is surplus to its requirements, has entered into an agreement for the disposal of that land to a developer and arranges for all or part of the proceeds to be paid directly by the developer to the operator as a payment on account of future unitary receipts
- Land is introduced by the purchaser as a payment in money's worth in order to reduce the capital cost of the project to the operator
- The proceeds arising from the disposal of land are introduced by the purchaser in order to reduce the capital cost of the project to the operator.

The following examples consider the accounting and tax treatment to be applied in straightforward circumstances.

Appendix A

Example 1

The *Department of Environment & Local Government* (the purchaser) enters into a PPP contract with an operator and has identified surplus land with a current market value of £10 million - assumed to be the fair value for accounting purposes - which it wishes to be introduced as a payment on account of future unitary receipts, and the documentation makes this clear.

Accounting Treatment

Under FRS5, the accounting treatment will follow the substance of the transaction and (assuming initially that the physical asset – a waste management facility - is on the balance sheet of the operator) the total capital cost of the project will be debited to fixed assets in the operator's balance sheet and depreciated in the normal way. The contribution of land is, therefore, recorded by the operator as an asset at its fair value of £10m (as part of project assets or separately from them according to whether the land is used in the project). The credit entry is to “deferred income”. (The contribution has to be recorded as “deferred income” rather than being used to reduce the project cost because of certain accounting rules in the *Companies (Amendment) Act 1986*.)

The “deferred income” is released to profit and loss account over the period to which the contribution relates. In general, this would be the whole of the contract period.

Alternatively, where the waste management facility is off the operator's balance sheet – the operator, therefore, has a financial asset - the Companies Act rules referred to above do not apply. The operator will set up a financial asset equal to the total amount of its investment. The operator would treat receipts from the purchaser as being partly interest and finance charges earned and partly collection of principal and the fair value of a contribution (i.e. the £10 million) would be treated in much the same way - credited to the financial asset - and would, therefore, affect the pattern in which interest is earned on

the amount of the principal that is outstanding from time to time.

Tax Treatment

Although the accounting treatment under FRS5 is an important consideration for tax purposes, particularly when determining the time at which receipts are to be taxed, it cannot determine whether the relevant item falls to be treated as income or capital. Here, the documentation (being in accordance with the facts and the intentions of both parties) shows that the introduction of the land is to reduce the future payments made by the purchaser to the operator and is, in effect, a prepayment of the unitary charge. The release of the contribution to the operator's profit and loss account will be chargeable to tax as income of the operator's

trade and it is likely that the timing of the income for taxation purposes will follow the accounts treatment.

Where the land is not immediately sold then its market value at the date of signing the PPP contract will, for tax purposes, be taken as the value of the prepayment of the unitary charge and the cost of the land to the operator.

Example 2

The *Department of Environment & Local Government* introduces land valued at £10m. into a PPP contract, to be used as a contribution to the construction costs and the documentation makes this clear.

Accounting Treatment

The accounting treatment is no different to that in Example 1 above, irrespective of how the land or cash proceeds are to be utilised.

Tax Treatment

As previously stated, whilst the accounting treatment is useful, it cannot determine the correct tax treatment. As with Example 1, providing the documentation reflects the facts and intentions of both parties, the tax treatment will accord with it and the contribution will fall to be treated as a contribution towards the capital costs of construction. Once that has been so established:

- The operator is treated as having received a capital contribution resulting in a reduction in the base cost of the asset e.g. the waste management facility, for capital gains tax purposes, in accordance with *Section 565 TCA 1997*. Revenue considers that where exceptionally the grant is not made from public funds (per *Section 565*), a reduction in the base cost of the asset is still required for tax purposes, since it is considered that the operator has not incurred the expenditure for the purposes of *Section 552 TCA 1997*;
- If the agreement specifies the particular costs to be met by the contribution, this will be followed when deciding whether any reduction in expenditure qualifying for capital allowances is required under *Section 317 TCA 1997* unless, exceptionally, the facts require a different approach;

Appendix A

- If there is a partial contribution - for example, towards the cost of a building with many different elements - then the grant will be apportioned across the various categories of expenditure (e.g. buildings, plant etc.) unless the parties have agreed how the contribution is to be allocated, in which case that allocation will be followed, unless the facts dictate otherwise.

Example 3

The *Department of Environment & Local Government* has previously realised proceeds from the disposal of surplus land and wishes to contribute all or part of those proceeds to the PPP operator, as a payment on account of future unitary receipts and the documentation makes this clear.

Accounting and Tax Treatment

The accounting and tax treatment will be exactly the same as in Example 1, reflecting the reality of the situation that cash has effectively passed from the purchaser to the operator on day 1 of the contract, in order to be spread over the period of the contract reducing the purchaser's future annual unitary charge payments.

Example 4

The *Department of Environment & Local Government* has previously realised proceeds from the disposal of surplus land and wishes to contribute all or part of those proceeds to the PPP operator, as a contribution to the construction costs of the project and the documentation makes this clear.

Accounting and Tax Treatment

The accounting and tax treatment will be exactly the same as in Example 2.

Example 5

The *Department of Environment & Local Government* enters into a PPP contract with an operator and has identified surplus land with a current market value of £10 million - assumed to be the fair value for accounting purposes - (or previously realised proceeds of £10 million from the disposal of surplus land) and wishes to contribute all or part of those proceeds to the PPP operator. The documentation is silent on how the land (or proceeds) are to be used.

Accounting and Tax Treatment

In such cases, particular care needs to be taken to ensure both the tax and accounting treatment reflect the facts of the case. However, if the documentation is silent then the tax treatment would normally follow the accounting treatment, producing the same result as in Example 1.

Further Information

Any questions regarding the terms of this article or other issues in connection with the taxation of PPP transactions can be addressed to:

Direct Taxes International &
Administration Division (Declan
Rigney),
Blocks 8-10, Dublin Castle,
Dublin 2.
Telephone: 01 - 702 4105
Fax: 01 - 679 3314 z