

## **INTERPRETATION NOTE: NO. 79**

DATE: 22 September 2014

**ACT : INCOME TAX ACT NO. 58 OF 1962**  
**SECTION : SECTIONS 25, 25C AND 26 AND PARAGRAPHS 2, 3, 4 AND 9 OF THE FIRST SCHEDULE AND PARAGRAPH 40 OF THE EIGHTH SCHEDULE**  
**SUBJECT : PRODUCE HELD BY NURSERY OPERATORS**

### ***Preamble***

In this Note unless the context indicates otherwise –

- **“First Schedule”** means the First Schedule to the Act;
- **“nursery”** means a place where young trees or plants are grown for the purpose of sale;
- **“nursery operator”** means a person who grows young trees or plants for the purposes of sale at a nursery;
- **“paragraph”** means a paragraph of the First Schedule;
- **“section”** means a section of the Act;
- **“the Act”** means the Income Tax Act No. 58 of 1962; and
- any word or expression bears the meaning ascribed to it in the Act.

### **1. Purpose**

This Note provides guidance on the valuation of produce held and not disposed of by nursery operators at the beginning and at the end of each year of assessment. It also examines the capital gains tax consequences of the disposal of produce.

It replaces Practice Note No. 32 dated 7 October 1994.

### **2. Background**

Section 26(1) stipulates that the taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as the income is derived from such operations, be determined in accordance with the Act but subject to the First Schedule. The First Schedule deals with the computation of taxable income derived from pastoral, agricultural or other farming operations.

The taxable income from farming operations is combined with the taxable income from other sources to arrive at the taxpayer's taxable income for the year of assessment.

The First Schedule applies regardless of whether a taxpayer derives an assessed loss or a taxable income from farming operations. The Schedule may further apply even after farming operations have been discontinued [section 26(2)].

Both section 26 and the First Schedule apply to farming operations conducted by a nursery operator. Some nursery operators have in the past, however, failed to comply with paragraph 2 of the First Schedule to the Act. Paragraph 2 requires a nursery operator carrying on farming operations to include in that operator's return of income the value of all produce held and not disposed of at the beginning and at the end of each year of assessment.

### 3. The law

Section 26 and the paragraphs of the First Schedule which are referred to in this Note are reproduced in the **Annexure**.

### 4. Application of the law

#### 4.1 Introduction

The First Schedule applies to any person who derives taxable income from carrying on pastoral, agricultural or other farming operations. Such a person can include an individual (whether farming alone or in partnership), a deceased estate, an insolvent estate, a company, a close corporation or a trust.

A nursery can consist of any one of the following operations or a combination of them:

- The carrying on of farming operations comprising, among others, the production of seed and the growing of plants, trees or bulbs for sale.
- The carrying on of non-farming activities such as the buying of plants and trees, fertiliser and other trading stock for immediate resale.

A nursery operator conducting both operations will have to split the operations between farming operations and operations other than farming.

The expression "farming operations" is not defined in the Act and should be interpreted according to its ordinary meaning as applied to the subject matter with regard to which it is used.<sup>1</sup>

It has been held that the question of whether a person is carrying on farming operations is one of fact<sup>2</sup> and must be decided considering all the facts of a particular case. However, in *Kluh Investments (Pty) Ltd v C: SARS*<sup>3</sup> Rogers J stated the following:

"Once all the facts relevant to determining whether the case does or does not fall within s 26(1) and para 14 [of the First Schedule] have been ascertained, the question whether on those facts there has been a carrying on of farming operations seems to me to be a question of law."

<sup>1</sup> E A Kellaway *Principles of Legal Interpretation of Statutes, Contracts and Wills* (1995) Butterworth's at 224.

<sup>2</sup> ITC 1319 (1980) 42 SATC 263 (EC) at 264, cited with approval in *CIR v D & N Promotions (Pty) Ltd* 1995 (2) SA 296 (A), 57 SATC 178 at 183.

<sup>3</sup> Case No. A48/2014, Western Cape High Court, 9 September 2014, as yet unreported in [9].

Farming and agriculture are defined in the *Merriam-Webster's dictionary*<sup>4</sup> as –

“the science, art, or practice of cultivating the soil, producing crops, and raising livestock and in varying degrees the preparation and marketing of the resulting products”.

However, every activity in the nature of farming will not constitute “farming operations”. This was confirmed by Heher AJA in the Supreme Court of Appeal in *C: SARS v Smith* when he stated the following:<sup>5</sup>

“In ordinary parlance the phrase ‘carrying on farming operations’ is capable of several meanings. In the context of s 26(1) it could mean simply ‘a particular form or kind of activity’ or it could bear a more commercial nuance, ‘a business activity or enterprise’.

“The Act is directed to the taxation of profit-making activities. There is no apparent reason why the legislature should have intended a taxpayer who farms as a hobby or who dabbles in farming for his own satisfaction to receive the benefits conferred by the First Schedule.”

An example of the above principle can be found in ITC 1324<sup>6</sup> in which it was held that a grower who merely intended to sell crops surplus to his needs was not carrying on farming operations.

Thus, in order to fall within the First Schedule a farming operation needs to be a trade of the taxpayer.

It is now settled law that the test for determining whether a taxpayer is carrying on farming operations is a subjective one, that is, one based on the taxpayer’s intention. This was held to be the case in the *Smith case* above in which Heher JA stated that –<sup>7</sup>

“a taxpayer who relies on s 26(1) is (over and above proof that he is engaged in an activity in the nature of farming) only required to show that he possesses at the relevant time a genuine intention to carry on farming operations profitably. All considerations which bear on that question including the prospect of making a profit will contribute to the answer, none of itself being decisive”.

The court went on to cite ITC 1185 in which Miller J stated the following:<sup>8</sup>

“It is no difficult matter to say that an important factor is: what was the taxpayer’s intention when he bought the property? It is often very difficult, however, to discover what his true intention was. It is necessary to bear in mind in that regard that the *ipse dixit*<sup>9</sup> as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the relevant facts and circumstances, what the motive, purpose and intention of the taxpayer were . . . This is not to say that the court will give little or no weight to what the taxpayer says his intention was, as is sometimes contended in argument on behalf of the Secretary in cases of this nature. The taxpayer’s evidence under oath and that of his witnesses, must necessarily be given full consideration and the credibility of the witnesses must

<sup>4</sup> [www.merriam-webster.com/dictionary/agriculture](http://www.merriam-webster.com/dictionary/agriculture) [Accessed 22 September 2014].

<sup>5</sup> 2002 (6) SA 621 (SCA), 65 SATC 6 at 9/10.

<sup>6</sup> (1980) 42 SATC 288 (Z).

<sup>7</sup> Above at 65 SATC 13.

<sup>8</sup> (1972) 35 SATC 122 (N) at 123/4.

<sup>9</sup> According to the *Glossary of foreign terms* by J Silke and Justice MM Corbett which forms part of the South African Tax Cases Reports published online by LexisNexis, the expression “*ipse dixit*” means “He himself said it; a bare assertion or statement without proof, resting on the authority of the person who made the assertion or statement”.

be assessed as in any other case which comes before the court. But direct evidence of intent and purpose must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts.”

In evaluating the genuineness of the taxpayer’s intention the nature and extent of the enterprise will be relevant. The following examples of factors to be considered were provided by Erasmus J in ITC 1698:<sup>10</sup>

“[T]he size and location of the property on which the operation is being conducted, the portion of that property being used for that purpose, capital expenditure, turnover, labour, the regularity and purposefulness of the activity, the time and effort spent thereon by the taxpayer in relation to his other gainful activities, if any, and the existence of a real prospect of profit (or lack thereof). The list is not exhaustive and the permutations of such activities are infinite. None of these considerations is necessarily in itself decisive.”

It is not a requirement that a person has to own the land on which the farming operations are carried on but the person must have a right to the land and the yield from it. This principle was illustrated in ITC 1548<sup>11</sup> in which the court found that the shearing and harvesting activities undertaken by a farmer on behalf of others on their land was not farming and neither were the transport services the farmer provided – the farmer was performing a service for other farmers and did not have a right to those farmers’ land or the yield from it.

The factors referred to above are not exhaustive and whether or not farming operations are being conducted will depend on all the facts and circumstances of each case.

The same test that is used to determine whether a person is carrying on farming operations applies to a nursery operator.

## **4.2 Nursery produce**

Section 22 deals with amounts to be taken into account in respect of the value of trading stock and specifically excludes farming.

Under paragraph 2 of the First Schedule a nursery operator’s return of income must include the value of all produce held and not disposed of at the beginning and at the end of each year of assessment.

The value of consumable stores, such as fuel, spare parts, fertilizer and materials for packing, held at the end of the year of assessment for farming purposes, must not be brought to account as trading stock because section 22 excludes a trade of farming. Such amounts will also not be brought to account under paragraph 2 since they do not comprise produce. However, to the extent that such consumable stores are held for non-farming purposes, such as fertiliser acquired for resale, they must be brought to account under section 22.

The amount that a farmer may claim as a deduction for consumable stores may, however, be limited under section 23F when the liability for the goods has been incurred but the goods have not been supplied during the year of assessment.

<sup>10</sup> (2000) 63 SATC 161 (SEC) at 170.

<sup>11</sup> (1991) 55 SATC 26 (C).

The term “produce” is not defined in the Act, and therefore, its ordinary dictionary meaning is retained, which is natural or agricultural products as opposed to manufactured goods.<sup>12</sup>

The general rule is that crops accede to the soil in the same way that permanent buildings or improvements do.<sup>13</sup>

Seeds planted can result in crops that are incorporated with the soil by a process of nature, and become one with that from which they draw their nourishment.<sup>14</sup> This principle is based on the rationale that the owner of the soil, which nourishes the seeds or plants, should become the owner of the eventual product.<sup>15</sup> Crops are however not inseparable from the soil since they can be reaped or removed once they have ripened or matured.<sup>16</sup> Growing crops are thus part of the land with no separate existence and do not constitute produce until they have been harvested or picked when mature or ripe. For this reason, crops growing at the end of the year of assessment are not required to be brought into account for income tax purposes.

Consequently, the value of growing crops is excluded from opening stock at the beginning of the succeeding year of assessment. Plants grown, which are not yet ready for sale, will fall into this category of growing crops and must not be brought into account as produce.

There are, however, limitations and exceptions to the rule that everything that is planted in the soil becomes part of the soil. Such an exception exists for plants, bulbs, shrubs or trees, which are destined to be removed like those in a nursery as they retain their identity as movables and do not become part of the soil.<sup>17</sup> In *Gore NO v Parvatas (Pty) Ltd*<sup>18</sup> it was held that bulbs which are planted as bulbs and are to be removed from the soil as such must be distinguished from plants that are grown from seeds which take root and bear crops that are then harvested. Unlike the growing crops the bulbs are destined to be removed and do not form part of the soil. The decisive factor as to whether something becomes movable is the intention of the person who planted it.

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<sup>12</sup> D M Davis *et al* *Juta's Income Tax* [online] (Juta Law Online Publications: 2004) under South African Income Tax: Legislation and Commentary / Commentary on Income Tax: / First Schedule / paragraph 2. In *R v BHIGJEE* 1953 (2) SA 783 (N) at 784 the court held that unlike mealie meal, sugar was not a product of farming operations

<sup>13</sup> *Secretary for Lands & another v Jerome* 1922 AD 103.

<sup>14</sup> *Secretary for Lands & another v Jerome* above at 105. See also *Macdonald Ltd v Radin NO & the Potchefstroom Dairies & Industries Co Ltd* 1915 AD 454 and *Gore NO v Parvatas (Pty) Ltd* 1992 (3) SA 363 (C).

<sup>15</sup> See *Secretary for Lands and Another v Jerome* above at 105. See also C G van der Merwe “Planting and Sowing” 27 (First Reissue Volume) *LAWSA* [online] (My LexisNexis: 31 October 2001) in paragraph 336.

<sup>16</sup> *Secretary for Lands and Another v Jerome* above at 110.

<sup>17</sup> *Burrows v Mc Evoy* 1921 CPD 229. See also C G van der Merwe *Sakereg* 2 ed (1979) Butterworth's at page 245/246.

<sup>18</sup> 1992 (3) SA 363 (C). See also *Burrows v McEvoy* 1921 CPD 229 at 235/236 and *LAWSA* above in paragraph 336.

The court was satisfied that bulbs planted in the soil with the intention of being removed from it, retained their identity as movables.<sup>19</sup>

The question whether a bulb is produce for tax purposes will depend on the reason for its removal from the soil. Bulbs which are removed from the soil for sale will comprise produce. Bulbs removed from the soil as part of a natural growing cycle, for example, with the intention of replanting them in preparation for the next season, will not comprise produce since they are not ready for sale. The onus is on the nursery operator to distinguish between the two types of bulbs.

A difficulty arises with seedlings and other plant material (including bulbs) produced and grown in containers for ultimate sale in the same containers. SARS accepts that such items will only have a value as produce once they have matured sufficiently to be in a saleable condition. The onus remains on the nursery operator to make that determination on a sound basis.

The related expenditure incurred in getting the plants, trees, seedlings or bulbs to a marketable state should generally be deductible under section 11(a) read with section 23(g) on the basis that it was incurred in the production of income in carrying on a trade.<sup>20</sup> Examples of such expenditure include labour and fertilizer. Capital development expenditure incurred on items such as irrigation schemes and the erection of farm buildings will qualify for deduction under paragraph 12 provided all the requirements of that provision are met. The proceeds derived from the sale of the plants and bulbs are included in gross income in the year of assessment in which the sale takes place.<sup>21</sup>

### **4.3 Valuation of produce**

#### **4.3.1 Valuation method**

Paragraph 9 stipulates that the value to be placed on produce included in any return shall be such fair and reasonable value as the Commissioner may fix.

The fair and reasonable value of the produce fixed by the Commissioner is subject to objection and appeal under section 3(4)(c).

A reasonable value is considered to be the lower of production cost or market value.

The term “market value” is not defined for the purposes of the First Schedule but in the context would bear its ordinary meaning of the price which could have been obtained upon a sale of the produce between a willing buyer and a willing seller dealing at arm’s length in an open market.

The value of production costs is determined by considering expenditure allowable for income tax purposes, excluding expenditure deductible under paragraph 12.

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<sup>19</sup> At 670. In this case the court referred to Pothiers *Traite de la Communauté* where it was said that a nurseryman’s bulbs, once transplanted from the soil where they originally grew, retain the quality of movables which they acquired when they were first taken out of the soil. They are not considered to be part of the soil because they were planted “*pour perpétuelle demeure*”. See also LAWSA volume 27 in 336.

<sup>20</sup> See *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13.

<sup>21</sup> See the definition of “gross income” in section 1(1).

In ITC 936<sup>22</sup> the Commissioner's decision to value the appellant's produce on the cost of production basis was taken on review. The court noted that the cost of production basis was a recognised and proven method of valuation and the Commissioner's decision to use it could not be said to have been so unreasonable that no reasonable person would have adopted it. Whilst the market value method was open to the Commissioner, the Commissioner was not obliged to use it. The appeal was accordingly dismissed.

The "reasonable man" test does not give preference to one party over the other and both parties are treated on par.<sup>23</sup>

#### **4.3.2 Value of closing stock [paragraph 3(1)]**

Paragraph 3(1) stipulates that the value of produce held and not disposed of at the end of the year of assessment must be included in income for that year of assessment, and that there shall be allowed as a deduction from this income the value of produce as determined in accordance with paragraph 4, held and not disposed of at the beginning of that year of assessment.

#### **4.3.3 Value of opening stock [paragraph 4]**

The value of produce held and not disposed of at the beginning of a year of assessment by a nursery operator who carried on operations on the last day of the year immediately preceding the year of assessment is deemed to be the sum of –

- the value of produce held and not disposed of at the end of the year immediately preceding the year of assessment [paragraph 4(1)(a)(i)], and
- the market value of the produce –
  - acquired during the current year of assessment otherwise than by purchase or natural increase or in the ordinary course of farming operations [paragraph 4(1)(a)(ii)(aa)]; or
  - held for purposes other than farming operations, which the nursery operator during the year of assessment commenced to hold for the purpose of farming operations [paragraph 4(1)(a)(ii)(bb)].

A nursery operator who acquires produce by donation, inheritance or distribution *in specie* must include the market value of that produce in opening stock under paragraph 4(1)(a)(ii)(aa) and in that way will secure a deduction for such produce. For more on the treatment of produce on death see **4.3.6**.

#### **4.3.4 Discontinuation of farming operations**

Under section 26(2) some provisions of the First Schedule will continue to apply to a nursery operator who still holds produce after farming operations have ceased. These provisions will continue to apply until the last of the produce has been disposed of. Paragraph 3(3) deems produce subject to a similar agreement to a "sheep lease" to be held and not disposed of by the grantor of the lease or agreement (lessor). The value of the produce must be included in the determination of the lessor's taxable income each year until the produce is disposed of.

<sup>22</sup> (1960) 24 SATC 361 (C).

<sup>23</sup> *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A) at 435H-I.

#### 4.3.5 Commencement or recommencement of farming operations

The value of the opening stock of produce at the commencement or recommencement of farming operations by a nursery operator is deemed to be the sum of –

- the value of any produce held and not disposed of at the end of the day immediately preceding the date of the commencement or recommencement of those operations [paragraph 4(1)(b)(i)], and
- the market value of the produce [other than produce referred to in paragraph 4(1)(b)(i)] –
  - acquired during the current year of assessment otherwise than by purchase or natural increase or in the ordinary course of farming operations [paragraph 4(1)(b)(ii)(aa)]; or
  - held for purposes other than farming operations, which the nursery operator during the year of assessment commenced to hold for the purpose of farming operations [paragraph 4(1)(b)(ii)(bb)].

The value (lower of production cost and market value) of produce held at the date of commencement or recommencement of farming operations will accordingly be allowed as a deduction in that year of assessment.

Produce acquired by a nursery operator by donation, inheritance or distribution *in specie* during the current year of assessment must be included in opening stock at market value. For more on produce acquired by a deceased estate see 4.3.6.

#### 4.3.6 Death

The death of an individual who carries on nursery operations has income tax and capital gains tax consequences for the deceased person, the deceased estate and the heirs or legatees. These consequences are briefly discussed below with reference to produce.

##### (a) Income tax

###### *Deceased person*

The taxable income of a person upon death must be determined for the period from the beginning of the year of assessment to the date of death.

As discussed earlier, a person carrying on nursery operations includes the value of produce held and not disposed of at the beginning and end of the year of assessment in opening and closing stock generally at the lower of production cost and market value. The same principle applies to the final year of assessment of the deceased person with the result that produce will be reflected at the lower of production cost and market value in opening and closing stock in that year.

###### *Deceased estate*

An executor of a deceased estate who continues to carry on farming operations must include the market value<sup>24</sup> of produce acquired from the deceased person in opening stock in the deceased estate's tax computation.<sup>25</sup>

<sup>24</sup> Determined at the date of death of the deceased.

<sup>25</sup> Paragraph 4(1)(b)(ii)(aa).



Any produce still on hand at the end of the deceased estate's first year of assessment will be included in closing stock at the lower of production cost and market value, and the same applies to amounts to be included in opening and closing stock in subsequent years of assessment of the deceased estate.

On inclusions in the gross income of the estate and deductions claimable by the estate, see "Heirs and legatees" below.

#### *Heirs or legatees*

Any amount received by or accrued to the deceased estate from the disposal of produce must be included in the gross income of the deceased estate unless it is derived for the immediate or future benefit of an ascertained heir or legatee, in which case it must be included in the gross income of that heir or legatee [section 25(1)].

Deductions or allowances relating to nursery operations conducted by the executor must be claimed by the deceased estate unless they relate to income which has been included in the income of an ascertained heir or legatee under section 25(1). In the latter event the deductions or allowances must be claimed by the heir or legatee [section 25(2)]. For example, an ascertained heir or legatee would claim the market value of produce acquired by the estate on the date of death.

The amount received by or accrued to an heir or legatee who disposes of produce acquired by inheritance will be of a capital nature provided that it was not made part of a farming operation (see "Capital gains tax" below).

By contrast, any amount received by or accrued to a farmer on disposal of inherited produce which has been incorporated into the farmer's farming operations must be included in the farmer's gross income. Under paragraph 4(1)(a)(ii)(aa) the farmer will be entitled to an opening stock deduction for the inherited produce equal to its market value. Any inherited produce not disposed of in the year of assessment in which it was acquired must be included in closing stock at the lower of production cost or market value.

#### **(b) Capital gains tax**

For more information on the capital gains tax consequences of deceased estates, see chapter 16 of the *Comprehensive Guide to Capital Gains Tax* (Issue 4).

#### *Deceased person*

Under paragraph 40(1) of the Eighth Schedule a deceased person is deemed to dispose of that person's assets (with some exceptions) to the deceased estate for an amount received or accrued equal to their market value on the date of death.

One of the exceptions to this rule is assets bequeathed to the person's spouse. In that case the surviving spouse is subject to roll-over treatment under paragraph 67(2)(a) of the Eighth Schedule and steps into the shoes of the deceased person in relation to the asset. This means that the surviving spouse takes over from the deceased person, amongst other things, the date of acquisition, the date of incurral of expenditure and the amount of expenditure on the asset.

Produce held on the date of death is thus generally deemed to be disposed of by the deceased person for an amount received or accrued equal to its market value, except if the produce is bequeathed to the person's spouse. The proceeds under

paragraph 35 of the Eighth Schedule will generally be determined by reducing the market value of the produce deemed to be disposed of under paragraph 40(1) of the Eighth Schedule by the amount of the produce included in closing stock.<sup>26</sup>

In determining the base cost of produce, any expenditure incurred in acquiring it must be reduced by any portion which has been allowed as a deduction under section 11(a).<sup>27</sup> Thus the cost of any produce which has been fully allowed under section 11(a) will have a base cost of nil.

The base cost of produce acquired before 1 October 2001 may be determined using the time-apportionment, market value or 20% of proceeds method under paragraphs 26 and 27 of the Eighth Schedule.

#### *Deceased estate*

The deceased estate is deemed to acquire the assets from the deceased person for an amount of expenditure equal to the market value of those assets on the date of death (paragraph 40(1A)(a) of the Eighth Schedule).

Paragraph 40 of the Eighth Schedule envisages that an executor will deal with the assets of the estate either by –

- awarding an asset to an heir or legatee; or
- disposing of the asset to a third party.

An asset awarded by the executor to an heir or legatee is treated as having been disposed of for proceeds equal to its base cost.<sup>28</sup>

The executor of the deceased estate must determine a capital gain or loss for assets disposed of to a third party. The proceeds on disposal of an asset are reduced under paragraph 35(3)(a) of the Eighth Schedule by any amount included in gross income or which was taken into account in determining taxable income. Likewise, the base cost of an asset is reduced under paragraph 20(3)(a) by any amount which is or was allowable or is deemed to be allowed as a deduction in determining taxable income. Whether these proceeds and base cost reductions occur will depend on whether there is an ascertained heir or legatee.

If there is an ascertained heir or legatee any amount received by or accrued to the estate which would have been income in the hands of the deceased person is deemed to be income in the hands of the heir or legatee under section 25(1). In this situation the deceased estate will not reduce its proceeds under paragraph 35(3)(a) of the Eighth Schedule.

If there is no ascertained heir or legatee, section 25(1) deems the amount to be income of the deceased estate, and in this event the amount received by or accrued to the deceased estate must be reduced under paragraph 35(3)(a) in arriving at its proceeds.

The same principle applies to deductions, that is, section 25(2) attributes them to an ascertained heir or legatee but leaves them in the deceased estate when there is no such heir or legatee. Thus, when the deductions remain in the deceased estate they

<sup>26</sup> Under paragraph 35(3)(a) of the Eighth Schedule.

<sup>27</sup> Under paragraph 20(3)(a) of the Eighth Schedule.

<sup>28</sup> Paragraph 40(2)(a) of the Eighth Schedule.

will reduce base cost under paragraph 20(3)(a) of the Eighth Schedule but if they are attributed to an heir or legatee the deceased estate's base cost will not be reduced. An example of such a deduction is the opening stock of the deceased estate. In this regard the deceased estate is granted an opening stock deduction at market value for the produce acquired from the deceased person [paragraph 4(1)(b)(ii)(aa)]. As a result, its expenditure deemed to have been incurred under paragraph 40(1A)(a) of the Eighth Schedule will be reduced to nil by paragraph 20(3)(a) of the Eighth Schedule if there is no ascertained heir or legatee. The deceased estate will accordingly have a base cost of nil for the produce in question. Conversely, if there is an ascertained heir or legatee there will be no such reduction because the deduction against income will have been attributed to the heir or legatee.

#### *Heirs or legatees*

Under paragraph 40(2)(b) of the Eighth Schedule an heir or legatee is deemed to have acquired inherited produce at a base cost equal to the deceased estate's base cost. This deemed cost is treated as expenditure actually incurred for the purposes of paragraph 20(1)(a) of the Eighth Schedule and may, depending on the circumstances (see below), be reduced under paragraph 20(3)(a) of the Eighth Schedule.

A disposal by an heir or legatee would, for example, be on capital account if the inherited produce was not made part of an existing farming operation.

As a rule, an heir or legatee who disposes of inherited produce on capital account will have a base cost for that produce equal to its market value on the date of death of the deceased person. The produce acquired by the deceased estate by natural increase occurring after the date of the deceased's death would have a base cost to the estate of nil since the estate would not have incurred any expenditure for that produce. An heir or legatee who inherits such "natural increase" produce will also acquire it at a base cost of nil. The proceeds from a sale of produce on capital account will as a rule be equal to the amount received or accrued.

By contrast, an heir or legatee who commences to use the produce in a farming operation or brings it into an existing farming operation will be on revenue account. In these circumstances the heir or legatee will acquire that produce for revenue expenditure equal to its market value [paragraph 4(1)(a)(ii)(aa) read with section 25(2)]. The base cost of the produce established under paragraph 40(2)(b) of the Eighth Schedule must therefore be reduced under paragraph 20(3)(a) of the Eighth Schedule by the paragraph 4(1)(a)(ii)(aa) deduction. An heir or legatee who disposes of produce on revenue account will have proceeds of nil because the amount would be included in gross income.<sup>29</sup>

#### **4.3.7 Insolvency or liquidation**

Section 25C deems the estate of a natural person before sequestration and that person's insolvent estate to be one and the same person for the purpose of determining –

- any allowance, deduction or set off to which that insolvent estate may be entitled;

<sup>29</sup> The amount received by or accrued to the heir or legatee will be reduced by the portion included in gross income under paragraph 35(3)(a) of the Eighth Schedule.

- any amount which is recovered or recouped by or otherwise required to be included in the income of that insolvent estate; and
- any taxable capital gain or assessed capital loss of that insolvent estate.

The person before sequestration must submit a return of income for the period commencing on the first day of the year of assessment and ending on the date before the date of sequestration.<sup>30</sup> Produce will have a value equal to the lower of production cost and market value for closing stock purposes at the end of that person's year of assessment in the normal way.

The insolvent estate must submit a return of income for its first year of assessment from the date of sequestration until the end of that year and for all subsequent years of assessment until the estate is wound up.

The insolvent estate will have an opening stock equal to the value included in closing stock of the person before sequestration based on the "one and the same person" principle. Any assessed loss of the person before the date of sequestration will be brought forward into the insolvent estate. Produce must continue to be brought into closing stock at the lower of production cost and market value in the first year of assessment of the insolvent estate and for the purposes of determining future opening and closing stock. Any amount received by or accrued to the insolvent estate from the disposal of produce must be included in the gross income of the insolvent estate.

For CGT purposes there is no deemed disposal on date of sequestration as a result of the "one and the same person" principle in section 25C. Given that produce is floating capital there should be no CGT implications when produce is disposed of by the trustee of the insolvent estate.

A company that is being wound up or liquidated remains the same taxable entity until it is finally dissolved.<sup>31</sup> In practice a company must submit an interim return of income for the period from the beginning of the year of assessment up to the date immediately before the date of liquidation and another return from the date of liquidation until the end of the year of assessment. Produce must be brought to account in opening and closing stock in these interim returns at the lower of production cost and market value.

Any amounts derived by the company after date of liquidation must be included in its gross income.

## 5. Conclusion

Persons conducting the business of a nursery in the course of which plants or trees are grown for sale are regarded as carrying on farming operations. Persons in this category are taxed in accordance with section 26 subject to the First Schedule. The same tests used to determine whether a person carries on farming operations apply to these nursery operators.

<sup>30</sup> Paragraph (b)(i) of the proviso to section 66(13)(a).

<sup>31</sup> *Van Zyl NO v CIR* 1997 (1) SA 883 (C), 59 SATC 105.

The produce held at the beginning and at the end of the year of assessment of a nursery operator carrying on farming operations is specifically excluded from section 22 and must be dealt with under the First Schedule. The value of the produce held and not disposed of must be brought into account at the beginning and end of the year of assessment. The value to be placed upon the produce on hand is the fair and reasonable value as the Commissioner may fix in accordance with paragraph 9. The plants or trees grown by a nursery, which are not ready for sale, will fall into the category of growing crops and must not be brought into account when the taxable income from farming operations is determined.

Any trading stock purchased from outside sources and offered for sale is not attributable to farming operations and must be dealt with under section 22.

**Legal and Policy Division**  
**SOUTH AFRICAN REVENUE SERVICE**

## Annexure – The law

### Section 26

**26. Determination of taxable income derived from farming.**—(1) The taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as it is derived from such operations, be determined in accordance with the provisions of this Act but subject to the provisions of the First Schedule.

(2) In the case of any person who has discontinued carrying on pastoral, agricultural or other farming operations and is still in possession of any livestock or produce, or has entered into a “sheep lease” or similar agreement relating to livestock or produce, which has been taken into account and in respect of which expenditure under the provisions of this Act or any previous Income Tax Act has been allowed in the determination of the taxable income derived by such person when such operations were carried on, the provisions of this Act, but subject to the provisions of paragraphs 1, 2, 3, 4, 5, 6, 7, 9, or 11 of the First Schedule, shall continue to be applicable to that person in respect of such livestock or produce, as the case may be, until the year of assessment during which he disposes of the last of such livestock or produce, notwithstanding the fact that such operations have been discontinued.

### First Schedule

2. Every farmer shall include in his return rendered for income tax purposes the value of all livestock or produce held and not disposed of by him at the beginning and at the end of each year of assessment.

3. (1) Subject to the provisions of sub-paragraphs (2) and (3), the value of livestock or produce held and not disposed of at the end of the year of assessment shall be included in income for such year of assessment, and there shall be allowed as a deduction from such income the value of livestock or produce, as determined in accordance with the provisions of paragraph 4, held and not disposed of at the beginning of the year of assessment.

(2) For the purposes of subparagraph (1), the value of livestock or produce held and not disposed of at the end of any year of assessment by any person who discontinued farming operations during such year, shall be included in his income for such year and for all subsequent years of assessment so long as such livestock or produce, or any portion thereof, is so held and not disposed of.

(3) Any livestock which is the subject of any “sheep lease” or similar agreement concerning livestock, and any produce which is the subject of a similar agreement, shall be deemed to be held and not disposed of by the grantor of such lease or agreement.

4. (1) The values of livestock and produce held and not disposed of at the beginning of any year of assessment shall, subject to the provisions of sub-paragraph (2), be deemed to be—

- (a) in the case of a farmer who was carrying on farming operations on the last day of the year immediately preceding the year of assessment, the sum of—
  - (i) the values of livestock and produce held and not disposed of by him at the end of the year immediately preceding the year of assessment; and

- (ii) the market value of livestock or produce—
  - (aa) acquired by such farmer during the current year of assessment otherwise than by purchase or natural increase or in the ordinary course of farming operations; or
  - (bb) held by such farmer otherwise than for purposes of pastoral, agricultural or other farming operations, which such farmer during such year of assessment commenced to hold for purposes of pastoral, agricultural or other farming operations; or
- (b) in the case of any person commencing or recommencing farming operations during the year of assessment, the sum of—
  - (i) the value of any livestock or produce held and not disposed of by him at the end of the day immediately preceding the date of such commencement or recommencement; and
  - (ii) the market value of livestock or produce (other than livestock or produce to which sub-item (i) refers)—
    - (aa) acquired by such person during the year of assessment otherwise than by purchase or natural increase or in the ordinary course of farming operations; or
    - (bb) held by such person otherwise than for purposes of pastoral, agricultural or other farming operations, which such person during such year of assessment commenced to hold for purposes of pastoral, agricultural or other farming operations.

(2) . . . . .

(3) . . . . .

9. The value to be placed upon produce included in any return shall be such fair and reasonable value as the Commissioner may fix.