IN THE TAX COURT
(WESTERN CAPE HIGH COURT, CAPE TOWN)

Case No: 13132

In the matter between:

DR A **Appellant**

and

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

JUDGMENT DELIVERED ON 8 DECEMBER 2014

ALLIE, J

The Evidence:

[1] The Appellant included in his 2007 and 2008 income tax returns, in terms of paragraph 2 of the First Schedule, under the narration "*wingerd boerdery*" certain amounts as produce held and not disposed of by him at the beginning and end of those years of assessment. They were:

1.1. End of 2006: R402 618;

1.2. End of 2007: R411 736;

1.3. End of 2008: R242 486.

[2] The evidence of Mr B, the chartered accountant who completed the Appellant's income tax return, was that those amounts show values allocated to the grapes that were harvested and delivered by the Appellant to the Co-operative of which he was a member, namely XY. Those grapes were allegedly immediately crushed and were in the process of being made into wine at year-end. The value was based on the estimated yield from the delivered grapes multiplied by the published distilling wine price, a method which was followed because it was referred to in the SARS "*Draft Guidelines: Recognition of Produce Held by Wine Farmers in a Pool.*"

[3] The Appellant was assessed accordingly.

[4] Mr B undertook a similar valuation exercise for the 2009 year of assessment. A value for "*produce held and not disposed of*" was initially included in the Appellant's ledger accounts for that year. He described it in the balance sheet entries as "*Voorraad Wyn*". Before the tax return was finalised, Mr B formed the opinion that no closing stock amount fell to be included under the First Schedule. He reversed the relevant entries.

[5] As a result Appellant's 2009 income tax return reflected a zero value to be added back for "*produce held and not disposed of*" at year-end. Despite this, the Appellant claimed a deduction of R242 486 for "*produce held and not disposed of*" at the end of the previous year.

[6] After an audit into the Appellant's 2009 income tax year, the Respondent issued an additional assessment in which an amount of R789 338 was included in the Appellant's taxable income. The letter of assessment states that this was an amount in respect of closing stock from farming operations, based on paragraphs 2, 3(1) and 9 of the First Schedule.

[7] The method adopted by the SARS auditor in fixing the amount of R789 338 was set out in Annexure A to the letter of assessment. He took the tonnage of grapes delivered by the Appellant at the 2009 year-end to XY (671.8 tonnes), converted that into litres of liquid derived from the grapes. He relied on an estimate of 773 litres per ton published by the South African Wine Information and Systems ("SAWIS"), and multiplied the result by what he believed to be the "*estimated distilling wine price per litre*" entries as "*Voorraad Wyn*".

[8] For appellant it was argued that if an amount is in principle to be included, the Appellant denies that the amount so fixed by respondent is fair and reasonable.

[9] On Respondent's behalf it was admitted that respondent made an error in calculating the amount determined and that the price of R1.52 per litre that respondent used was wrong and the price that ought to have been used was 97.84 cents per litre, being the agreed distilling wine price.

[10] Mr C, an expert on winemaking said it is a simple process. He agreed in cross-examination with the proposition that wine is nothing more than the controlled outcome of the natural process of growth and decay of the grape. Grapes will naturally ferment and turn into wine if left alone. The winemaking process is merely a way of controlling and fine-tuning this natural transformation of the grape juice. The addition of commercial yeast and some chemicals, controlling its temperature, and eventually filtering and clarifying does not alter the fact that the wine is, largely, the naturally developed juice of the crushed grape.

[11] The evidence was that the wine in process on hand at the end of the year of assessment, arising from the Appellant's grapes, could not have gone far in the winemaking process. Deliveries occurred from 28 January to 25 February 2009. It is not in dispute that the grapes are picked, delivered and crushed on the same day. Although some of the juice extraction may already have been completed, the fermentation process would not have run its course.

[12] The expert witness, Mr C, said that loss occurred during the process of wine-making. He also explained that the success of the outcome is subject to the factors such as, climate, weather, sugar content, etc.

[13] Messrs D and C testified that a winemaker, like XY, would incur huge expenditure in advance on imported products such as chemicals before the first

delivery of grapes by the farmers. Mr D estimated that some 50 per cent of XY's costs were incurred before the first batch of grapes was received.

[14] Messrs D and C accepted that the pulp would have a value, but they believed that in practice there was no market for the pulp as at the end of February. They believed that the pulp would in fact have had a negative value at that stage once XY's costs were taken into consideration. Those costs would already have been incurred, since the contributing farmers were liable once they had delivered their grapes.

[15] Messrs D and C were of the view that, pulp in the process of fermentation would never have been dealt with commercially as no winemaker would want to take possession of it before the fermentation process was complete.

[16] If the making of wine is recognised as a farming or agricultural operation (as it is when it is conducted by the grape farmer), it is unrealistic to say that the wine, or the wine in process, is not "produce". After all, the production of wine is the ultimate objective that the farmer's farming operation as a whole is directed at producing.

Crisp Issues requiring determination:

[17] The key issues to be determined are:

17.1 whether the grapes in process as at end February 2009 constitute the produce of the appellant;

17.2 whether the grapes were "*held*" by the appellant during the course of his farming operations;

17.3 whether the grapes were '*disposed of'*;

17.4 What method of computing should be followed in arriving at a value to be placed on the grapes in process.

The Applicable Law:

[18] Paragraphs 2, 3(1) and 9 of the First Schedule to the Income Tax Act 58 of 1962 ("*the ITA*"), provide that an amount must be included in farmers' gross income for the value of wine grapes harvested by them and already in the process of being made into wine at the financial year-end.

[19] In terms of section 26(1) of the ITA:

> *"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."*

[20] Paragraph 2 of the First Schedule provides that *"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 such year of assessment."*

[21] Paragraph 3(1) provides as follows:

> *"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 such 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."*

[22] Paragraph 4(1) provides *inter alia* that:

> *"The values of livestock and produce held and not disposed of at the beginning of any year of assessment shall … 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 …".*

[23] In terms of paragraph 9, *"the value to be placed upon produce included in any return shall be such fair and reasonable value as the Commissioner may fix".*

[24] Section 3(4)(*c*) of the ITA provides *inter alia* that a decision by the Respondent in terms of paragraph 9 of the First Schedule is subject to objection and appeal in accordance with Chapter 9 of the Tax Administration Act 28 of 2011 ("*the TAA*").

[25] Section 102(1) of the TAA provides that *"[a] taxpayer bears the burden of proving – (a) that an amount, transaction, event or item is exempt or otherwise not taxable; … (e) that a valuation is correct; or (f) whether a 'decision' that is subject to objection and appeal under a tax Act, is incorrect."*

[26] It is not in dispute that the appellant carries on pastoral, agricultural or other farming operations, as contemplated in section 26(1) of the Income Tax Act.

[27] It is not disputed that at the end of the appellant's 2009 year of assessment, i.e. at midnight on 28 February 2009, the appellant had no harvested grapes in his possession. All grapes that had been harvested between the beginning of the harvesting season at, the end of January and the end of February 2009, had been delivered to XY.

[28] It is common cause that the Respondent factually fixed the value of R789 338 in respect of the produce which he contends was held and not disposed of at year-end. The Appellant denies that as a matter of law any amount falls to be included at all. If however an amount is in principle to be included, the Appellant denies that the amount so fixed is fair and reasonable.

[29] The Respondent seeks to apply the provisions of paragraphs 2, 3(1) and 9 of the First Schedule to the Appellant's agricultural produce in the form of "*wine-in-process*". The latter being harvested wine grapes that are already crushed, out of which the juice content has been pressed, and which were being fermented, as part of the wine-making process.

[30] In the absence of evidence to the contrary, I accept that the grapes must have been in the very early stages of wine-making. It was not yet at a stage where XY regarded it as ready to be sold and delivered.

[31] Section 22 does not to apply to the trade of farming. This is because special provision was made for farmers' trading stock in the First Schedule.

[32] It is common cause that the appellant conducts farming operations as envisaged in section 26(1). He has not declared his income derived from XY for the sale of wine produced from, *inter alia,* his grapes as deriving from anything other than farming operations.

Produce:

[33] In **Ko-operatiewe Wynbouwers Vereniging van Zuid-Afrika Bpk v Industrial Council for the Building Industry 1949 (2) SA 600 (A) at 614, (KWV)** it was held that "*wine farming consists of a number of different operations, such as cultivation of vineyards, pruning of the grape vines, rendering the vines free from disease, gathering the crop, pressing the grapes into wine and probably delivering the finished product to the 'first buyer'.*"

[34] In *KWV* (*supra*), the court referred to **Bryant v Minister of Labour and Minister of Justice 1943 TPD 205.** In that case a dairy farmer sold and distributed to customers the milk that was produced on his dairy farm. It was held that the employees who were engaged primarily in the delivery of milk to customers were engaged in "*farming operations*". *Bryant*'s case was considered, and not interfered with, in **R v Giesken and Giesken 1947 (4) SA 561 (A).**

[35] The Appellant submitted that the "*wine-in-process*" at the end of the year in question is not "*produce*" as contemplated in the First Schedule, because by then, they had been crushed, pressed, mixed with the grapes of other farmers and chemicals were added to them so that they were no longer identifiable as the grapes of the appellant.

[36] The word "*produce*" is not defined in the ITA. There is no reported case in which it has been interpreted in an income tax context.

[37] The dictionary meaning of the word "*produce*" is broad: "*things that have been produced or grown*" (Concise South African Oxford Dictionary); "*that which is produced, either by natural growth or as the result of some action, spec. agricultural and natural products collectively; as opposed to manufactured goods*" (Shorter Oxford Dictionary); "*that which is produced, product; proceeds; crops; yield, esp of fields or gardens*" (Chambers 20th Century Dictionary); "*anything that is produced; product; agricultural products regarded collectively*" (Collins English Dictionary Millennium Edition).

[38] The authorities are unequivocal about the making of wine forming part of the activity of wine farming. The crushed and pressed grapes which are fermenting or on their way to becoming wine must logically, remain a result of the farming operation, in the same way that the harvested grapes were before they were crushed, and the completed wine will be.

"**Held and not disposed of":**

[39] The Appellant's counsel argued that appellant, as a member of the co-operative XY, once he had delivered his grapes to XY and they have been "pooled" in the sense of being crushed and mixed with grapes or grape juice of a similar type delivered by other members, can no longer be said to have "*produce held and not disposed of*" to bring into account as closing stock.

[40] The parties agree that a member of the co-operative does not transfer ownership of his or her produce to the co-operative, and that the co-operative acts as an agent for the member in controlling the produce.

[41] It is common cause that, the mixing or mingling of a member's grapes or grape juice with that of other members, without the intention of transferring ownership but in circumstances where the further identification of each member's own grapes is not possible, has the effect of creating joint ownership, in undivided shares, of the pooled grapes and later, of the pooled wine *pro rata* according to each member's contribution of the grapes to the pool (see: **Andrews v Rosenbaum & Co 1908 EDC 419 at 425**).

[42] In **LAWSA (1st Re-issue Vol 27 para 342)** ownership in a *merx* that has been mingled and mixed is defined as follows:

> **"***In the case of mingling (confusio) the original owners of the fluids or metals become co-owners of the mixture in proportion to the value of their material used in the final mixture. Each owner thus has an undivided share in the common mixture. In the case of mixing (commixtio) each owner of the original solids acquires not an abstract undivided share but a physical portion of the final mixture in proportion to the value of his solids. This implies that he can immediately institute a rei vindicatio for his portion of the mixture whereas in the case of mingling (confusio) the mixture can*

*only be physically separated after the institution of the actio communi dividundo.***"**

[43] After delivery, appellant became a co-owner in undivided shares in the pools to which his grapes were added.

[44] Appellant's rights to the grapes and the eventual outcome of the winemaking processes are regulated by the "*Leweringsooreenkoms*" read with the "*Statuut*" of XY.

[45] The word "*held*" is supplemented and reinforced by the phrase "*and not disposed of"* because the phrase is conjunctive. The complete phrase "*held and not disposed of*" makes it patently clear that the produce must have formed part of the farmer's farming produce and the farmer must still have a legal right to the produce as at the financial year end.

[46] It does not mean that the farmer must have had physical possession or control of the produce at the year end. If that was what the legislature intended, it would have used words that clearly conveyed that meaning.

[47] On behalf of appellant it was argued that the appellant disposed of the grapes once they became mixed and crushed. Appellant's contention is that, it cannot be said that the grapes were *"not disposed of*" at the end of February 2009.

[48] Appellant's counsel submitted that the concept "*held"* is broader than ownership and includes possession without ownership.

[49] If that submission is accepted, disposing of produce would not be limited to situations where ownership passes. There is no rational conclusion concerning ownership of produce to be drawn from the fact that the produce is mixed and its form altered because it does not necessarily follow in that instance, that the grapes are no longer "*held*" by the appellant.

[50] To understand the nature of the relationship that the farmer and the co-operative, XY, has *vis a vis* the grapes, reference must be made to the terms of the delivery agreement between XY and the appellant and the Articles of Association of XY.

[51] On behalf of appellant it was submitted that the appellant acquired a right to share in the proceeds of the wine made from his grapes as well as the grapes of other farmers in the pool.

[52] Clearly the appellant's right to share in the proceeds is determined by the amount and quality of his grapes delivered to XY.

[53] If the appellant's argument is taken to its logical conclusion, then no farming partnership would ever be required to account for closing stock because the partners own the partnership assets in undivided shares. There is no reason,

in principle, why a farming partnership should be presumed entitled to enjoy greater tax benefits than a sole proprietor.

[54] On behalf of respondent it was contended that the word "*held*" should be interpreted as including "*held (whether in whole or in undivided shares)*". This, it was submitted, does not require a departure from the words of the First Schedule as "held" (in the sense of "owned") can clearly extend to any form of *dominium*, including undivided shares.

[55] The following is a more commercially sensible interpretation: the grapes were held by the appellant as produce once they were picked. On delivery and acceptance into the various pools at XY, the appellant acquired a right to the proceeds of the wine, proportionate to his contribution of grapes. Accordingly, his ownership in the grapes is a crucial determining factor for calculating and asserting his right to a fraction of the wine in process and ultimately his right to claim a corresponding portion of the net proceeds of the wine.

[56] The fact that his ownership and/or rights to the grapes so delivered is circumscribed by the conditions set out in the agreements with XY, does not detract from objective position that he did not dispose of the grapes in that he held a right to the resulting product of the winemaking process by virtue of his ownership in the grapes. Appellant exchanged his right to claim back and/or exercise control over the raw material, namely the grapes, for a claim sounding in money subject to provision for certain contingencies. The appellant's claim to the

value of the unprocessed grapes is subsumed by his claim to the net proceeds because the unprocessed grapes is an essential component of the wine.

[57] Expanding the legal manifestation of a right does, not in this instance, lead to a change in the substance of a right.

[58] It can accordingly not be said in the *sui, generis* contractual relationship between the co-operative and the farmer/member, that the grapes were disposed of in the commercial and legal sense contemplated by section 3(1) of the First Schedule.

[59] I find that the grapes picked at end of February 2009 is produce in the farming operations that were held by appellant. Once they were crushed and pressed, under the auspices of XY, they remained the property of the appellant, albeit in fractional ownership. Appellant did not disposed of them until after the end of February 2009, when the grapes were finally processed into wine and sold.

[60] The grapes delivered to XY as at the end of February 2009 is accordingly closing stock of appellant's farming operation and should have been reflected as such in his income tax return.

[61] The SARS grounds of assessment are deficient in the following respects:

61.1 The amount of R789 338 relied on by the respondent is, manifestly erroneous, unfair and unreasonable. The error arose out of employing an illogical and incongruous methodology. No evidence was adduced on behalf of respondent in support of the error.

61.2 After the respondent amended his grounds of assessment, no alternative value was fixed and the appellant was not informed what the respondent's case is on an alternative value to the amount of R789 338.

61.3 The respondent did not respond to the appellant's request for reasons for the assessment, which was required of him in terms of Rule 3 of the Tax Court Rules. The purpose for providing reasons, which are to be provided before the objection, is not only to have the respondent apply his mind to what has been assessed, but also to enable the appellant to know what case he has to meet. This procedural defect was not remedied in the respondent's grounds of assessment.

[62] The parties' conduct is more aptly akin to the conduct described in the following paragraph in **Commissioner for the South African Revenue Service v Pretoria East Motors [2014] ZASCA 91 at para [6]**:

"The present appeal must therefore be approached on the basis that the onus was on the taxpayer to show on a preponderance of probability that the decisions of SARS against which it appealed were

wrong (CIR v SA Mutual Unit Trust Management Co Ltd 1990 (4) SA 529 (A) at 538D). That, however, is not to suggest that SARS was free to simply adopt a supine attitude. It was bound before the appeal to set out the grounds for the disputed assessments and the taxpayer was obliged to respond with the grounds of appeal and these delineate the disputes between the parties."

[63] Turning to the value placed on the produce by respondent. I am not persuaded, in the light of the errors in calculation conceded on behalf of respondent and proved by the appellant that the amount assessed is fair and reasonable.

[64] With the paucity of evidence adduced on what would constitute a fair and reasonable method of quantification, this court is not in a position to substitute respondent's calculation with that of it's own.

[65] Further, in view of the evidence advanced on appellant's behalf that an apportionment of produce is necessary between wine produce and produce used for dried fruit sales, this court cannot, on the available evidence, make a determination with regard to the amount of the assessment.

[66] I am of the view that the issue of determining the value to be placed on the produce must be remitted back to the respondent for further consideration and

for re-assessment with due regard to the finding contained in paragraph 60 above.

[67] Since the respondent has been successful in having the basis of its assessment upheld and the appellant has been successful in proving that the amount of the assessment was justifiably challenged, although appellant has not proven the correct calculation of the assessment, respondent is not entitled to levy interest on the assessed amount until it has been revised nor is any costs order being made.

IT IS ORDERED THAT:

1. The Appellant held produce on hand that was not disposed of as at the end of the 2009 year of assessment that should have been and shall now be included in his gross income as the value of wine grapes.

2. The issue of the method to be employed in determining the amount to be so included in appellant's gross income and the actual amount assessed is referred back to respondent for a determination by the respondent on a proper consideration of all the relevant factors, including allowing the taxpayer the opportunity to rework the costs associated with the closing stock, to ensure that both the closing stock value and the expense is included in the farmer's tax computation for the year under consideration.

3. Respondent shall not levy interest on the amount so determined for the period prior to this judgment.

4. No order as to costs is made.

ALLIE, J