SOUTH AFRICAN REVENUE SERVICE

INTERPRETATION NOTE NO. 29

DATE: 30 March 2005

ACT	**:**	**INCOME TAX ACT, 1962 (the Act)** **SECTION: SECTION 5(10) AND PARAGRAPH 19 OF THE FIRST SCHEDULE TO THE ACT**
SUBJECT	**:**	**FARMING OPERATIONS: EQUALISED RATES OF TAX**

1. Purpose

The purpose of this Note is to provide guidelines with regard to the method applied in the calculation of the rating amount applicable to farmers who elected that their tax be calculated at equalised rates of tax in terms of paragraph 19(5) of the First Schedule to the Act.

Practice Note No 30, issued on 22 August 1994, is hereby replaced.

2. Background

A person, deriving income from farming operations may in terms of paragraph 19(5) of the First Schedule, elect to be subject to tax according to the rating formula set out in section 5(10) of the Act. This rating concession applies only to individuals (natural persons) and executors of deceased estates and trustees of insolvent estates. Once the option has been exercised to adopt the equalised rates, this election will be binding on the taxpayer for all future years irrespective of the fact that farming operations may be terminated. No provision is made in the Act for a variation either by the farmer or by the Commissioner.

3. The law

The following persons may elect to make use of the provisions of paragraph 19:

- Any natural person whose taxable income for any year or period of assessment consists of or includes taxable income derives from farming operations carried on by him or her for his/her own benefit.

- The executor of the estate of any deceased person or the trustee of the insolvent estate of any natural person, in his/her capacity as such, who has continued farming operations in the year of assessment immediately succeeding the year of assessment in which that person died or became insolvent and are merely a continuance of the operations carried on by that person prior to date of death or insolvency.

Paragraph 19(5) provides that the taxpayer must elect that the normal tax to be levied in respect of farming income must be determined in terms of this paragraph. This election must be made within three months after the end of the year or period of assessment. Where a taxpayer has not elected during the prescribed period the three month period may be extended. In practice extension will be granted up to a date prior to the raising of the assessment. The application may be submitted with the return of income in respect of the year of assessment in which taxable income from farming operation is derived. An application form is included in the information brochure that accompanies the annual return of income

The rating concession aims at a reduction in the rate of normal tax due to the abnormal accrual of income in the relevant year. The provisions of paragraph 19(4) states that the utilisation of the rating formula does not relieve a farmer from tax on any portion of his/her taxable income.

Where the averaging provisions have been adopted and finds application in a specific year of assessment, the taxpayer forfeits entitlement for that year of assessment to utilise the following provisions of the First Schedule to the Act:

- Paragraph 13(1)(b) (provisions related to the replacement of livestock sold by reason of his/her participation in a livestock reduction scheme organised by Government.);

- Paragraph 15(3) (rating formula in respect of taxable income derived from plantations); and

- Paragraph 17 (rating formula arising as a result of abnormal receipts from the disposal of sugar cane damaged by fire).

Where a farmer makes the election in terms of the provisions contained in paragraph 19(5) of the First Schedule to the Act, the normal tax payable by the taxpayer in respect of any year of assessment must be determined in accordance with the provisions of section 5(10) in which the following formula must be applied –

$$Y = \left[\frac{A}{B + D - (C + L)} \times (B - L) \right] + (L \times R)$$

in which formula –

- "Y" represents the amount of normal tax to be determined.
- "A" represents the amount of normal tax (as determined before deduction of any rebate) calculated at the full rate of tax chargeable for the said year in respect of a taxable income equal to the amount represented by the expression "B + D – (C + L)" in the formula.
- "B" represents the taxpayer's taxable income for the said year.
- "C" represents an amount equal to the sum of –

(i) any special remuneration received by or accrued to any mineworker in respect of special services rendered by him which is over and above his/her normal remuneration and regular allowances which is included in the taxpayer's income for the said year;

(ii) where the provisions of paragraph 15(3) of the First Schedule are applicable to the taxpayer, an amount by which the taxable income derived by the taxpayer during the said year from the disposal of plantations and forest produce exceeds the annual average taxable income derived by him from that source over the three years of assessment immediately preceding the said year;

(iii) where the provisions of paragraph 17 of the First Schedule are applicable, an amount equal to the income derived of the disposal of sugar cane as a result of fire in his/her cane fields that would not have been derived by him otherwise; and

(iv) where the provisions of subparagraph (1) of paragraph 19 of the First Schedule are in the case of the taxpayer applicable in respect of the said year, the amount by which his/her taxable income derived from farming that year exceeds his/her average taxable income from farming as determined in relation to that year in accordance with subparagraph(2) of the said paragraph.

- "D" represents an amount which is equal to so much of any current retirement annuity fund contributions allowable as a deduction in terms of section 11(n)(aa)(A) of the Act only because of the inclusion of an amount referred to in section 5(10)(d)(i), (ii), (iii), (iiiA) and 5(10)(f) of the Act.

- "L" represents lump sums from retirement, retrenchment, etc accrued on or after 1 September 1995.

- "R" represents the greater of the amounts determined by applying the formula –

$$R = \frac{F}{B + D - (C + L + G)}$$

"B", "C", "D" and "L" shall be determined as above as applicable in the said year or in the said preceding year, as the case may be.

- "F" represents the amount of normal tax (as determined before the deduction of any rebate) calculated at the full rate of tax chargeable for the said year or the said preceding year in respect of taxable income equal to the amount represented by the expression "B + D – (C + L + G)" in the formula for that year or preceding year, as the case may be.

- "G" represents an amount of taxable capital gain included in the taxable income in terms of section 26A for the said year or the said preceding year, as the case may be.

4. Application of the law

Paragraph 19(2) provides that the average taxable income from farming in relation to the relevant period must be determined as follows:

- Where the taxpayer carried on farming operations before the commencement of the current year of assessment, the taxpayer's annual average taxable income from farming determined with regard to the current and four previous years of assessment, during which the farming operations were carried on.

- Where the taxpayer has never carried on farming operations before the commencement of the current year of assessment, his/her average taxable income from farming in the first year is deemed to be–

  a) the amount of his/her taxable income when taxable income from farming for the period does not exceed R5 000;

  b) the amount of R5 000 when his/her taxable income from farming for the period exceeds R5 000 but not R7 500; or

  c) an amount equal to two-thirds of his/her taxable income when his/her taxable income from farming for the period exceeds R7 500.

For the purpose of determining symbol "C" the balance of an assessed loss incurred in any previous year must not be deducted *from the taxable income derived from farming in the current year of assessment.* Support for this practice is derived from the judgement handed down in *CIR v Zamoyski* (47 SATC 50) where the court attached an interpretation to the words "taxable income…derived from farming operations" for the purpose of paragraph 12(3) of the First Schedule to the Act.

Example 1

Y, a farmer, under 65 years of age, commenced farming in tax year 1.

	Total taxable income	**Farming taxable income**
	R	**R**
Year 1	300 000	100 000
Year 2	290 000	200 000
Year 3	400 000	20 000
Year 4	120 000	15 000
Year 5	700 000	500 000
		835 000

Average taxable income from farming in respect of year 5 is, therefore, R167 000 (R835 000÷ 5)

Retirement annuity fund contributions

In terms of section 11(*n*) of the Act a person may deduct contributions made to a retirement annuity fund. There are various limits to this deduction. Section 11(*n*)(*aa*)(A) states that the deduction will be limited to 15% of non retirement-funding income. Taxable income derived from farming operations is non retirement-funding income. Symbol "D" in the formula refers to contributions to a retirement annuity fund that are deductible in terms of section 11(*n*)(*aa*)(A), i.e. in respect taxable income on which 15% is calculated, which taxable income arises from any amounts–

- that represents special remuneration received by mineworkers for certain special tasks;
- in respect of plantation farming that qualifies for special treatment in terms of paragraph 15 of the First Schedule;
- in respect of sugar cane farming that qualifies for special treatment in terms of paragraph 17 of the First Schedule;
- that qualifies for the concession in terms of paragraph 19 of the First Schedule; and
- that are included in symbol "L" in the formula, for example, taxable lump sums from retirement funds, retrenchment packages, etc.

The effect is that contributions to a retirement annuity fund cannot be used to reduce a person's taxable income from other sources that do not qualify for special treatment and thereby reducing the overall tax liability.

Example 2

X made contributions to a retirement annuity fund in the amount of R150 000 during the year of assessment. He derived taxable income from the following sources:

	R
Farming operations	400 000
Taxable interest	160 000
Lump sum from a XYZ Retirement Annuity Fund	500 000
	1 060 000

The average taxable income from farming for purposes of paragraph 19 was R300 000.

The maximum deduction in respect of contribution to a retirement annuity fund is thus 15% x R1 060 000 = R159 000, but limited to the actual contributions of R150 000. Thus –

		R
15% x R 500 000 (Lump sum)	=	75 000
15% x R 400 000 (Farming income)	=	60 000
15% x R 160 000 (Taxable interest)	=	24 000
		159 000
Limited to actual contributions of		R150 000

The Act does not make provision for the apportionment of the actual contributions; apportionment may therefore be made to income that is not influenced by the formula first and thereafter to those affected by the formula, i.e. lump sum and excess farming income being the portion of farming income that exceeds the average taxable income from farming.

"D" in the example is therefore –

15% x R300 000 (Farming income taxed at normal rates, i.e. R400 000 – R100 000)	R 45 000
15% x R160 000 (Taxable interest)	R 24 000
	R 69 000

Portion of contributions affected by the formula is therefore equal to R150 000 (allowable contributions) **less** R69 000 (R460 000 x 15%) {i.e. the amount calculated on the portion of taxable income that is not affected by the formula}. "D" is, therefore, equal to R81 000.

Example 3

Facts

G carried on farming operations and elected that the provisions of paragraph 19 be applicable to her. She is 65 years of age. Taxable income from farming operations for the current year (year 5) and the four previous years of assessment were as follows:

	Taxable income or assessed loss from farming
	R
Year 1	600 000
Year 2	500 000
Year 3	70 000
Year 4	(50 000)
Year 5	400 000
	1 520 000

The taxable income from farming in year 5 excludes the loss incurred in year 4. The average taxable income from farming for purposes of year 5 is, therefore, R304 000 (R1 520 000 ÷ 5).

During the current year of assessment (year 5) she derived taxable income from the following sources:

Source	**R**
Taxable farming income	400 000
Taxable interest	100 000
Pension	120 000
Taxable income before deductions	620 000

The following deductions were incurred:

Deductions	**R**
Retirement annuity fund contributions	90 000
Medical expenses	30 000
Total allowable deductions	120 000

She has not incurred any capital development expenditure that will be allowable against taxable farming income during the current year or previous year of assessment.

Step 1

Determine the values of symbols "B", "C" and "L".

"B"	=	Taxable income = R620 000 – R120 000
	=	R500 000
"C"	=	Excess of current farming income over average farming income (R400 000 – R304 000)
	=	R96 000
"L"	=	Lump sum accrued = nil

Step 2

Determine the value of "D"

The maximum deduction in respect of contribution to a retirement annuity fund is 15% x R620 000 = R93 000, but limited to the actual contributions of R90 000. Thus –

		R
15% x R 120 000 (Pension)	=	18 000
15% x R 400 000 (Farming income)	=	60 000
15% x R 100 000 (Taxable interest)	=	15 000
		93 000
Limited to actual contributions of		R90 000

"D" in the example is therefore –

	R
15% x R304 000 (Average taxable farming income)	45 600
15% x R100 000 (Interest)	15 000
15% x R120 000 (Pension)	18 000
	78 600

Portion of contributions affected by the formula is therefore equal to R90 000 (allowable contributions) **less** R78 600 {i.e. the amount calculated on the portion of taxable income that is not affected by the formula}. "D" is, therefore, equal to R 11 400.

Step 3

Determine the rating amount

B + D – (C+L)	=	500 000 + 11 400 – (96 000 + Nil)
	=	415 400

Step 4

Determine that normal tax payable the rating amount

A = Normal tax before any rebate calculated on B + D – (C + L)

= 78 070 + ((415 400 - 270 000) x 40%)

= 78 070 + 58 160

= 136 230

Note: Assume the tax rates and rebates applicable to the 2005 year of assessment apply.

Step 5

Calculate "Y", amount of normal tax, in the formula.

$$Y = \left[\frac{A}{B + D - (C + L)} \times (B - L)\right] + (L \times R)$$

$$Y = \left[\frac{136\ 230}{415\ 400} \times (500\ 000 - \text{Nil})\right] + \text{Nil}$$

$$= 163\ 974.45$$

		R
Normal tax payable		163 974.45
Less:	Primary rebate	5 800.00
	Secondary rebate (65 and older)	3 200.00
Normal tax liability		154 974.45