

DRAFT INTERPRETATION NOTE 79 (Issue 2)

DATE:

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTIONS 9HA, 25, 25C AND 26 AND PARAGRAPHS 2, 3, 4 AND 9 OF THE FIRST SCHEDULE
SUBJECT : PRODUCE HELD BY NURSERY OPERATORS

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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 58 of 1962; and
- any other 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.

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

The relevant sections of the Act and paragraphs of the First Schedule are quoted 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, amongst 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.¹

It has been held that the question of whether a person is carrying on farming operations is one of fact² and must be decided considering all the facts of a particular case.

The term “agriculture” is defined in the *Merriam-Webster Dictionary*³ 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 principle was confirmed by Heher AJA in the Supreme Court of Appeal in *C: SARS v Smith* when he stated the following:⁴

“In ordinary parlance the phrase ‘carrying on farming operations’ is capable of several meanings. In the context of section 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.”

¹ EA Kellaway *Principles of Legal Interpretation of Statutes, Contracts and Wills* (1995) Butterworth’s at 224.

² 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.

³ www.merriam-webster.com/dictionary/agriculture [Accessed 1 August 2017].

⁴ 2002 (6) SA 621 (SCA), 65 SATC 6 at 9–10.

An example of the above principle can be found in ITC 1324⁵ 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 principle was held to be the case in the *Smith case above* in which Heher JA stated that –⁶

“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:⁷

“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*⁸ 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 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 1698:⁹

“[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.”

⁵ (1980) 42 SATC 288 (Z).

⁶ Above at 65 SATC 13.

⁷ (1972) 35 SATC 122 (N) at 123–4.

⁸ 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”.

⁹ (2000) 63 SATC 161 (SEC) at 170.

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 1548¹⁰ 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.

In *C: SARS v Kluh Investments (Pty) Ltd*¹¹ the respondent company had allowed another company to conduct plantation farming for that company's own account and that company's only obligation was to return the plantation intact when the agreement came to an end. Shortly afterwards the respondent sold the plantation to this company and at issue was whether the portion of the consideration relating to the plantation had to be included in the respondent's gross income under paragraph 14(1). The court held that paragraph 14 did not apply to the respondent because it was not carrying on farming operations. It did not have –

- the right to the yield of the plantation;
- the use of the land and the plantation; or
- derive any income from it.

The factors referred to in the above cases are not exhaustive and whether 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.

In relation to the meaning of "held", *Juta's Tax Library* states the following:¹²

"[I]t is therefore considered that a taxpayer holds stock for this purpose where that **stock is owned, and not merely physically held**. The owner, not the possessor, must therefore account for the stock. This view is shared by Meyerowitz (at 9.89)."

(Emphasis added)

In ITC 1873¹³ the court was called upon to decide on the meaning of "held and not disposed of" in the context of grapes that had been supplied to a co-operative by a farmer. The farmer's grapes were crushed and mixed by the co-operative with the grapes and grape juice of other members as part of the initial wine-making process.

¹⁰ (1991) 55 SATC 26 (C).

¹¹ 2016 (4) SA 580 (SCA), 78 SATC 177.

¹² D Davis *et al* Jutas Tax Library [online] (Jutastat e-publications: RS 21, 2016) in Commentary on Income Tax – section 22.

¹³ (2014) 77 SATC 93 (WC).

The issue was whether the farmer still had produce that could be said to be held and not disposed of which could be brought to account as closing stock. Allie J stated the following:¹⁴

“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.

“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.”

On appeal in *Avenant v C: SARS*¹⁵ the SCA held that “produce on hand and not disposed of” includes the fractional ownership of pooled produce and therefore included the taxpayer’s undivided share in the grapes that had been crushed and merged with the grapes of other farmers. As regards the issue of ownership and possession, the court concluded that –¹⁶

“in the present case where ownership is retained by the appellant [the taxpayer] but possession is not, the produce is clearly ‘held’ for the purposes of para 2 of the First Schedule”.

Once produce has been sold under an unconditional contract and the taxpayer no longer has legal ownership of it but is unconditionally entitled to the consideration for it (that is, the consideration constitutes gross income in the taxpayer’s hands), the produce will no longer be considered to be “held and not disposed of” for the purposes of the First Schedule. Produce disposed of under an instalment credit agreement which provides that ownership will pass only once the whole or a portion of the purchase price has been paid is regarded as having been disposed of and hence must be excluded from closing stock. In these circumstances, section 24(1) deems the purchase price to be included in gross income when the agreement is entered into.

The expression “held and not disposed of” therefore means produce owned by the taxpayer which has not been disposed of.

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.

¹⁴ At 103.

¹⁵ [2016] JOL 36039 (SCA), 78 SATC 343.

¹⁶ *Above at SATC 356 in paragraphs 25 and 28.*

The term “produce” is not defined in the Act and its ordinary dictionary meaning is therefore retained, which is natural or agricultural products as opposed to manufactured goods.¹⁷

In the *Avenant* case cited above, the court confirmed that produce in the form of pulp from harvested grapes had to be accounted for as part of closing stock, notwithstanding that it comprised work-in-progress. If such an inclusion in closing stock did not occur, there would not be a proper balancing of income and expenditure in the year of assessment.¹⁸

The general rule is that crops accede to the soil in the same way that permanent buildings or improvements do.¹⁹

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.²⁰ 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.²¹ Crops are however not inseparable from the soil since they can be reaped or removed once they have ripened or matured.²² 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, since they retain their identity as movables and do not become part of the soil.²³ In *Gore NO v Parvatas (Pty) Ltd*²⁴ 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.

¹⁷ DM 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

¹⁸ At 78 SATC 355.

¹⁹ *Secretary for Lands & another v Jerome* 1922 AD 103.

²⁰ *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).

²¹ 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.

²² *Secretary for Lands and Another v Jerome* above at 110.

²³ *Burrows v Mc Evoy* 1921 CPD 229. See also CG van der Merwe *Sakereg* 2 ed (1979) Butterworth's at page 245/246.

²⁴ 1992 (3) SA 363 (C). See also *Burrows v McEvoy* 1921 CPD 229 at 235/236 and *LAWSA* above in paragraph 336.

The decisive factor as to whether something becomes movable is the intention of the person who planted it.

The court was satisfied that bulbs planted in the soil with the intention of being removed from it, retained their identity as movables.²⁵

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 have a value as produce only 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.²⁶ 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.²⁷

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 a fair and reasonable value.

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.

²⁵ 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.

²⁶ See *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13.

²⁷ See the definition of “gross income” in section 1(1).

In ITC 936²⁸ 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.²⁹

In *Avenant v C: SARS* the court described as unrealistic the appellant's contention that the pulp from harvested grapes was entirely valueless as work-in-progress.³⁰ The court cited the following extract from *Richards Bay Iron & Titanium (Pty) Ltd & another v CIR* on the difficulty of valuing work-in-progress:³¹

"The suggested difficulty in identifying and ascribing a value to things in the process of being manufactured on the last day of the tax year does not entitle the court to disregard the plain language of the definition. Moreover, the difficulty strikes me as being more apparent than real. Certainly in other tax jurisdictions the legislators and the courts have not balked at the concept of valuing work-in-progress and there is no reason to suppose that the South African Parliament was daunted by the prospect. As has been noted, appellants themselves encountered no great difficulty in doing so when required by respondent to do so."

Having regard to the facts of the case, the court also rejected the appellant's contention that the lower of production cost and market value as specified by SARS involved inexact conjecture rather than a fair and reasonable value.³²

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

²⁸ (1960) 24 SATC 361 (C).

²⁹ *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A) at 435H-I.

³⁰ [2016] JOL 36039 (SCA), 78 SATC 343 at 358.

³¹ 1996 (1) SA 311 (A), 58 SATC 55 at 73.

³² At SATC 358.

- 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 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 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 still holding 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.

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 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(c)**.

4.3.6 Death

(a) Introduction

A number of amendments affecting deceased persons and their deceased estates came into operation on 1 March 2016 and apply to persons dying on or after that date. For the position before 1 March 2016, see issue 1 of this Note.

The changes involved moving some of the rules in paragraphs 40, 41 and 67 of the Eighth Schedule into the main body of the Act in the form of a new section 9HA and a redrafted section 25.

The income tax and CGT consequences for the deceased person, the deceased estate and the heirs or legatees on the death of a nursery operator are briefly discussed below in relation to produce.

(b) 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.

Under paragraph (a) of the proviso to section 66(13)(a) in the year of assessment in which a person dies, a return must be made for the period commencing on the first day of that year of assessment and ending on the date of death. Under section 6(4) the primary, secondary and tertiary rebates must be apportioned for a period of assessment of less than 12 months, which will usually apply to a deceased person in the year of death.

Under section 9HA(1) a deceased person is deemed to dispose of all produce on hand, other than produce disposed of to a surviving spouse as contemplated in section 9HA(2), at the date of that person's death for an amount received or accrued equal to the market value as contemplated in paragraph 31 of the Eighth Schedule of that produce as at that date. Under paragraph 31(1)(g) the market value to be used for produce is the price which could have been obtained upon its sale between a willing buyer and a willing seller dealing at arm's length in an open market.

As discussed in 4.3.1, the opening stock of produce in the year of death would generally have been determined at the lower of production cost and market value.

A nursery operator is deemed to dispose of produce for the benefit of a surviving spouse if that surviving spouse is a resident and that produce is disposed of –

- by *ab intestato*³³ or testamentary succession;³⁴
- as a result of a redistribution agreement between the heirs and legatees of the nursery operator in the course of liquidation or distribution of the deceased estate of that nursery operator;³⁵ or
- in settlement of a claim arising under section 3 of the Matrimonial Property Act 88 of 1984.³⁶

Under such a disposal to a surviving spouse, the deceased nursery operator is deemed to dispose of the produce for the amount that was allowed as a deduction in respect of the produce for purposes of determining the nursery operator's taxable

³³ This term refers to a person who dies without a valid will, that is, intestate.

³⁴ This term refers to a person whose estate is wound up under a valid will.

³⁵ Under a redistribution agreement the heirs can agree to redistribute the assets of the estate amongst themselves.

³⁶ This Act makes the accrual system automatically applicable to a marriage out of community of property unless its application is specifically excluded in the antenuptial contract. Under the accrual system a claim will arise on death in the hands of one spouse against the other for the difference in growth of the estates of the spouses. If produce were used to settle such a claim it would be subject to roll-over treatment under s 9HA(2)(b) read with s 25(4).

income, before the inclusion of any taxable capital gain, for the year of assessment ending on the date of that nursery operator's death. In other words, produce included in opening stock is deemed to be disposed of at the value at which it was included in opening stock, and produce acquired during the year of death is brought to account at cost price. The intention is to place the nursery operator in a tax-neutral position so that no profit or loss will be made on produce disposed of to a surviving spouse. This treatment is necessary in order to give effect to the roll-over treatment afforded to the surviving spouse under section 25(4).

(c) Deceased estate

When a person dies, that person's year of assessment comes to an end and a new entity comes into existence, namely, the deceased estate. In reality a deceased estate is not a person but simply an aggregate of assets and liabilities of the deceased person administered by an executor.³⁷ This common-law position is varied by the Act in that a deceased estate is deemed to be a person as defined in section 1(1) and the executor is deemed to be its representative taxpayer, also as defined in section 1(1).

Section 25(5) provides that a deceased estate must be treated as if it were a natural person, other than for purposes of the primary, secondary and tertiary rebates under section 6, the medical scheme fees tax credit under section 6A and the additional medical expenses tax credit under section 6B. It, however, remains a separate taxpayer in its own right and is not deemed to be the same natural person as the deceased person.

The first return for the deceased estate commences on the day after the date of death and ends on the last day of February or, if earlier, on the date on which the liquidation and distribution account becomes final. For subsequent years of assessment the executor of a deceased estate must continue to submit returns of income for each year of assessment until the liquidation and distribution account becomes final.

Inclusion in income of a deceased estate

Under section 25(1) the following amounts must be treated as income of the deceased estate of a deceased person:

- Any income received by or accrued to or in favour of any person in his or her capacity as the executor of the estate of a deceased person.
- Any amount received or accrued as contemplated in the above bullet point which would have been income in the hands of that deceased person had that amount been received by or accrued to or in favour of that deceased person during his or her lifetime.

Thus, under the second bullet point, if a nursery operator was carrying on farming operations, any produce disposed of by the executor to a third party must be included in the gross income of the deceased estate under section 25(1)(b), since it would have constituted income for the deceased nursery operator. It is therefore irrelevant in determining the capital or revenue nature of produce whether the executor is actually carrying on farming operations.

³⁷ *CIR v Emary* NO 1961 (2) SA 621 (A), 24 SATC 129.

Acquisition of produce by the deceased estate [section 25(2)]

Except for produce disposed of by the deceased nursery operator to a resident spouse, under section 25(2) the deceased estate is deemed to acquire produce from the deceased nursery operator for an amount of expenditure equal to its market value on the date of death.

Produce disposed of by the deceased nursery operator to a surviving spouse is deemed to be acquired by the deceased estate for an amount of expenditure contemplated in section 9HA(2)(b), namely –

- for produce included in opening stock in the year of death, at its opening stock value; and
- for produce acquired by the deceased nursery operator during the year of death, at its cost price.

Expenditure incurred by the executor in order to carry on nursery operations during the course of winding up the estate will simply be claimed under the core rules, for example, under section 11(a).

Disposal of produce to heirs or legatees [section 25(3)(a)]

Under section 25(3)(a) an asset awarded to an heir or legatee is treated as being disposed of by the deceased estate for an amount received or accrued equal to the amount of expenditure incurred by the deceased estate in respect of that asset. As discussed above, such expenditure could comprise the deemed expenditure under section 25(2) for produce acquired from the deceased person or under section 11(a) if the executor purchased more produce after the date of death. The amount of the deemed expenditure will depend on whether the produce is bequeathed to an heir or legatee (section 25(2)(a)) or to a surviving spouse [section 25(2)(b)]. The intention of section 25(3)(a) is to leave the deceased estate in a tax-neutral position, so that the amount included in its gross income is equal to the amount of expenditure incurred or deemed to be incurred by it.

Disposal of produce to third parties by the executor

Amounts derived from the disposal of produce by the executor of the deceased estate to third parties must be included in the gross income of the deceased estate under section 25(1). Deductions or allowances relating to nursery operations conducted by the executor must likewise be claimed by the deceased estate under the relevant deduction provision, for example, section 11(a).

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 of the deceased estate in subsequent years of assessment.

Cessation of deceased estate

The deceased estate must account for all income and expenditure up to the point at which the liquidation and distribution account becomes final. Amounts received or accrued after that date must be accounted for by the heirs or legatees.

The liquidation and distribution account is required to lie open for a period not less than 21 days for inspection by any person interested in the estate.³⁸ This period must be stipulated by the executor in the *Government Gazette* and in one or more newspapers circulating in the district in which the deceased was ordinarily resident.³⁹

The estate becomes distributable after the period stipulated in the notice assuming no objection has been lodged against the account, and it is at this point that the account becomes final.⁴⁰ Should objection be lodged against the account, the date on which it becomes final will depend on the facts. For example, if the objection is sustained and the revised liquidation and distribution account lies open for inspection for a further 21 days, the account will become final after that period assuming no further objection has been lodged against the revised account. If the Master dismisses the objection and the aggrieved party applies to court to have the Master's decision set aside, the account will become final only when the court process is completed.

On the reckoning of the 21-day period, section 4 of the Interpretation Act 33 of 1957 provides as follows:

4. Reckoning of number of days.—When any particular number of days is prescribed for the doing of any act, or for any other purpose, the same shall be reckoned exclusively of the first and inclusively of the last day, unless the last day happens to fall on a Sunday or on any public holiday, in which case the time shall be reckoned exclusively of the first day and exclusively also of every such Sunday or public holiday.

Thus, if the account was advertised in the *Gazette* on Tuesday 3 January 2017, the period of 21 days will end at midnight on Tuesday 24 January 2017.

(d) Heirs or legatees

Heirs or legatees other than a surviving spouse [section 25(3)(b)]

The effect of section 25(3)(b) is that an heir or legatee is deemed to acquire produce for an amount equal to the expenditure incurred or deemed to be incurred by the deceased estate under section 25(2). As already discussed that expenditure would be equal to the market value of the produce on the date of death in respect of produce acquired from the deceased person, or in any other case, an amount equal to the actual cost incurred by the executor under section 11(a).

Surviving spouse

With a surviving spouse, a distinction needs to be drawn between produce –

- held by the deceased person on date of death [section 25(4)]; and
- acquired by the deceased estate after date of death (for example, through purchase) [section 25(3)(b)].

Acquisition of produce by surviving spouse from the deceased person

The acquisition of produce from the deceased person is regulated by section 25(4) which treats the surviving spouse, the deceased person and the deceased estate as one and the same person for purposes of determining any allowance or deduction to

³⁸ Section 35(4) of the Administration of Estates Act 66 of 1965.

³⁹ Section 35(5)(a) of the Administration of Estates Act 66 of 1965.

⁴⁰ Section 35(12) of the Administration of Estates Act 66 of 1965.

which that spouse may be entitled or that is to be recovered or recouped by or included in the income of that spouse in respect of that produce [section 25(4)(a)].

Section 25(4)(b) then treats the surviving spouse contemplated in section 25(4)(a) as one and the same person as the deceased person and deceased estate with respect to –

- the date of acquisition of the asset by that deceased person;
- any valuation effected by that deceased person as contemplated in paragraph 29(4) of the Eighth Schedule [not relevant to produce, since all consequences will be on income account and this valuation is for CGT purposes];
- the amount of any expenditure and the date on which and the currency in which that expenditure was incurred in respect of the asset –
 - by that deceased person as contemplated in section 9HA(2)(b); and
 - by that deceased estate, other than the expenditure contemplated in section 9HA(2)(b);
- the manner in which that asset had been used by the deceased person and the deceased estate; and
- any allowance or deduction allowable in respect of an asset to the deceased person and the deceased estate.

The expenditure taken over by the surviving spouse for produce is the amount referred to in section 9HA(2)(b). Section 9HA(2)(b)(i) deals with produce and applies only to the year of assessment in which a person dies. The expenditure to be taken over by the surviving spouse is equal to the amount that was allowed as a deduction in respect of the asset for purposes of determining the deceased person's taxable income, before the inclusion of any taxable capital gain, for the year of assessment ending on the date of that person's death.

Thus, to the extent that the produce acquired by the surviving spouse came from the opening stock of produce of the deceased person in the year of death, it is deemed to be taken over at that value, and to the extent that it came from produce acquired or produced by the deceased person during the year of death it is deemed to be taken over at the cost to the deceased person.

No rule is provided for produce acquired in earlier years of assessment because the deceased person would have claimed the relevant expenditure in those years.

Produce taken over by surviving spouse acquired by the deceased estate after date of death [section 25(3)(b)]

The executor may acquire produce after the date of death of the deceased person through purchase. The acquisition of such produce by the surviving spouse is not governed by section 25(4) because section 25(4)(a) refers to an asset contemplated in section 9HA(2), which is one disposed of by the deceased person.

Rather, the surviving spouse is treated in the same manner as any other heir or legatee and acquires such produce under section 25(3)(b) for an amount equal to the expenditure incurred by the deceased estate.

(e) Capital or revenue nature of produce and capital gains tax

Since a deceased farmer would have held produce as floating capital at the date of death, the amount deemed to be received by or accrued to the farmer for such produce under section 9HA(1) and (2) will be of a revenue nature and included in the farmer's gross income.

Any amount that would have constituted income in the hands of the deceased person will constitute income of the deceased estate under section 25(1)(b). Thus the disposal of produce by the deceased estate will also be on revenue account.

Under section 25(4)(b)(iv) a surviving spouse is treated as having used produce in the same manner that it was used by the deceased person and the deceased estate. Since both those persons used the produce as floating capital, the surviving spouse is deemed to use produce acquired from the deceased person and the deceased estate as floating capital. There can therefore be no question of the produce giving rise to a receipt of a capital nature in the hands of the surviving spouse, even if the surviving spouse does not carry on farming operations. Under section 26(2) such produce would continue to be held on revenue account until disposed of, even if farming operations were discontinued.

Produce will also comprise floating capital and be on revenue account in the hands of an heir or legatee (other than a surviving spouse) who is a farmer and brings the inherited produce into a farming operation.

The amount received by or accrued to an heir or legatee (other than a surviving spouse) disposing of produce acquired by inheritance will be of a capital nature provided that it was disposed of at the earliest opportunity and not made part of a farming operation.

The Eighth Schedule eliminates receipts and accruals of a revenue nature on disposal from proceeds under paragraph 35(3)(a). Likewise, expenditure of a revenue nature is eliminated from base cost under paragraph 20(3)(a).

It remains then to consider the CGT position of an heir or legatee other than a surviving spouse who disposes of inherited produce on capital account. The capital gain or loss on such a disposal will be determined by subtracting the base cost from the proceeds in the normal way. The base cost would comprise the expenditure deemed to be incurred by the heir or legatee under section 25(3)(b), namely, market value on date of death plus any further purchase or production costs incurred by the executor. The proceeds will comprise the amount received or accrued on the disposal under paragraph 35 of the Eighth Schedule.

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;
- 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.⁴¹ 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.⁴² 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.

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 its fair and reasonable value under 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

⁴¹ Paragraph (b)(i) of the proviso to section 66(13)(a).

⁴² *Van Zyl NO v CIR* 1997 (1) SA 883 (C), 59 SATC 105.

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.

Special rules apply for income tax and CGT purposes upon the death or sequestration of a nursery operator carrying on farming operations.

Legal Counsel

SOUTH AFRICAN REVENUE SERVICE

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Annexure – The law**Section 9HA**

9HA. Disposal by deceased person.—(1) A deceased person must be treated as having disposed of his or her assets, other than—

- (a) assets disposed of to his or her surviving spouse as contemplated in subsection (2);
- (b) a long-term insurance policy of the deceased, if any capital gain or capital loss that would have been determined in respect of a disposal that resulted in proceeds of that policy being received by or accruing to the deceased would have been disregarded in terms of paragraph 55 of the Eighth Schedule; or
- (c) an interest of the deceased in—
 - (i) a pension, pension preservation, provident, provident preservation or retirement annuity fund in the Republic; or
 - (ii) a fund, arrangement or instrument situated outside the Republic which provides benefits similar to a pension, pension preservation, provident, provident preservation or retirement annuity fund,

if any capital gain or capital loss that would have been determined in respect of a disposal of that interest that resulted in a lump sum benefit being received by or accruing to the deceased would have been disregarded in terms of paragraph 54 of the Eighth Schedule,

at the date of that person's death for an amount received or accrued equal to the market value as contemplated in paragraph 31 of the Eighth Schedule of those assets as at that date.

(2) A deceased person must, if his or her surviving spouse is a resident, be treated—

- (a) as having disposed of an asset for the benefit of that surviving spouse if that asset is acquired by that surviving spouse—
 - (i) by *ab intestato* or testamentary succession;
 - (ii) as a result of a redistribution agreement between the heirs and legatees of that person in the course of liquidation or distribution of the deceased estate of that person; or
 - (iii) in settlement of a claim arising under section 3 of the Matrimonial Property Act, 1984 (Act No. 88 of 1984); and
- (b) as having disposed of that asset for an amount received or accrued that is equal to, in the case of—
 - (i) trading stock, or livestock or produce contemplated in the First Schedule, the amount that was allowed as a deduction in respect of that asset for purposes of determining that person's taxable income, before the inclusion of any taxable capital gain, for the year of assessment ending on the date of that person's death; or
 - (ii) any other asset, the base cost of that asset, as contemplated in the Eighth Schedule, as at the date of that person's death.

(3) If any asset that is treated as having been disposed of by a deceased person as contemplated in subsection (1) is transferred directly to an heir or legatee of that person, that heir or legatee must be treated as having acquired that asset for an amount of expenditure incurred equal to the market value as contemplated in paragraph 31 of the Eighth Schedule of that asset as at the date of that deceased person's death.

Section 25(1) to 5)**25. Taxation of deceased estates.—(1) Any—**

- (a) income received by or accrued to or in favour of any person in his or her capacity as the executor of the estate of a deceased person; and
- (b) amount received or accrued as contemplated in paragraph (a) which would have been income in the hands of that deceased person had that amount been received by or accrued to or in favour of that deceased person during his or her lifetime,

must be treated as income of the deceased estate of that deceased person.

(2) Where the deceased estate of a person acquires an asset from that person, that deceased estate must, if that asset is an asset—

- (a) other than an asset contemplated in section 9HA(2), be treated as having acquired that asset for an amount of expenditure incurred equal to the amount contemplated in section 9HA(1); and
- (b) contemplated in section 9HA(2), be treated as having acquired that asset for an amount of expenditure incurred equal to the amount contemplated in section 9HA(2)(b).

(3) Where the deceased estate of a person disposes of an asset to an heir or legatee of that person—

- (a) that deceased estate must be treated as having disposed of that asset for an amount received or accrued equal to the amount of expenditure incurred by the deceased estate in respect of that asset; and
- (b) the heir or legatee must be treated as having acquired that asset for an amount of expenditure incurred equal to the expenditure incurred by the deceased estate in respect of that asset.

(4) (a) This subsection must be applied in respect of an asset acquired by a surviving spouse of a deceased person as contemplated in section 9HA(2) for purposes of determining the amount of any—

- (i) allowance or deduction to which that spouse may be entitled or that is to be recovered or recouped by or included in the income of that spouse in respect of that asset; or
- (ii) the amount of any capital gain or capital loss in respect of a disposal of that asset by that spouse.

(b) The surviving spouse contemplated in paragraph (a) must be treated as one and the same person as the deceased person and deceased estate with respect to—

- (i) the date of acquisition of that asset by that deceased person;
- (ii) any valuation of that asset effected by that deceased person as contemplated in paragraph 29(4) of the Eighth Schedule;
- (iii) the amount of any expenditure and the date on which and the currency in which that expenditure was incurred in respect of that asset—
 - (aa) by that deceased person as contemplated in section 9HA(2)(b); and
 - (bb) by that deceased estate, other than the expenditure contemplated in section 9HA(2)(b);
- (iv) the manner in which that asset had been used by the deceased person and the deceased estate; and
- (v) any allowance or deduction allowable in respect of that asset to the deceased person and the deceased estate.

(5) A deceased estate must, other than for the purposes of section 6, section 6A and section 6B, be treated as if that estate were a natural person.

Section 25C

25C. Income of insolvent estates.—For the purposes of this Act, and subject to any such adjustments as may be necessary the estate of a person prior to sequestration and that person's insolvent estate shall be deemed to be one and the same person for purposes of determining—

- (a) the amount of any allowance, deduction or set off to which that insolvent estate may be entitled;
- (b) any amount which is recovered or recouped by or otherwise required to be included in the income of that insolvent estate; and
- (c) any taxable capital gain or assessed capital loss of that insolvent estate.

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 a fair and reasonable value.