

**FARMING AND MANUFACTURING: THE TAX CONSEQUENCES OF
CONDUCTING THESE ACTIVITIES SIMULTANEOUSLY**

By

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Minor dissertation: presented in partial fulfilment of the requirements for the degree

of:

Master of Commerce in Taxation (*South African Taxation*)

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University of Cape Town

South Africa

January 2018

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“The hardest thing in the world to understand is the income tax.”

~ Albert Einstein

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DECLARATION

I, Debora Anneke Grotepass, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgments indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university. I authorise the University to reproduce for the purpose of research either the whole or any portion of the contents in any manner whatsoever.

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ACKNOWLEDGEMENTS

Thanks to Peter Surtees for the motivation, and for opening my eyes to see the world of tax in a new light.

Dr Liske Kotze Hörstmann, thanks for your invaluable help and feedback in helping me to finalise this writing

My parents, who have supported me in every challenge I have ever taken on - without your continued support and belief in me, I would never have reached goals in my life to date.

To my loving husband, Johan-Hugo, thank you for your ever-present support.

ABSTRACT

Different tax rules apply to farming and manufacturing activities respectively, and it appears that the South African Revenue Service (SARS) applies an arbitrary practice in determining whether, and if so, at what point a farming operation needs to be distinguished from manufacturing activities.

This dissertation explores how and when a taxpayer is required to distinguish between farming and manufacturing activities within the context of a single business i.e. when one form of 'trade' comes to an end, and when another form of 'trade' commences.

The First Schedule to the Income Tax Act, 1962 (ITA), and paragraph 12, in particular, gives certain privileges to farmers that other taxpayers do not enjoy. Similar to this, taxpayers who are conducting manufacturing activities, or operations accepted and listed by SARS as a process of manufacture or similar process, enjoy advantageous allowances in respect of the write off of machinery and buildings.

Thus, the point at which one activity ends and the next activity begins can have significant tax consequences. This dissertation argues that these consequences are too significant to be governed by arbitrary decisions. In conclusion it is shown that the ITA provides the wherewithal to enable the decisions to be made based on sound statutory principles. Where the wherewithal is not present, appropriate additions to the legislation are recommended. Examples from case law are also discussed from which general principles to be used in practice are developed.

LIST OF ABBREVIATIONS

Meaning	Abbreviation
SARS	South Africa Revenue Service, previously known as the Inland Revenue
ITA	Income Tax Act, 1962
SCA	Supreme Court of Appeal
First Schedule	First Schedule to the ITA
SA	South Africa
The Common law	South African common law is founded on Roman-Dutch law
The Commissioner	The Commissioner for SARS appointed under section 6 of the SARS Act, currently Mark Kingon
TAA	Tax Administration Act
A Public Notice	Notices issued in terms of the TAA
GAAR	General Anti Avoidance Rules
Income Tax	Direct tax on income or remuneration
SATC	South African Tax Cases

GLOSSARY OF TERMS USED IN THIS DISSERTATION

Business operation: In the context of this writing, an 'operation' refers to a sub-unit or segment within the business under discussion in the case study.

Disposal: This will be the action of selling an item of stock.

Engaged: Directly involved in.

Farming: There is no formal definition for farming in the ITA; therefore, a taxpayer will be classified as a farmer based on the underlying (farming) activities he performs. Throughout this writing, a 'farmer' will be a taxpayer who is engaged in full time farming activities.

Going concern: A business that is operating with the intention of making a profit, and will continue with this intention in the foreseeable future.

Large scale: A continuous processing of a high volume of uniform goods

Manufacturing: There is no formal definition for manufacturing in the ITA. Manufacturing is deemed to be a process in which a standardised good is manufactured in bulk quantities.

Process of manufacture: Based on case law, for a process to be one of "manufacture", it has to produce an article essentially different from the article as it existed before undergoing the process.¹

SARS: Since the first Income Tax Act in 1914, the head of the revenue authority has been known variously as the Commissioner for Inland Revenue, the Secretary for

¹ Deloitte, "2188. Manufacturers," Integritax, https://www.saica.co.za/integritax/2013/2188._Manufacturers.htm.

Inland Revenue, and the Commissioner for the South African Revenue Service. For the sake of simplicity, this dissertation uses the abbreviation SARS throughout.

Standardised Value: An agreed upon value for a transaction.

Straight line basis: Parts of the whole are written off in equal proportions from year to year (this typically relates to the write-off of machinery for tax purposes). No apportionment for parts of the year is made.

Trade: A business or occupation in a particular *sector* of the economy.

Use of italics: Special emphasis is added to make a point in this writing by making use of *italics*.

CHAPTER ONE

INTRODUCTION

1.1 AN EXORDIUM TO THE RESEARCH

Beneficial tax rules exist for taxpayers who are involved in farming and manufacturing activities in comparison to other taxpayers. It is my view that the South African Revenue Service (SARS) applies an arbitrary practice in determining whether a taxpayer qualifies for tax allowances that are specifically available to farmers and manufacturers. Currently, it is not clear at what point a farming operation needs to be distinguished from a manufacturing operation.

The terms of the First Schedule to the Income Tax Act, 1962 (ITA), (and in particular paragraph 12), give certain privileges to farmers that other taxpayers do not enjoy. Farmers are typically entitled to accelerated tax allowances, and more beneficial tax write off periods. Similar to this, taxpayers who are conducting manufacturing activities, or operations accepted and listed by SARS as a process of manufacture, enjoy advantageous allowances in respect of the write-off of machinery and buildings. It is possible for a taxpayer to be conducting two distinct trades within one business. This writing will attempt to explore when a taxpayer is conducting two distinct trades i.e. one being farming and the other being manufacturing. The treatment of capital and income producing expenditure will be discussed, by making use of a practical case study (section 2.2)., In this particular case study, the point at which the relative trades commence and cease and the tax allowances that each trade will qualify for will be discussed in detail. Proposed tax treatment will be discussed by making reference to the ITA, case law, SARS' practice and practical application.

1.2 BACKGROUND AND IMPORTANCE OF AGRICULTURE IN SOCIETY

Currently agricultural activities (farming) make up just under 2.5% of national GDP² of South Africa (SA). Given that this sector plays a crucial role in ensuring the food supply of SA, its importance within the SA economy cannot be overlooked.

Historically, farmers have enjoyed certain privileges that other taxpayers did not enjoy (such as more favourable tax allowances) because of the unique environment in which farmers operate, and the ever-present challenges to which they are subjected. It also doesn't come as a surprise that 'farmers' are listed as *special taxpayers*, when one opens the contents page of Haupt.³ It is common knowledge within the SA context that farmers face a lot of pressure owing to drought and political factors.

Therefore, farmers in SA have enjoyed certain tax 'benefits' to aid them in developing the agricultural sector and in acknowledgement both of their importance to the economic and social wellbeing of the country and of the unique challenges they face. For example, few merchants face the real danger that their trading stock may be wiped out in one hailstorm or one infection of animal disease. It is thus imperative that we nurture our agricultural sector, and help businesses to set up their activities in the most tax efficient manner; as food security will become a long term objective and requirement. At the end of the day, quality food at affordable prices is necessary for everyone in the general population of SA. Therefore, farming entrepreneurs (who produce large quantities of food) must be made aware of the tax incentives available

² J. Greyling, "A look at the contribution of the agricultural sector to the South African economy," Grain SA, <http://www.grainsa.co.za/a-look-at-the-contribution-of-the-agricultural-sector-to-the-south-african-economy>

³ P. Haupt, "Notes on South African Income Tax 2016," (Roggebaai, Republic of South Africa: Huxham & Haupt, 2016).

to people operating in the farming market, to ensure that they can unlock the full value of the produce that they are farming.

Food security is becoming an ever-growing problem, due to climate change and socio-economic factors. Therefore, farming activities will become more important in the production of food. As technological advances become vital in the running of a profitable farming operation, it is essential to understand the tax incentives available to farmers, and how to maximise them, to ensure that profitable, and strong agricultural businesses are set up. The business strategies adopted by the agricultural farms, will have important implications for poverty and equity concerns in the country.

'Improving agriculture, the backbone of the African economy, can drive massive poverty reduction and improve life across the continent.'

– Bill Gates⁴

Increased pressure on the profitability of farming and agricultural business activities is forcing the agricultural sector to be an early adopter of new technologies in order that it may improve the productivity and profitability of the sector. Historically much of the farm work performed was done by hand, but increasingly farmers are opting for mechanisation. Whilst it can be assumed that productivity will increase in the growing mechanised industry, one should also be made aware of the beneficial tax incentives available on buildings, as well as plant and machinery for taxpayers who have set up business as farmers.

Related to this are the economic benefits of achieving a seamless transition from farming to manufacturing of farming products. Put differently, it makes sense for a

⁴ B. Gates, "Big Bet: Africa Can Achieve Food Security By 2030," <http://www.africatrictlybusiness.com/big-bet-africa-can-achieve-food-security-2030>. (Feb 11, 2015)

farmer to beneficiate the raw produce into consumable foods instead of exporting the raw produce. If the farmer is able to process the farming produce into a mass produced, standardised good, he will ultimately be unlocking the value of the produce, and should be able to make further profits from conducting these additional activities. There is a growing tendency by South African farmers, who historically only conducted farming activities, to expand these activities into produced goods. It makes economic sense for a farmer to operate at a high capacity, so as to unlock the value of economies of scale. It has become typical for the larger farmers to include an element of manufacturing before disposing of their stock. This writing aims to discuss the tax consequences of those farmers who are expanding their operations to include that of manufacture.

1.3 LEGISLATION

1.3.1 The Provisions of the ITA specific to farming

Farmers are subject to all the provisions of the Income Tax Act (ITA). However, the First Schedule is specific to farmers and provides the means by which their income from farming is determined. Once this determination has been made, the result is brought into the body of the ITA via section 26.

Section 26(1) stipulates that the taxable income of *any person carrying on pastoral, agricultural or other farming operations* (emphasis added) shall, in so far as the income is derived from such operations, be determined in accordance with the ITA but subject to the First Schedule which deals with the computation of taxable income derived from pastoral, agricultural or other farming operations⁵. However, the First Schedule

⁵ South African Tax Guide, "Taxation of Farming Income," <http://www.sataxguide.co.za/taxation-of-farming-income/>.

applies only to taxpayers conducting farming activities, regardless of whether the taxpayer derives an assessed loss or a taxable income from farming operations. This means that the taxpayer needs to be a genuine, if not necessarily full time farmer, engaged in farming activities with the intention to make a profit, to have access to the provisions of the First Schedule. It is for this reason that the First Schedule is discussed in detail. The structure of the First Schedule is summarised below (full extract and discussion of the First Schedule is available in the Appendix)

Paragraph	Subject:
2 – 5 & 9	Valuation of livestock and produce
6 – 7	Election of standard values
8	Ring fencing of livestock acquisitions
11	Donations and in specie dividends
12	Capital development expenditure
13	Forced sales and drought relief provisions
14 – 16	Plantation farming
17	Sugar cane destroyed by fire
19	Rating formula for farmers (who are not companies)
20	Expropriation of farming land

Paragraphs of importance in the First Schedule

Paragraph 12 of the First Schedule enables a farmer to deduct listed capital expenditure from their farming income in full, in the year this capital item is brought into use. In a case study in which a taxpayer conducts farming and manufacturing activities within one business, it stands to reason that they will want to have as much of their income as possible classified as farming income; from which capital expansion

projects will be able to be written off in full. Similarly, but to a lesser extent, taxpayers that conduct manufacturing operations enjoy advantageous capital allowances in respect of machinery and buildings. From this information I want to highlight the importance of determining the underlying activities that the taxpayer is engaged in, as this will directly impact the tax allowances that he qualifies for.

It is settled law that when interpreting provisions of tax legislation that provide special privileges to a particular class of taxpayer, the courts will interpret these provisions strictly and narrowly to ensure that only taxpayers for whom the lawmaker intended them will have access to these provisions⁶. That being said, human nature dictates that taxpayers will try their utmost to squeeze their activities into a privileged category. I will therefore discuss when a particular category ends, and when another category of activities commences for tax purposes within a single business. A further discussion on the case law applicable in each operating activity follows in the coming chapters.

1.3.2 Taxpayers conducting more than one trade

This study discusses the tax implications of a taxpayer who is involved in both farming and manufacturing activities. Such a taxpayer will often have the dilemma to identify what tax treatment to apply to their operations and to what extent. i.e. it will become imperative to determine when activities fall within those of farming operations (which will have more beneficial tax treatment) and when activities fall within manufacturing operations. In order to achieve this goal, the practice to be applied is the interpretation rules applicable to fiscal legislation as supported by judicial commentaries and clarification of essential issues from the literature.

⁶ *Ernst v CIR*, 19 (1953).

While all of the rulings which are referred to were undeniably dependent on the specific circumstances of each taxpayer at hand, it is submitted that various *general principles* may nonetheless be harvested from these sources. While not attempting to provide a universal solution or simple checklist, the main goal of this study is thus to identify and discuss principles as may arise from the case law and commentaries referred to.

1.4 AIMS AND OBJECTIVES

To achieve this goal, certain aims are set which are listed in table 1 (below). To achieve these aims, reference will be made relevant to the case study (discussed in section 2.2), followed by a discussion on the relevant legislation and case law in SA.

The main objectives of this dissertation is to distinguish between farming and manufacturing activities within the context of a single business i.e. when one form of *trade* comes to an end, and when another form of *trade* commences. Therefore, this writing describes and analyses the appropriate use of the First Schedule when applied to farmers who are also conducting manufacturing activities. In order to achieve this, this writing refers to legislation, general principles from case law and SARS practice in both farming and manufacturing activities.

Table 1: An outline of the specific research questions focused on in this research.

1.	<i>What constitutes farming activities?</i>	As this is not clearly defined in the ITA, reference is made to case law to derive general principles.
2.	<i>What type of income qualifies to be included in farming income?</i>	Case law has determined that only income that was derived directly from farming activities may be classified as such.
3.	<i>A discussion of what trading stock is in farming and the tax treatment thereof?</i>	Reference is made to legislation and case law, and made applicable to the specific case study on hand.
4.	<i>A discussion of what is capital development expenditure in farming and the tax treatment thereof?</i>	Special tax write-offs on farming capital expenditure that are only available to farmers, will be discussed, as well as the limitations thereof.
5.	<i>What constitutes manufacturing activities? Reference to a process of manufacture will be made.</i>	General principles are derived from case law, and SARS practice is discussed and made applicable to the particular case study on hand.
6.	<i>At what price should a farming entity dispose of produce to a manufacturing entity within the bounds of a single business?</i>	A discussion based on the particular case study is set, discussing general principles from case law and SARS' practice
7.	<i>Where machinery is involved in farming and manufacturing activities, how does the farmer apply section 12C of the ITA as well as paragraph 12 of the First Schedule to machinery used in production? (not the same machinery?)</i>	Given the constraints of the ITA and principles derived from case law, various case studies are discussed and made applicable to practices used by farmers.
8.	<i>How are overheads such as wages, electricity and other general operating expenditure allocated between farming and manufacturing activities within one business?</i>	Expenses are to be allocated based on the underlying activities that take place in each particular case study, which gave rise to that particular expense.

1.5 RESEARCH METHOD

The doctrinal research methodology is applied throughout this writing. According to McKerchar, doctrinal research can be described as “the traditional or ‘black letter law’ approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary.”⁷

Firstly, this qualitative dissertation provides a systematic exposition to the rules governing farming with reference to section 26 and the First Schedule of the ITA. Where appropriate, consideration will be given to court cases and the respective court rulings, to document the evidence, based on the analysis of principles arising from these cases. Although the ruling is often specific to circumstances in that particular case, there are principles that arise from court cases that have become practised industry norms within the SA context. These principles arising from the rulings will also allow for clarity of the application of the First Schedule when computing taxable income from farming operations⁸. A similar approach will be followed to discuss manufacturing activities.

Once the farming and manufacturing activities have been defined for tax purposes, I will attempt to make these principles applicable to case studies with reference to case law, SA legislation and SARS practice. A chapter will then follow as to when farming activities begin and cease, and when manufacturing activities commence within the context of a single business. This will be discussed with reference to the tax consequences of an entity performing both of these activities.

⁷ M McKerchar, "Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation," eJournal of Tax Research, <http://classic.austlii.edu.au/au/journals/eJITaxR/2008/1.html>.

⁸ C. Mullins, "Taxation of Game Farming in the Eastern Cape: How appropriate is the First Schedule of the Income Tax Act No.58 of 1962 for computing taxable income?" (University of Cape Town, 2017).

As all primary and secondary sources used contain information available in the public domain, no ethical considerations are necessary.

1.6 LIMITATION OF SCOPE:

In this integrated farming situation, all the activities are carried out by the farmer himself, within one entity. (No outside, additional party is used in the post farming operations). Therefore, only the income tax implications that fall within the scope of this writing will be discussed. It is also assumed that the entity that performs both farming and manufacturing activities is a profit-making entity. In addition, international legislation will be excluded from this writing, as this writing is specific to the SA context. The conclusions drawn will therefore be based on the findings from legislation and various case law discussions.

1.7 OVERVIEW OF CHAPTERS

The report will be broadly structured as follows:

1.	Introduction
2.	Farming and manufacturing case study
3.	What comprises farming? – tax treatment in terms of section 26 and the First Schedule, followed by a discussion of case law
4.	What comprises manufacturing? – tax treatment and discussion from various cases
5.	Discussion as to where farming operations begin and cease, and when manufacturing operations commence. Some practical considerations, applicable to the case study on hand will also be discussed.
6.	Conclusion

CHAPTER TWO

FARMING AND MANUFACTURING CASE STUDY

2.1 BACKGROUND

In order to discuss the various activities which are the subject of this work, a case study will be presented to better illustrate the diverse activities that a farming company could be engaged in.

2.2 CASE STUDY

The case study which will be discussed is based on a business, carried on through a protein company (this business is a registered *company* at all times throughout this writing), which initially started off as a cheese factory, primarily involved in the manufacture of cheese on a large scale. As time progressed, this business expanded its activities to include the ownership of livestock; to ensure that it maintained a steady stream of milk, to be utilised in the manufacturing operations. Goats, sheep and cattle were acquired to aid in the production of milk, to be used in the manufacture of cheese. In order to make the farming operations profitable, and given the resources that were available to the entity (i.e. land, labour, machinery) it was decided to expand the existing farming operations in herd size, as well as to incorporate chickens and pigs in the business.

Synergies within this context were attempted to be realised at all times. The protein company produces significant quantities of whey during the process of making cheese. Whey, which is a waste product of cheese, is fed to the pigs. Waste and by-products in the manufacture of cheese are attempted to be used as a source of foods, to fatten

up the livestock, in order to further unlock the value of the wasted and past sell-by-date stock.

With time, the farming operations expanded to a point where livestock herds reached sustainable levels which allowed for a steady stream of meat production could be maintained. Instead of selling the livestock off to abattoirs, the company decided to open a butchery, to provide meat cuts to artisanal restaurants. Meat was only cut-up into prime cuts to be utilised by these restaurants. No curing, or further processing of this meat took place. Additionally, meat off-cuts were sold off to staff at scrap value. As a result, the demand for the prime cuts grew, the butchery started accumulating high stock levels of meat off-cuts.

At this point, it was decided to start another segment within the business, that of a bakery. This bakery utilised eggs from the poultry division in the production of baked goods. Similarly, milk was used from the cattle division. Excess meat not sold by the butchery was transferred to the bakery and used in the manufacture of pies. The activities conducted by the corporation are illustrated by means of a diagram depicted in Figure 2.1. From the outlined case study, it is evident that the protein company conducts manufacturing, as well as farming activities. In this work an attempt will be made to determine when the entity is conducting a particular activity (farming or manufacturing), and at what point it reaches the cut-off point of that particular activity.

The challenges and opportunities available to a farmer who conducts both farming and manufacturing activities will be addressed. For example, at what price should the farming activity dispose of produce to the manufacturing activity?

Where machinery is involved in both the farming and manufacturing activities, how does the farmer apply section 12C, and perhaps section 12B, of the ITA and paragraph

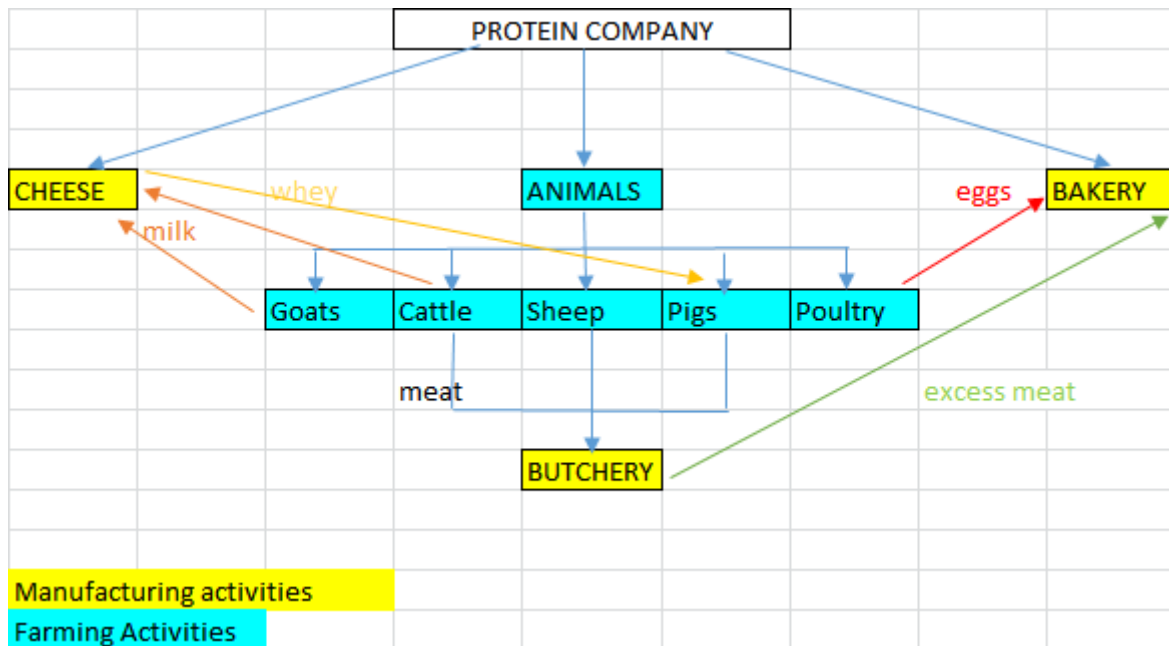


Figure 2.1. A diagrammatic representation of the activities performed by the protein company, and classification of farming or manufacturing for tax purposes.

12 of the First Schedule to the same machinery? Another challenge facing the farmer would be the allocation of overheads, such as wages, electricity and communication costs such as telephone and the internet to the different activities.

2.3 CONCLUSION

The above is a brief overview of the case study which will be referred to throughout this writing. This case study applies, since the taxpayer is directly engaged in farming operations, as well as a process of manufacture. Throughout this writing, the author will attempt to prove that a taxpayer is able to be involved in both farming and manufacturing activities.

The next chapter will deal with the general and legislative principles related to farming activities, as well as a discussion on the activities performed in the above case study. Thereafter, the general and legislative principles relating to manufacturing activities will be discussed. A detailed discussion will follow highlighting the practical and

legislative implications of being involved in farming and manufacturing activities simultaneously.

CHAPTER THREE

FARMING

3.1 INTRODUCTION

From the previous chapters it was established that there exists no formal definition of farming for tax purposes within the ITA. Whether a person is conducting a farming enterprise is a question of fact. This chapter will seek to determine what will qualify as a farming enterprise for tax purposes.

3.2 LEGISLATION

3.2.1 The provisions of the ITA specific to farming

Farmers are subject to all the provisions of the ITA. However, the First Schedule is specific to farmers and provides the means by which their income from farming is determined. Once this determination has been made, the result is brought into the body of the ITA via section 26.

3.2.1.1 Determination of taxable income derived from farming

Section 26 ITA states:

26.(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*.⁹ (Emphasis added)

⁹ "Income Tax Act No. 58 of 1962.," (1962).

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 First Schedule applies only to taxpayers conducting farming activities, regardless of whether the taxpayer derives an assessed loss or a taxable income from farming operations. A full summary of the First Schedule can be found in the Appendix to this writing. Below is a short summary of some of the paragraphs of particular importance to this chapter:

3.2.1.2 Extract of the First Schedule

Paragraph 1 – states that the First Schedule is applicable to anyone who is engaged in *farming activities*.

Paragraph 2 – farmers are to include the value of opening stock and closing stock in the calculation of their taxable income.

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 the end of each year of assessment.¹⁰

Taxpayers conducting farming activities must include the opening and closing stock of livestock and produce in the trading stock section of their income tax return. The value of opening and closing stock is determined with reference to paragraph 3 of the First Schedule.

Paragraph 3 – This paragraph expands on the opening and closing stock held by the farmer.

¹⁰ "Income Tax Act No. 58 of 1962.."

3. (1) Subject to the provisions of subparagraphs (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.¹¹

Taken together, it then follows that: (i) the value (as determined) of closing stock is added to taxable income and that (ii) opening stock (as held at the end of the previous year) is deducted from taxable income. Notably, the stock held in opening and closing stock will be carried at *standard value*. A short discussion on this concept follows in paragraph 5.

Paragraph 4 - The opening stock of livestock will equal the value of the closing stock held at the end of the previous year. Added to this will be the market value of livestock / produce acquired during the year, otherwise than purchased, natural increase or in the ordinary course of farming operations. A dividend *in specie*, or a donation of livestock would be an example of this.

Paragraph 5 – This paragraph relates to the values at which closing stock will be carried at year end.

5. (1) The value to be placed upon livestock for the purposes of this Schedule shall, subject to the provisions of paragraph 4 (1) as respects livestock held and not disposed of at the end of the year of assessment, be the *standard value* applicable to the livestock.¹²

The values at which this stock is carried at year end, will be carried forward to the following year of assessment as opening stock, and will continue to be held at this *standard value*. This standard value will be determined in terms of the values placed

¹¹ Ibid.

¹² Ibid.

upon that stock in the Government Gazette. A table that summarises these values is in the appendix (Table 1.1). In most cases, the standard value per livestock item is less than the market value at which that stock can be purchased or sold. This standard value is fixed by regulations in terms of the Act. This standard value of the farmers' livestock on hand, at the end of the tax year, is therefore included in the taxable income as closing stock¹³.

In light of the values set out in Table 1.1, it follows that in almost all cases the purchase price of the livestock (which will be a deduction) will be significantly higher than the value at which the closing stock will be added back for tax purposes. In almost all cases, this will lead to a situation in which the value of closing stock will be lower than the value of purchases; which will lead to a reduction in taxable income.

From Table 1.1 in the appendix, it is evident that the value of closing stock will be significantly understated in relation to the market value of the livestock held at year end.

Paragraph 8 – deals with expenditure incurred in the acquisition of livestock:

8. (1) Where any farmer has during any year of assessment incurred expenditure in respect of the acquisition of livestock, the deduction which may be allowed to him under section 11 (a) of this Act in respect of the cost price of such livestock shall be *limited* to an amount which, together with the value of livestock held and not disposed of by him at the beginning of such year, does not exceed the income received by or accrued to him from farming during such year and the value of livestock held and not disposed of by him at the end of such year. ¹⁴

The above extract makes it clear that you cannot have a negative movement of stock.

¹³ "Standard classification and standard values of livestock," SARS, <http://www.sars.gov.za/AllDocs/Documents/Livestockvalues/Live%20stock%20values.pdf>.

¹⁴ "Income Tax Act No. 58 of 1962.."

8 (2) Any amount which has been disallowed under the provisions of subparagraph (1) shall be carried forward and be deemed to be expenditure incurred by the farmer in respect of the acquisition of livestock during the succeeding year of assessment. ¹⁵

Expenses that were disallowed in the previous tax year due to inadequate income being available for set-off may be carried forward to a next year of assessment; until there is sufficient (farming) income available against which those expenses can be set-off.

(3) The provisions of this paragraph shall not apply -(a) in any case where it is shown by the farmer that livestock the cost of which falls to be dealt with under such provisions is no longer held and not disposed of by him; and ¹⁶

This paragraph means that if a farmer disposes of all of his livestock, and is no longer conducting farming activities, he will no longer be allowed to set off expenditure related to the purchase of livestock against his income. It follows that the farmer who continues to farm would be able to deduct expenditure relating to previous purchases of livestock.

Expenditure in respect of acquisition of livestock is limited to the farmers' taxable income for the specific year under review. Because of the effect of using standard values for livestock (specifically when adding back the closing stock); a farmer could create a large farming loss in the tax year by making large purchases of livestock. Purchases would be deductible under section 11(a); and closing stock would be reflected at reduced standard values. To prevent the creation of a farming loss by means of livestock acquisitions, paragraph 8 limits the deduction in respect of livestock purchased to the proceeds of livestock sales during the year of assessment. Any amount disallowed as a deduction under paragraph 8 shall be carried forward and

¹⁵ Ibid.

¹⁶ Ibid.

deemed to be expenditure incurred by the farmer in respect of acquisitions of livestock during the following years of assessment, when there is adequate taxable income from the disposal of livestock to set off against the expenditure or where the livestock no longer exists.

Paragraph 11 – relates to domestic consumption, donation and *in specie* dividends.

11. If during any year of assessment livestock or produce-

(a) has been applied by the farmer for his private or domestic use or consumption;

(b) has, for purposes other than that of the production to the farmer of income from sources within the Republic, been removed by him from the Republic; or

(c) (i) has been donated by the farmer;

(ii) has been disposed of by the farmer, other than in the ordinary course of his farming operations, for a consideration less than the market value thereof;

(iii) where the farmer is a company, has on or after 21 June 1993 been distributed *in specie* (whether such distribution occurred by means of a dividend, including a liquidation dividend, a total or partial reduction of capital (including any share premium), a redemption of redeemable preference shares or an acquisition of shares in terms of section 85 of the Companies Act, 1973 (Act 61 of 1973)), to a shareholder of such company; or (iv) has been applied by the farmer for any other purpose other than the disposal thereof in the ordinary course of his farming operations and under circumstances other than those contemplated in subparagraph (a) or (b) or item (i), (ii) or (iii) of this subparagraph, there shall be included in the income of such farmer for that year of assessment-

(A) where such livestock or produce has been applied in a manner contemplated in subparagraph (a), an amount equal to the cost price to him of such livestock or produce, or where the cost price cannot be readily determined, the market value of such livestock or produce; or

(B) where such livestock or produce has been applied, disposed of or distributed in a manner contemplated in subparagraph (b) or (c), an amount equal to the market value of such livestock or produce:

Provided that where-

(a) any livestock or produce so applied, is used or consumed by the farmer in the ordinary course of his farming operations, the amount included in his income under this paragraph shall for the purposes of this Act be deemed to be expenditure incurred in respect of the acquisition by him of such livestock or produce; or

(b) the provisions of subparagraph (c) (ii) are applicable and an amount of consideration as contemplated in such subparagraph has been received by or accrued to the farmer,

the amount included in his income in terms of this paragraph shall be reduced by such consideration.¹⁷

Paragraph 11 of the First Schedule contains provisions similar to those in section 22(8) of the ITA. These provisions are aimed at non-trade disposals of livestock and produce. In the case of domestic consumption; if livestock or produce has been applied by a farmer for private or domestic use or consumption; he shall include the *cost price* of that livestock or produce in his income. If the farmer is unable to determine this cost price, he shall include the market value of such produce or livestock in his income. Where livestock or produce is removed from SA for purposes other than in the production of income, it shall be included in the farmers' income at *market value*¹⁸

Where the farmer has disposed of livestock or produce in the following 'non-trade' manner:

- donated the livestock or produce,
- disposed of the livestock or produce other than in the ordinary course of farming operations for a consideration less than market value,
- distributed the livestock or produce as an in specie dividend, or
- has applied livestock or produce in any other manner, other than the disposal thereof in the ordinary course of farming activities,

the *market value* (Emphasis added) of such livestock or produce shall be included in his income. Take note of sub paragraph B in the above extract; as the disposal of stock at market value, will be discussed in further detail in Chapter 5.

Paragraph 12 – Special provisions relating to capital development expenditure – the categories of expenditure listed are capital in nature. However, because of the

¹⁷ Ibid.

¹⁸ Haupt.

vagaries to which farmers are subject, and as incentive to improve the land, farmers may set these categories of expenditure off against taxable farming income *in full* in the year in which they are incurred.

12. (1) Subject to the provisions of subparagraphs (2) to (6), inclusive, there shall be allowed as deductions in the determination of the taxable income derived by any farmer the expenditure incurred by him during the year of assessment in respect of-

(a) the eradication of noxious plants;

(b) the prevention of soil erosion;

(c) dipping tanks;

(d) dams, irrigation schemes, boreholes and pumping plants;

(e) fences;

(f) the erection of, or extensions, additions or improvements (other than repairs) to, buildings used in connection with farming operations, other than those used for the domestic purposes of persons who are not employees of such farmer;

(g) the planting of trees, shrubs or perennial plants for the production of grapes or other fruit, nuts, tea, coffee, hops, sugar, vegetable oils or fibres, and the establishment of any area used for the planting of such trees, shrubs or plants;

(h) the building of roads and bridges used in connection with farming operations;

(i) the carrying of electric power from the main transmission lines to the farm apparatus or under an agreement concluded with the Electricity Supply Commission in terms of which the farmer has undertaken to bear a portion of the cost incurred by the said Commission in connection with the supply of electric power consumed by the farmer wholly or mainly for farming purposes;¹⁹

Paragraph 12(1) provides that capital expenditure is allowed as a deduction in determining the taxable income of a farmer, if the expenditure on the list is incurred during the year of assessment as stated above in the extract from the ITA. Where the deductions under paragraph 12(1)(c)-(i) exceed the farmer's taxable income from farming before these deductions, the excess must be added back to farming income and deducted in the following year of assessment (i.e.: carried forward in terms of paragraph 13(3)). The excess is known as unredeemed capital development expenditure.

¹⁹ "Income Tax Act No. 58 of 1962.."

(3) The amount by which the total expenditure incurred by any farmer during any year of assessment in respect of the matters referred to in items (c) to (j), inclusive, of subparagraph (1) exceeds the taxable income (as calculated before allowing the deduction of such expenditure and before the inclusion as hereinafter provided of the said amount in the farmer's income) derived by him from farming operations during that year of assessment shall be included in his income from such operations for that year and be carried forward and be deemed for the purposes of subparagraph (1) to be expenditure which has been incurred by him during the next succeeding year of assessment in respect of the matters referred to in the said items.²⁰

When determining these capital expenses for farming operations, it is imperative to link this to expenses specifically incurred for farming operational use. It follows that expenses incurred on a farm that are not specifically for farming operational use (for example the tennis court for the farmer's children) will not qualify as farming expenditure, and will therefore not qualify for a deduction in terms of this section. The Act explicitly states that domestic (living) farming expenditure is disallowed as a deduction from taxable income.

In terms of section 12 B(1)(f) of the ITA, farmers qualify for a farming machinery write off of 50% of the cost price in the first year of putting the equipment into use, 30% write off in the second year of use, and 20% write off in the third year of use. Over and above the reduced write-off period, another benefit is that this write-off period need not be apportioned for parts of a year. The write-off is determined on a straight line basis.

Paragraph 14 – disposal of a farming plantation

14. (1) Any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed *not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income.*

²⁰ Ibid.

(2) Where any plantation is disposed of by a farmer with the land on which it is growing the amount to be included in such farmer's gross income in terms of subparagraph (1) shall-

(a) if the amount representing the consideration payable in respect of the disposal of the plantation is agreed to between the parties to the transaction, be the amount so agreed to; or

(b) failing such agreement, be such portion of the consideration payable in respect of the disposal of the land and the plantation as in the opinion of the Commissioner represents the consideration payable for the plantation.²¹ (*Emphasis added*)

Paragraph 14(1) states that the proceeds of disposal of a plantation will constitute farming income and not proceeds of a capital nature. Importantly, this is discussed further in section 3.5 in the discussion of the Klüh case, where the disposal of a plantation farming operation is discussed, with reference to a case.

3.3 CASE LAW GUIDELINES AND EXAMPLES

Examples from case law that provide guidelines in determining whether a taxpayer is conducting farming operations:

- *Avenant v The Commissioner for the South African Revenue Service*²²: the court had to interpret section 26(1) of the ITA and certain paragraphs of the First Schedule to determine what constitutes produce to be included in closing stock at year end. The court held that the transformation of grapes into wine does not result in the income earned from the sale of wine being removed from the ambit of income derived from the taxpayer's agricultural/farming operation. The income earned from the sale of wine is therefore also taxable in terms of the First Schedule²³. From the case study at hand, the income earned by processing grapes still falls within the definition of farming income. A full

²¹ Ibid.

²² *Avenant v CSARS*, 367, (2016).

²³ L. Botha and H. Louw, "Trading Stock in Wine Farming Industry," https://www.saica.co.za/integritax/2016/2545._In_vino_veritas__an_important_case_for_the_wine_farming_industry.htm.

discussion on the treatment of trading stock for farming, and their subsequent processing, in light of this case, follows in section 3.6.

- *CIR v D & N Promotions (Pty) Ltd*²⁴: the taxpayer received interest on his account with the co-operative and contended that this formed part of 'farming income.' The court interpreted the First Schedule and found that the interest income wasn't directly linked to the farming activities, and was therefore excluded from farming income.²⁵ If one wishes to apply section 26 of the ITA, it is not sufficient for a farmer just to earn farming income, he must also be carrying on farming operations to be considered a farmer. It is therefore vital to assess the underlying activities performed by the farmer.
- *ITC 1135*²⁶: in this Rhodesian case, the taxpayer had ceased farming but continued to provide dipping and grazing facilities to farmers. The court found that, although he was providing services to farmers, this did not mean that the taxpayer was farming²⁷, and was therefore not allowed access to allowances available to farmers.
- *ITC 1548 (1991)*²⁸: the taxpayer was a farmer and conducted shearing and reaping operations for other farmers to earn additional income. The court found that the income derived from these activities did not constitute farming income. These activities were found not to be farming income, even though shearing and reaping are activities necessarily carried out by farmers. The reason for this was that the farmer conducted these additional activities for additional income which did not relate to his own farming practices.
- In *ITC 1319 (1980)*²⁹: This case reminded us that farming is a question of fact. Farming operations as contemplated in section 26(1) are a particular form of 'trade' within the broad definition of that term in section 1 of the ITA. 'Trade' in that sense embraces any activity or venture carried out with the object of

²⁴ *CIR v D & N Promotions (Pty) Ltd (1993, NPD)*, 55 SATC 89, (1993).

²⁵ *Ibid.*

²⁶ *ITC 1135 (31 SATC 228 at 231)*, 228 231 (1967).

²⁷ *Ibid.*

²⁸ *ITC 1548*, 55 (1991).

²⁹ *ITC 1319*, 42 (1980).

making a profit.³⁰ However, every activity in the nature of farming will not automatically constitute “farming operations”, as some underlying activities (such as earning interest, for example, or ‘hobby-farming’) will not be linked to farming. There must be an intention to farm, coupled with a reasonable prospect of profit.³¹ However, this second aspect of the judgment was overruled in the *Smith*³² case when the court stated that it is imperative to farm with the intention to make a profit. This is a subjective test, so the SCA rejected the “reasonable prospect” test, being objective in nature.³³

The SCA found the following in *Smith*:

“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’.³⁴

“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.”³⁵

It follows that it is possible for a taxpayer to be conducting farming activities in conjunction with some other activities, to derive at an end product. The farming activities conducted in the case study under discussion will not be overridden by the manufacturing activities, as the nature of the activities distinctively comprises that of

³⁰ *Burgess v Commissioner for Inland Revenue 1993 (4) SA 161 (A) at 181H-182I, 161 (1993).*

³¹ Haupt.

³² *Commissioner for South African Revenue Service v Smith (2002 (6) SA 621 (SCA)) 65 SATC 6, 621 (2002).*

³³ Ibid.

³⁴ *Commissioner For The South African Revenue Services v Smith, 563 (2002).*

³⁵ *Commissioner for South African Revenue Service v Smith(2002 (6) SA 621 (SCA))65 SATC 6.Smith*

farming. From the above it is apparent that the company is conducting *two distinct types of operations within one entity* in the case study under study.

Since farming has very attractive deduction incentives from a tax perspective, historically many taxpayers have misused these privileged allowances against taxable income from other trades. Typically, these were *part time* farmers whose main source of income was from professional or commercial sources. In these instances, farming was often practiced as a hobby while the taxpayer derived his income from another trade. Consequently, part time farming has been listed as a 'tainted trade' in section 20A of the ITA, which means that the losses made from farming, may not be set off against the taxable income from other trades. Section 20A is discussed briefly below.

3.4 SECTION 20A – SET OFF OF ASSESSED LOSSES FROM CERTAIN ACTIVITIES

In 2005, SARS introduced section 20A into the ITA. It was effective from 1 March 2004, meaning that taxpayers were subject to this section as from the 2005 year of assessment. Section 20A is a ring-fencing provision which limits the utilisation of an assessed loss from a 'tainted trade' to other income derived by a natural person (individual). This means that if an *individual* is conducting a 'tainted trade' in addition to earning other taxable income, he will not be able to set off the loss from that 'tainted trade', against the taxable income derived by earning a salary, or other profit making operations, conducted in his own name. One of the listed 'tainted trades' is part time farming.

In the case study under discussion, the taxpayer is a full time farmer, operating as a private company. It follows that section 20A does not apply and will not be discussed further.

3.4.1 Discussion of farming operations in conjunction to other trades

In the case study presented in section 2.2, if the taxpayer is conducting two trades in one entity. Because the taxpayer is a full time farmer, potential trading losses made within the farming operation may be set off against profits made by the manufacturing entity and vice versa.

The courts have been at pains to emphasise that the privileges accorded to certain classes of taxpayers, farming being a typical example, must be narrowly construed so as to ensure that only those persons for whom the privileges are intended are able to make use of them.³⁶

Activities performed by the farmer must comprise those of farming. Notably, when evaluating *CIR v D & N Promotions (Pty) Ltd*³⁷, the taxpayer earned interest on farming income. However, this interest was not earned by conducting farming activities, and therefore did not qualify to be included as taxable farming income.³⁸ One must always keep in mind that the income earned by a farming operation must be earned by conducting activities that comprise farming, to qualify for the classification of farming income. Here follows a discussion of the Klüh case, in which the disposal of a farming plantation did not qualify as farming proceeds, due to the underlying circumstances of the case.

3.5 WHAT QUALIFIES AS FARMING INCOME / PROCEEDS WITH REFERENCE TO PRIOR CASES

³⁶ *Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd* 20 SATC 355, 20 South African Tax Cases 355 (1955).

³⁷ *CIR v D & N Promotions (Pty) Ltd* (1993, NPD), 55 SATC 89.

³⁸ *Ibid.*

3.5.1 Background of the Klüh Investments Case

On 1 March 2016 the Supreme Court of Appeal in *CSARS v Klüh Investments (Pty) Ltd*³⁹, confirmed the decision of the Western Cape High Court that the taxpayer was not conducting farming operations. In doing so, it provided a good example of the correct approach to interpreting fiscal, and indeed, any legislation.⁴⁰

In this case, the SCA had to decide whether SARS's application of section 26(1) of the ITA and paragraph 14(1) of the First Schedule was correct and whether proceeds received from disposal within the context of these provisions was capital or revenue in nature. The taxpayer appealed the tax court's decision, which found in favour of SARS. The High Court overturned the tax Court's decision, prompting SARS to appeal to the SCA.⁴¹

Section 26(1) of ITA states that if a person carries on "pastoral, agricultural or other farming operations" the taxable income of that person shall be determined in accordance with the provisions of the Act, but subject to the provisions of the First Schedule. Paragraph 14(1) of the First Schedule states that:

"any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income".⁴²

³⁹ *CSARS v Klüh Investments (Pty) Ltd*, 115 (2016).

⁴⁰ P Surtees, "When are you conducting farming operations? SCA confirms the correct approach," <http://petersurtees.co.za/when-are-you-conducting-farming-operations-sca-confirms-the-correct-approach/>.

⁴¹ H. Louw, "The Klüh-ed up taxpayer wins – a decision on section 26 of the Income Tax Act," Cliffe Dekker Hofmeyr, <https://www.cliffedekkerhofmeyr.com/en/news/publications/2016/tax/tax-and-exchange-control-alert-8-april-the-kluh-ed-up-taxpayer-wins-a-decision-on-section-26-of-the-income-tax-act.html>.

⁴² "Income Tax Act No. 58 of 1962.."



Figure 2.1: Photograph showing the plantation owned by Kluh:

Based on the provision in paragraph 14 of the First Schedule, SARS wanted to tax Kluh on the proceeds of the sale of the plantation, and to include this amount in Kluh's gross income. (Emphasis added)

3.5.2 Factual background relating to Kluh Investments Case

During May 2001, Steinhoff agreed to purchase the forestry, timber-growing and plywood manufacturing business of Thesen as a going concern, including the land and plantation. However, Steinhoff's ultimate holding company blocked the acquisition of the land and plantation as it was, at the time, not their policy to acquire fixed property in SA. Steinhoff then agreed to purchase only Thesen's machinery and equipment including the sawmill and all the operational assets of the business. The taxpayer - a special purpose vehicle of a Swiss company - agreed to acquire the remaining assets, which included the land *and plantation* (emphasis added), and thereafter took possession/ownership thereof.⁴³

However, in 2004, Steinhoff made a company decision to purchase the taxpayer's plantation business (which also included the land). Approximately 90% of the purchase price was in respect of the plantation and the seller realised a significant capital gain

⁴³ Ibid.

of about R45 million. SARS treated this amount as gross income, in terms of section 26(1) of the ITA, read with paragraph 14(1) of the First Schedule.⁴⁴

3.5.3 Outcomes of Kluh Investments Ruling

As there is no definition of 'farming operations' in the Act, determining whether a person's economic activity constitutes farming operations is essentially a question of fact. The SCA found that the approach adopted by the High Court in this regard was confusing, in that the facts should be taken as they stand and should be applied to the provisions of the statute. The relevant findings in this regard are as follows:⁴⁵

- “Steinhoff owned the equipment necessary for conducting the farming operations and employed the employees who worked on the plantation, whereas the taxpayer owned no equipment and had no employees and therefore did not receive any operational income between the acquisition and disposal of the plantation.⁴⁶ Therefore, Steinhoff was regarded as the farmer in this instance, who was engaging in farming operations, and was therefore entitled to the fruits thereof. In contrast to this, was Kluh, although owning the land, was not entitled to the fruits thereof., Kluh (in its capacity of land owner) had not been engaged in farming operations.”⁴⁷
- In terms of the oral agreement concluded between Steinhoff and the Kluh in 2001, Steinhoff had to conduct the plantation operations so that it could in future restore the plantation to its June 2001 (original condition) state, if the arrangement between it and the taxpayer came to an end. In light of this obligation, Kluh obtained insurance for the plantation against fire.⁴⁸ Therefore, Kluh was insured for a 'fixed type' of asset. No mention was made of farming income. The land was merely an asset that Kluh rented out in order to earn rental income. This might be similar to a property developer renting

⁴⁴ Ibid.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ Ibid.

out a premises, in which the owner of the property is not engaged in the operations of the tenant, and subsequently cannot be charged on incomes earned by the tenant.

- From the initial acquisition of the plantation, the taxpayer (Kluh) did not want anything to do with any farming operations and the whole “*raison d’etre*” of the taxpayer’s involvement was to acquire bare ownership of the land and plantation, which Steinhoff was prevented from doing as per the group policy at the time.⁴⁹

The SCA then considered the arguments raised by SARS. Firstly, SARS argued that the purpose of paragraph 14(1) of the First Schedule is to extend tax liability by treating the proceeds of the disposal of a plantation as gross income. The SCA stated that the word ‘farmer’ in paragraph 14(1) “is clearly a short-hand for a person carrying on farming operations as contemplated in section 26(1)”. This means that the carrying on of farming operations in terms of section 26(1) is necessary for the First Schedule and the deeming provision in paragraph 14(1) to apply. The word ‘farmer’ in paragraph 14(1), a deeming provision, could not be used, as suggested by SARS, to determine whether the taxpayer was a ‘farmer’ or conducting farming operations in terms of section 26(1). (SARS stated that Kluh was the farmer who was engaged in farming operations, based on this, they wanted to include the proceeds from the sale of the plantation in Kluh’s gross taxable income). Therefore, the SCA rejected SARS’s argument.⁵⁰

Secondly, SARS argued that the mere disposal of the plantation by the taxpayer, as owner of the land, constituted the conduct of operations in terms of section 26(1) (farming), despite it not being involved in the operations on the land. The SCA found that this argument could be misleading because paragraph 14(1) recognises that the disposal of a plantation is not a *per se* farming operation. This is evident from

⁴⁹ Ibid.

⁵⁰ Ibid.

paragraph 14(1), which contemplates that the proceeds of the disposal of a plantation are ordinarily capital in nature even where the taxpayer is a farmer and for this reason then deems it to form part of gross income. SARS conceded that its argument would only hold water if the word 'farmer' were substituted with the word 'taxpayer' in paragraph 14(1), which the court could not do. This argument was thus also rejected.⁵¹ Kluh was found to be merely the landlord, not the farmer.

From the evidence available, it was shown that Kluh never wanted anything to do with any farming operations. It had "neither the appetite for the risks associated with farming nor the requisite skills, equipment and personnel to undertake farming operations". The sole reason for its existence was to acquire bare ownership of the land and plantation. The parties had agreed from the start that Steinhoff had the right to conduct the farming operations and had on termination of the agreement to return the plantation to Kluh in the state in which it had been at inception of the agreement.⁵²

Finally, SARS argued that the farming operations were conducted by Steinhoff on behalf of the taxpayer. The SCA held that even if Steinhoff in some sense acted on behalf of the taxpayer, the taxpayer did not have the right to the yield of the plantation, and the use of the land and the plantation, nor did it derive any income from the land and the plantation. These rights were granted to Steinhoff, which it exercised and which received income from it. Only Steinhoff could thus be regarded as a 'farmer' in relation to the taxpayer's plantation. The only risk that the taxpayer faced was that the value of its investment in the land might suffer, similar to the risks faced by a landlord

⁵¹ Ibid.

⁵² Surtees.

or bare *dominium owner* if the tenant or usufructuary breached its obligations. The SCA thus also rejected SARS's argument on this point.⁵³

Thus, it is evident that the taxpayer (Kluh) did not derive income from farming operations. It derived income from the leasing of land, which does not comprise that of farming income. From this case, we can thus conclude that Steinhoff may be designated to be the taxpayer, engaged in farming operations, and not Kluh.

3.5.4 Conclusion and comments

The SCA rejected SARS's appeal and dismissed it with costs, including the costs of two counsel. The decision highlights the fact that in interpreting and applying tax legislation, the courts will look at all the facts before it and will not be misled by SARS's arguments, especially when they are aimed at unjustifiably increasing the revenue collected by SARS. If SARS thus wishes to increase the tax net and its tax revenue, it needs to amend the existing legislation, at the risk of increasing taxpayers' already heavy tax burden⁵⁴.

As the SCA found, SARS in its argument put the cart before the horse. Firstly, that the purpose of paragraph 14(1) was to extend tax liability by treating the proceeds of disposal of a plantation as gross income. Secondly, that the mere sale of a plantation constitutes farming operations, irrespective of the extent of the actual conduct of the taxpayer in the farming operations. Third, that Steinhoff had conducted the farming operations *on behalf of Kluh* ⁵⁵.

⁵³ Louw.

⁵⁴ Ibid.

⁵⁵ Surtees.

The court found that before one could consider whether the First Schedule applied, the taxpayer had to be carrying on farming operations as contemplated in section 26(1). Only then was one permitted to consider the First Schedule. In response to the first of SARS' three submissions, the court noted that paragraph 14 is a deeming provision. It is axiomatic that when something is deemed to be something else it is in fact not that something else. It followed that, in the absence of paragraph 14, a plantation would be a capital asset, and only if a *farmer* disposed of it would the proceeds be deemed to be gross income in the hands of the taxpayer. Second, SARS' argument was misleading in its assertion that the ITA recognises the disposal of a plantation as the carrying on of farming operations. The first hurdle was section 26(1) before any aspect of the First Schedule could apply. As to the third submission of SARS, according to the facts Klüh did not have the right to the yield of the plantation; it did not have the use of the land and the plantation, and it derived no income from them. These it had granted to Steinhoff.⁵⁶ A reminder that the one who engages in farming activities for a profit is entitled to the fruits of the land, and should consequently be liable for tax on those profits. In the result, the appeal failed and was dismissed with costs.⁵⁷

This judgment provides a useful lesson in the correct approach to the interpretation of legislation, in this case the Income Tax Act. The word 'farmer' in paragraph 14(1) means that SARS has to show that the taxpayer has met the requirements of section 26(1) before the First Schedule applies. It is not the case that, if a taxpayer carries

⁵⁶ Ibid.

⁵⁷ Ibid.

out an activity contemplated in the First Schedule, it automatically means that section 26(1) applies to the taxpayer.⁵⁸

From the above case, it is evident that a taxpayer will be deemed to be carrying on farming operations based on the underlying (farming) activities he performs, not merely because he owns land on which farming activities are conducted. There is not a set criterion in determining this, and it will be based on a question of fact relating to the particular case study. One therefore needs to look at the substance of the particular case study to determine whether farming operations are conducted or not.

The eventual message of the Klüh case is therefore that it gives us a useful technical precedent, mostly for small-scale owners of timber lots or farming operations on the application of section 26 and its independence from the First Schedule in the determination of whether farming operations are carried on⁵⁹.

The entity in which the farming operations take place is the entity that will *ultimately qualify* for the farming privileges of the ITA, in a group or owner / lessee case study, regardless of with whom rests the actual ownership of the land.

Therefore one should always first determine whether the taxpayer is 'carrying on' farming operations (subjective test based on surrounding circumstances). Ownership of land is not the key element in determining whether a taxpayer is conducting farming activities, rather his intention for which he performs those 'profit' activities is the key.

⁵⁸ Ibid.

⁵⁹ D. Clegg, "Do SARS and the Courts Have a Klüh?," Tax Talk, <http://www.thesait.org.za/news/337364/>.

If the taxable income is derived from the farming operations, there will be a direct causal connection (this is a requirement) to farming activities. Therefore, it is imperative that the requirements of section 26(1) of the ITA are satisfied.

In the present situation it is necessary to consider other farming activities and which of these can be included and which excluded. Examples would be: 'battery' eggs from chickens, buying feed from outside for cattle, feeding livestock from the waste of a protein factory, and using eggs in the bakery. If income is derived from land and farming operations, it is easier to show that it will form part of income of *farming operations* of the entity.

3.6 TRADING STOCK IN FARMING

3.6.1 Introduction

'Livestock' refers to the animals a farmer farms with. 'Produce' is what the farmer grows or what is produced by the livestock, such as milk, wool and grain.⁶⁰

A farmer, for income tax purposes, need only account for the livestock and produce held in terms of the First Schedule. Only certain provisions of section 22 of the ITA are applicable to farmers. Farmers are explicitly excluded from the section 22(1) closing stock provision, and the section 22(2) opening stock provision. In addition to this, consumable stores (typically seed, fertiliser, fuel, feed) are not brought into account in the closing stock of the farmer's tax calculation. These items are expensed in the year in which they are purchased and are not considered to form part of the stock held at year end.

⁶⁰ Haupt.



Figure 3.2 and 3.3: Photographs showing farming livestock goats and cows:

3.6.2 Definition in terms of the ITA

In terms of section 1 of the ITA, trading stock is defined as follows:

“Trading stock” includes anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer.’ – and held by the taxpayer at year end.⁶¹

Although section 22 of the ITA excludes from its ambit taxable income derived by a taxpayer from the activity of farming, section 26 provides that the taxable income of any person carrying on ‘pastoral, agricultural or other farming operations’ shall be determined in accordance with the Act, but ‘subject to the provisions of the First Schedule’. Paragraphs 2, 3(1), 4(1) and 9 of the First Schedule, which have as their object the valuation of ‘livestock and produce held and not disposed of’ by a taxpayer at the end of the year, accordingly form part of the ITA. It would be anomalous if the meaning attributed to ‘trading stock held and not disposed of’ in terms of section 22 of the Act differed from the meaning to be attributed to ‘livestock and produce held and not disposed of’ in terms of paragraphs 2, 3(1), 4(1) and 9 of the First Schedule.⁶²

⁶¹ "Income Tax Act No. 58 of 1962.."

⁶² *Durban City Council v Shell and B.P. Southern Africa Petroleum Refineries (Pty.) Ltd.* 1971 (4) SA 446 (A) at 457A-B.

3.6.3 Trading stock treatment in case law

'Livestock' and 'produce' are not terms defined in the act. In *Farmer v COT*⁶³, the court held that farmers must include all livestock used for farming purposes in their closing stock.⁶⁴ The focus should not be on: *What is livestock?* But rather, whether the livestock is used by the farmer in his farming operations. It follows that animals used by the farmer in farming operations are to be included in the closing stock. The crux is thus the manner in which these animals are being used. For example, a dog which is merely a family pet is not livestock. However, a sheepdog used for the safety and herding of sheep will be classified as livestock.⁶⁵

Another point to note is that livestock does not necessarily need to be held for sale (which will ordinarily be the case with stock). Cows held by a farmer who owns a dairy herd to produce milk will be classified as 'livestock.' It does not mean that this stock is necessarily available for sale.

In the case of *Richards Bay Iron & Titanium (Pty) Ltd and Another v CIR*⁶⁶, the following quote was noted:

'...a dairy farmer's milking herd, although 'livestock', would not be trading stock as ordinarily understood.'⁶⁷

Livestock is therefore a special form of trading stock, with special privileges attached to it. Although it is included in the value of trading stock at year end, it is not necessarily available for sale, and cannot be regarded in the same way as ordinary trading stock.

⁶³ *Farmer v COT*, (1944).

⁶⁴ *Ibid.*

⁶⁵ *Haupt.*

⁶⁶ *Richards Bay Iron & Titanium (Pty) Ltd and Another v CIR*, 58 311 (1996).

⁶⁷ *Ibid.*

The courts have held that the term produce does not include farming products which have not been harvested. For example, standing crops and wool (on the sheep) are not included in closing stock at the end of the year. If, however, the crops have been harvested or the sheep have been sheared before the year end and the produce is still on hand at the end of the year, it will be included in the balance of closing stock as produce.⁶⁸

3.6.4 Avenant Case Summary

3.6.4.1 Background

As stated above, there is often some confusion as to what constitutes trading stock (in particular livestock and produce) in a farming operation. In this case, the SCA clarified the meaning of farming 'produce' that is 'held and not disposed of' at the end of the tax year. The appellant was a grape farmer, who delivered his produce to a farming co-operative (of which he was also a member). The bulk of the income derived from his farming operations was received from the co-operative for the grapes which he delivered. Once these grapes had been delivered, they were pressed into pulp, and mixed with the pulp from other grapes delivered by other farmers who were also members of this co-operative. This pulp would then be produced (manufactured) into wine by the co-operative, after which it would be bottled and packaged. The co-operative would market and sell the wine. Once the wine had been sold, each farmer who contributed grapes to the pool would receive a pro-rata share of the net proceeds from the sale of wine from the co-operative. Due to the seasonality of producing grapes, it would often happen that the proceeds from the produce delivered to the co-operative would only be received in a subsequent year of assessment.

⁶⁸ .Ibid

The issue in the above-mentioned case was that the farmer did not include (add back) the value of the produce (grapes delivered to the co-operative) in his closing stock. This resulted in a rather large deduction for costs incurred in relation to trading stock during the year of assessment. However, there was no 'setting-off' of the value of that closing stock (as he no longer accounted for the produce in the balance of closing stock). Important to note is that no income had been earned on this produce at this time, since the co-operative had not yet completed making the wine, and selling thereof at year end.

In 2014, the Western Cape tax court held that the value of the produce should be included in closing stock at year end. As the appellant felt very strongly that this decision had been wrong, the case was appealed in the Supreme Court of Appeal.

3.6.4.2 The tax treatment of trading stock

Section 26(1) of ITA reads:

‘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.’

That provision must be read with paragraph 2 and 3(1) of the First Schedule of ITA, which provide respectively 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 the end of each year of assessment.’⁶⁹

⁶⁹ "Income Tax Act No. 58 of 1962.."

And 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.⁷⁰

As stated in Chapter 1 (section 1.3.1), paragraph 9 of the First Schedule provides that:

‘The *value* to be placed upon *produce* included in any return shall be such fair and reasonable value as the Commissioner may fix.⁷¹

Therefore, one would need to determine a fair value to be placed on that produce, so that one could include that in the balance of closing stock. It would be incorrect treatment to deem that value as zero.

3.6.4.3 The application of the Act to the facts of the Avenant case by the SCA

The income derived from the transformation of grapes into wine, and its subsequent sale, is classified as income derived from farming operations. It follows that the making of wine forms part of the farming operations. The fact that the grapes had been delivered to the co-operative and mixed with the pulp of other grape farmers did not mean that the farming produce had been disposed of. Therefore the appellant owned a portion of the mixed, pulped grapes (produce).

The court rejected the farmer’s argument that the pulp ceased to be produce in the hands of the farmer once it had been mixed into pulp. The farmer argued that the pulp

⁷⁰ Ibid.

⁷¹ Ibid.

became the work-in-progress in a process of manufacture of wine carried on by the co-operative, and not the appellant himself.

The appellant relied on the decision that was taken in *R v Giesken and Giesken*⁷², in relation to dairy farming where the following, was stated:

- ‘The exemption does not exclude farmers or their employees, but farming operations. If *Bryant’s* case is correctly decided, it would be part of such operations if the milk sold and distributed were milk produced by the appellant’s own farming operations. . . Once they are engaged in respect of milk which is not the product of the appellant’s farming operations, whether it be mixed with such product or not, the exemption no longer applies. The sale or distribution of milk obtained from other sources by purchase is not a farming operation, even if milk produced by the seller is added. The position is that, though they are engaged in farming operations, the sale and distribution of the milk is not a farming operation, and this is the case whether what is being delivered consists of 70 per cent of milk purchased and 30 per cent of milk produced by their farming operations, or *vice versa*.’⁷³

The appellant submitted that whilst it may be accepted that it is a part of dairy farming to pasteurise, sell and distribute a dairy farmer’s milk, the moment the farmer’s milk is mixed with milk from other sources, ie: other farmers, what is done thereafter ceases to be part of a ‘farming operation’. On parity of reasoning, once the pulp resulting from the appellant’s grapes was mixed with the pulp from other farmer’s grapes, no part of the resultant mixture was ‘produce’⁷⁴.

⁷² *R vs. Giesken and Giesken* 1947, 4 (1947).

⁷³ *Ibid*.

⁷⁴ *Avenant v CSARS*, 367.

The SCA did not agree with this argument, as it found that this particular exemption arose from regulations that were applicable to the dairy trade. Processing of milk to manufacture dairy goods will be discussed in the next chapter.

The SCA also rejected the appellant's second argument that the process of making wine was part of a process of manufacture, since it involved a 'substantial or essential change in the character of the materials'⁷⁵ out of which the finished good was made. In so deciding, the court was relying on *Safranmark*⁷⁶.

The respondent correctly submitted that the concept of 'wine in process' falls comfortably within the concept of the 'produce' of a wine grape farmer as envisaged by the First Schedule. The fact that the grapes have been pressed into a pulp and the process of fermentation begun, does not mean that the appellant's produce has disappeared. It is still there albeit in a different form.⁷⁷ Based on the facts of this case, it was held that the process of transforming grape pulp into wine formed part of farming operations; as it was necessary in order to market and sell the farmers' produce. The SCA therefore rejected the appellant's argument and held that in terms of paragraphs 20 and 22 of the ITA⁷⁸ wine remains grape juice in a fermented form. The fermented and pulped grapes were not in essence different to the produce delivered by the harvest. This grape 'juice' had not undergone a 'change in nature', and was still considered to form part of farming produce.

The appellant finally tried to hold that because the pulp was no longer in his possession, and that he merely held 'fractional ownership' in the combined pulp, he

⁷⁵ *Secretary for Inland Revenue v Safranmark (Pty) Ltd*, 43 South African Tax Cases 235 (1982).

⁷⁶ *Ibid.*

⁷⁷ *Avenant v CSARS*, 367.

⁷⁸ "Income Tax Act No. 58 of 1962.."

had disposed of the produce. The SCA held that when the mixing of the pulp took place, there was no intention to transfer ownership. The pulp was merely held by the co-op for the benefit of the appellant.

The decision of this case will clarify the application of trading stock principles to many different sectors of farming in which a farmer delivers produce to a farming co-operative, after which it is processed and sold, regardless of whether the produce is mixed with the produce from other farmers; prior to the sale by the co-op.

Judge Swain JA relied expressly on the following (paragraph 27):

‘That ownership was retained by the appellant means that the pulp could never have been held by the co-op for the purpose of sale by itself. The pulp had to have been held by the co-op for the appellant.’⁷⁹

It is vital that the farmer’s produce does not change its identity or nature into something qualitatively different in a process of manufacture. This farming produce will remain ‘produce’ and will be seen to be held and not disposed of in the hands of the farmer, until that ownership has passed into the hands of another party. In this case, ownership will only be transferred once the nature of the farmer’s produce has changed (in terms of a process of manufacture). Based on the facts of this particular case, the court found that the nature of the produce had not changed, and therefore remained to form a part of the stock held by the farmer at year end.

The crux of the principles found in this case is that the farmer retains ownership of the produce he delivers to the co-operative, or some form of plant that processes the produce into the desired product. It matters not if the farmer has parted with possession of sole ownership, or whether he shares ownership with some other

⁷⁹ *Avenant v CSARS*, 367.

farmers. Nor was there ever any question as to the basis on which ownership was purported to have been retained.⁸⁰

No support was found in the case to support the fact that ownership of the grapes had transferred to the co-op, (as what had been stated in the facts of the case). The ITA defines a 'co-operative', as a 'company' for purposes of the Act, and is therefore deemed to be a separate legal entity under common law principles. This would lead us to the next point, in that a co-op is seen as a separate legal persona from its members. In terms of tax principles, it would also be taxed as a separate entity.⁸¹ Avenant failed to highlight this point, and this point was therefore never considered when the court made the final decision that the ownership was retained with Avenant at year end.

In the *Avenant* case it was held that grape pulp produce retained its nature when it was made into wine. Based on the case study under discussion, it raises the question of whether milk from cows and goats remains produce if it is made into cheese or some other dairy product.

3.7 CONCLUSION

From topics covered in this chapter about farming, it is apparent that there are favourable tax provisions available to taxpayers who conduct farming operations. As seen from the above discussions, it is clear that there are many examples in which it is not always clear whether the taxpayer is conducting farming activities or not. In conclusion to the chapter, one is reminded that the crux of the principle is to determine

⁸⁰ RC. Williams et al., "SCA clarifies the meaning of farming "produce" that is "held and not disposed of" at the end of the tax year," PWC, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-june-2016.pdf>.

⁸¹ Ibid.

whether the taxpayer qualifies to use provisions from the First Schedule. To determine this, one needs to look at the underlying activities performed by the taxpayer.



Figure 3.4 and 3.5: Photographs showing the milking of cows and goats:

In the next chapter the principles on which a process of manufacture is based will be discussed, together with the context of the case study.

CHAPTER FOUR

PROCESS OF MANUFACTURE

4.1 INTRODUCTION

I have found that investors are often pleasantly surprised to hear about the generous tax allowances available to South African taxpayers who are involved in the business of manufacturing or a process similar to manufacture. Taxpayers who are conducting manufacturing processes can claim allowances from taxable income in terms of section 12C⁸² (40% in the year in which asset is brought into use, and 20% in the following 3 years for new or unused machinery, and 20% per year for used machinery) in respect of certain qualifying capital equipment used in a process of manufacture⁸³. There is also a 10% building allowance, which may be claimed annually for a period of 10 years in respect of buildings or improvements used in a process of manufacture in terms of section 13.

It is not always straight forward whether an expense incurred by a manufacturer is of an income or a capital nature. The primary test is to determine whether the expense can be classified as part of the manufacturer's income-earning operations (in which case, it will be revenue in nature) or whether it will enhance the manufacturer's income earning structure or capacity (in which case, it will be capital in nature).⁸⁴

⁸² "Income Tax Act No. 58 of 1962.."

⁸³ "Income Tax Act No. 58 of 1962.."

⁸⁴ Haupt.

4.2 CASE LAW IN RELATION A 'PROCESS OF MANUFACTURE' - GUIDELINES AND EXAMPLES

In *the New State Areas Ltd v Commissioner for Inland Revenue* [1946]⁸⁵, it was held that sewers constructed on a taxpayer's property formed part of the taxpayer's income-producing structure (capital in nature), but that sewers constructed beyond the perimeter of the taxpayer's land did not form part of its income-producing structure and therefore the charges imposed by the local municipality for their use represented expenditure of a revenue nature.⁸⁶ Therefore, manufacturers should always first determine whether an expense which may appear to be capital in nature could potentially be claimed as a revenue expense, as this will result in the most beneficial tax deduction. This was the argument in the *Palabora Mining Co Ltd v SIR* [1973]⁸⁷, where the taxpayer constructed a dam for the Phalabora Water Board to secure a water supply for the start-up of its plant. The court held that the taxpayer's loss in respect of the construction of the dam was of a revenue nature as the sole reason the expense was incurred; was to accelerate the earning potential of the taxpayer's profits. The primary dependence on the dam was closely linked to the taxpayer's income-earning profits.⁸⁸

Based on case law, a *process of manufacture* must produce an article that is *essentially different* from the article as it existed before under-going the process.⁸⁹ A process of manufacture, or a process similar to manufacture, is further clarified in

⁸⁵ *New State Areas Ltd v Commissioner for Inland Revenue*, 14 (1946).

⁸⁶ *Ibid.*

⁸⁷ *Palabora Mining Co Ltd v SIR*, 35 (1973).

⁸⁸ "Deductions 2188. Manufacturers. *Palabora Mining Co Ltd v SIR* [1973] 35 SATC 158," Integritax, https://www.saica.co.za/integritax/2013/2188._Manufacturers.htm.

⁸⁹ *Secretary for Inland Revenue v Safranmark (Pty) Ltd.*

Practice Note 42 issued by the South African Revenue Service (“SARS”) by way of 127 examples provided. A discussion of this practice note follows on later in section 4.5.

4.3 DETERMINING WHETHER IT IS A PROCESS OF MANUFACTURE

Before claiming the allowances granted to manufacturers, it is necessary to determine whether the process conducted by the taxpayer is that of manufacturing. There is no formal definition of manufacturing or something similar to manufacturing in the ITA. Whether or not an activity constitutes a process of manufacture is a question of fact. Here too, courts have had to provide guidance in their judgments. The ITA does not define what constitutes a process of manufacture or where it starts and ends. Various court cases have laid down some guidelines, to which reference will be made: The principal test of a process of manufacture is found in the case *SIR v Hersamer*⁹⁰ in which it was held that:

- the process must be a *complete process*,⁹¹ and
- there must be an essential change from input to the end product. To expand on this, the product, after undergoing the process of manufacture, must be essentially different from what it was before the process commenced.⁹²

Another, more recent example of this is *SIR v Safranmark (Pty) Ltd* where the court, in deciding that a KFC outlet was conducting a *process of manufacture*, set out the criteria for a process of manufacture or a similar process⁹³. Manufacturing activities have the following nature:

⁹⁰ *Secretary for Inland Revenue v Hersamer(Pty) Ltd.*, 177 (1967).

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ *Secretary for Inland Revenue v Safranmark (Pty) Ltd.*

- Plant and machinery used in the production of the stock is *specialized*⁹⁴
- The *method* of using the plant and machinery is specialized⁹⁵
- *Human effort and labour* are used in the process⁹⁶
- The *volume* of production is based on *anticipated demand* of the product⁹⁷
- The volume of production is on a *large* scale, in an *organised* manner⁹⁸
- The *end product* is different from the materials from which it was produced, not only in nature, but also in *utility*. The value of the raw materials have ceased to exist, and the end product has a different nature. (ie: the ingredients have ceased to retain its individual qualities, but because of the process of manufacture, have acquired a new, special quality/nature.)⁹⁹

If one takes the volume of operations and the large scale at which the stock was produced in the protein company, we are certain of the fact that the process of manufacturing cheese constitutes a process of manufacture.

The last point made in the activities comprising a manufacturing operation is the most vital as it emphasises the change which the product undergoes. Many businesses conduct operations (eg: mining land, buying and selling goods) where there is not a change in the nature of the product during the time that the taxpayer handles the product. Manufacturing is distinctly different from this, as stated in the *Safranmark* Case by the Appellate division, the Special Court stated:

‘the end product was essentially different from its main component.’¹⁰⁰

⁹⁴ Ibid.

⁹⁵ Ibid.

⁹⁶ Ibid.

⁹⁷ Ibid.

⁹⁸ Ibid.

⁹⁹ Ibid.

¹⁰⁰ Ibid.

This draws emphasis to the fact that the product must undergo a *change in nature*, for it to be considered to constitute a process of manufacture. More detail from case law as to this change in the composition / qualities that the (end) product undergoes is presented below.

‘As stated in *Secretary for Inland Revenue v Hersamer (Pty) Ltd* 1967¹⁰¹ the question whether on the proved facts a taxpayer’s operations amounted to a ‘process of manufacture’ is a question of law.¹⁰²

Our courts, in deciding the question of law, as to which see the *Hersamer* case at the place cited above, have emphasised that there must have been a ‘substantial or essential change of the character of the materials’ out of which the ‘manufactured’ article was made.

“the essence of making or manufacturing is that what is made shall be a different thing from that out of which it is made.”¹⁰³

In upholding respondent’s appeal, the learned President of the special court (Grosskopf J) expressed himself *inter alia* as follows:

‘In the present case it seems relevant to me that a standardised product is produced on a large scale by a continuous process utilising human effort and specialised equipment in an organised manner. When to that is added the factor that the end product is, in terms of its nature, utility and value, essentially different from its main component, the process must, it seems to me, be described as one of manufacture.¹⁰⁴

¹⁰¹ *Secretary for Inland Revenue v Hersamer(Pty) Ltd*.

¹⁰² Ibid.

¹⁰³ Ibid.

¹⁰⁴ *Secretary for Inland Revenue v Safranmark (Pty) Ltd*.

As to the merits (Corbett JA dissentiente)

‘That the end product is different from the materials from which it is produced not only in nature but also in utility and value in that the ingredients of the egg-and-milk mixture and of the breading mix have ceased to exist and the inedible raw chicken has become an edible product;’¹⁰⁵

Judge Corbett clearly takes a step back to see the ‘bigger picture’ in this last phrase, by emphasising the fact that the standardised product must have undergone a change in nature. He reminds us that it is important to see the process as a whole (what was the raw product, and what was the output to create the finalised good) to determine if the process undergone comprises that of manufacture.

‘Because the words ‘process’ and ‘manufacture’ do not have any precise meaning, the phrase ‘process of manufacture’ ‘is one to which it may be very difficult to assign a meaning expressed in terms which would properly distinguish between all cases which fall within the scope of the phrase and those which should fall outside its scope.’¹⁰⁶

In any case, one of the hallmarks of a ‘process of manufacture’, in contrast to:

‘frying some chicken’, is that the product will be of *uniform standard* and will be subject to *quality control*.¹⁰⁷

If we elaborate on this point, we come to the conclusion that it is paramount that the end-goods produced during a process of manufacture are of a *consistent quality and standard, and are not of an artisanal nature*. Therefore when we are manufacturing goods on a large scale, we can conclude that the end product will be of a uniform nature. This is in contrast to farming, where output is not always consistent from batch

¹⁰⁵Ibid.

¹⁰⁶ Ibid.

¹⁰⁷ Ibid.

to batch, or year to year, depending on the underlying environmental factors eg: droughts, floods, change in climate can all have an impact on the ultimate produce produced.

In the *Safranmark* case, the following points were raised relating to the process that the goods undergoes:

- (1) The term ‘process of manufacture’, in the present context, denotes an action or series of actions directed to the production of an object or thing which is essentially different from the materials or components which went into its making.¹⁰⁸
- (2) The requirement of ‘*essentially difference*’ necessarily imports an element of degree; and there are no fixed criteria – nor is there any precise universal test – whereby it can be determined whether or not a change in the material or components wrought by the process, be it as to the nature, form, shape or utility of the materials or components, has brought about an essential difference. This must be decided on the individual facts of each case ¹⁰⁹.

Once milk is pasteurised, it is presumed, and has been accepted by our courts¹¹⁰ that it has undergone a chemical change in composition that will add to the fact that the end product is essentially different to the raw materials. This adds to the evidence that the process of making cheese definitely comprises that of manufacturing. During pasteurisation the milk undergoes a change in chemical composition of the raw material.

4.4 WHAT IS A LARGE SCALE? IT IS ALL A MATTER OF DEGREE

One often wonders what can be considered ‘large’; in the context of a business. What one taxpayer considers large, is not necessarily large for a multinational company. In

¹⁰⁸ Ibid.

¹⁰⁹ Ibid.

¹¹⁰ *National Co-Operative Dairies Limited v Commissioner for Inland Revenue*, 54 (1991).

the context of this writing, *large scale* will be deemed to be a continuous processing of uniform goods.

‘In the present case it seems relevant to me that a standardised product is produced on a *large scale* by a *continuous process* utilising human effort and specialised equipment in an organised manner. When to that is added the factor that the end product is, in terms of its nature, utility and value, essentially different from its main component, the process must, it seems to me, be described as one of manufacture.¹¹¹

It was therefore upheld in the *Safranmark* case that the goods produced by KFC were part of a process of manufacture, given that the end product was produced on a large scale. The capital assets used to produce these standardised products were the company’s’ own assets that qualified for the process of manufacture wear and tear allowances. Based on this, the capital allowances claimed against capital expenditure was correct. It raises the question of scale of production. If one starts to produce on a mass basis, then it may more easily be deemed to become a manufacturing activity. Production is no longer artisanal and is manufactured in bulk quantities.

Following the era of the industrial revolution, there are countless industries that have since started producing a range of goods in a manufacturing environment. As demand for these goods increased, pressures also arose to keep the production costs at a minimum which ultimately lead to the expansion of the manufacturing environment.

4.5 SARS PRACTICE

Based on the current case study discussed, there are quite a few grey areas where it is not easy to determine whether something is purely manufacture or not; because of

¹¹¹ *Secretary for Inland Revenue v Safranmark (Pty) Ltd.*

this, SARS has published a list of business activities they deem to comprise that of a manufacturing concern. A process of manufacture, or a process similar to manufacture, is further clarified in Practice Note 42 issued by the South African Revenue Service ("SARS") by way of examples / extracts provided.

Annexure "B"

PROCESSES OF MANUFACTURE:

12. The following processes carried on by the dairy industry:

12.1 The pasteurisation of milk and by-products.

12.2 The sterilization of milk and by-products.

12.3 The manufacture of by-products such as yoghurt, maas and cream.

12.4 The manufacture of ice-cream and frozen foods.

12.5 The manufacture of butter and cheese.

12.6 The processing of fruit juices.¹¹²

Based on the above extract from Practice note 42, it can clearly be seen that once milk is pasteurised, and by-products such as cheese are manufactured therefrom, it clearly falls within the list of manufacturing activities for tax purposes as per SARS. Further to this, it can be concluded that once the milk has been 'harvested' from the animals, and is pasteurised (this is the start of the process of manufacture) for the making of cheese, this is when the process of manufacture begins, and consequently, will mark an end to the farming operations.

Annexure "A"

PROCESSES SIMILAR TO A PROCESS OF MANUFACTURE

59. Bulk processing of meat.¹¹³

Given the above from the SARS practice note, once the protein company starts processing the meat from the animals on a bulk level, the butchery will also be deemed to be a process of manufacture. There are many businesses that start out on a

¹¹² "Income Tax: Process of Manufacture, Processes similar to a Process of Manufacture and Processes not regarded as Processes of Manufacture or Processes similar to a Process of Manufacture," (Department of Finance: Inland Revenue, 1995).

¹¹³ Ibid.

relatively 'small' scale producing artisanal goods. As the business grows in popularity, which leads it to grow in capacity and output, they will gradually change from an entity producing artisanal goods, to one which is considered to be a manufacturing entity – similar to the one mentioned in the Safranmark case. In an SA context, there are many small businesses which started out as a family business baking cakes or cooking meat in their kitchen at home, and selling these to people on a small scale. This is clearly not a manufacturing enterprise, and is done on a small scale, on a one to one basis. However, what happens when a coffee shop such as Mugg & Bean becomes a national success and is franchised, opening many stores country wide? Similar to this is the restaurant chain Spur, which started out as a small restaurant, and today has outlets all over the world. Are the muffins served at Mugg & Bean, and the steaks served at Spur artisanal items? I think not. Anyone who visits these restaurants goes there because they know what product will be served to them – an item of a *standardised* nature. It has become standard practice within the national and world-wide context; that one would expect to be served a 'uniform product' similar to products served in other entities within the same franchise group of such restaurants.

From the above it is clear that a business which started out producing artisanal foods on a small scale, is now a mechanised entity, producing uniform goods – and most definitely part of a manufacturing concern. It follows that taxpayers can metamorphose into a manufacturing entity over time, as their production methods are improved and their business activities expanded.

4.6 SERVICES ANCILLARY TO MANUFACTURING ACTIVITIES

In the *Stellenbosch Farmers Winery Case*¹¹⁴ (SFW), the taxpayer (SFW) purchased raw wine from farmers and co-operatives. SFW owned tankers used to transport this raw wine from various farmers to their plant. In the bulk of all freights, the raw wine purchased was blended (mixed) with the produce from different farms. The Commissioner held that the specialised bulk-containers used by the SFW to transport wine to the taxpayers' premises did not form part of a process of manufacture. The court however found that the process of manufacture had already commenced before this 'raw' wine was pumped into the tanker, and therefore was part of the process of manufacture.

'The co-operative societies may have conducted a process of manufacture in producing the raw wine but that does not mean that SFW is not carrying on a process of manufacture in producing from the raw wine obtained by it from the suppliers the wine that it eventually sells. To qualify for the allowances in question it is necessary for the taxpayer to show that it is *engaged in a process of manufacture*, not in *the process of manufacture*. (Emphasis added) He does not have to be involved in the manufacturing of a product right the way through from its original material to some finished end product (see per Wessels JA in the *Hersamar case* (supra) at 192F-G). It may be that more than one taxpayer is involved in a process of manufacture during the production of the finished end product (see er Beadle JS in *COT v Processing Enterprises (Pty) Ltd* (supra) at (216-217)).'¹¹⁵

'once the process of manufacture has commenced, the movement of material from one piece of the plant to the next one in this way is an integral part of the process of manufacture and any plant or machinery used to effect such movement is used directly in such a process of manufacture.'¹¹⁶

¹¹⁴ *Commissioner for Inland Revenue Services v Stellenbosch Farmers' Winery Ltd*, 51 (1988).

¹¹⁵ *Ibid.*

¹¹⁶ *Secretary for Inland Revenue v Cape Lime Co Ltd*, 226 (1967).

As per Judge Selikowitz:

‘As the process of manufacture clearly begins in my view, prior to or at least at the stage when the raw wine is transported by the tankers, the latter are used directly in the process of manufacture. The tankers are specialised vehicles, made of special quality stainless steel, which must be maintained to a high standard of cleanliness’¹¹⁷

From the above we are reminded that once the process of manufacture has commenced, any services undertaken by the taxpayer directly in the process of manufacture, will form part of this process and should be accepted as such.

4.7 INCEPTION OF PROCESS OF MANUFACTURE

It is not always straight forward to determine when the process of manufacture actually begins. Given the case study under discussion in section 2.2: the process of milking a cow or a goat clearly constitutes that of farming. This process produces milk, which is the raw material used to produce cheese. Once the milk has been ‘milked/harvested’ from the animals, it may be transported to the cheese factory, cooled and then pasteurised. It follows that the milk undergoes a number of processes until it takes on the form of cheese, butter or cream.

Depending on the process followed to make the product, certain activities will be deemed to form part of the process of manufacture, whilst others will not. This will be different in each industry in which particular manufacturing activities are performed. Some taxpayers might follow different processes in producing similar goods; we must always have a look at the process followed by a particular taxpayer in their given set of circumstances. However, if an item of machinery is used *solely* to manufacture

¹¹⁷ *Commissioner for Inland Revenue Services v Stellenbosch Farmers' Winery Ltd.*

goods, in a particular case study, then it is highly probable, that the particular item will be integral to the process, and be classified as manufacturing equipment.

4.8 COMPARISON OF TAX TREATMENT BETWEEN A MILK TANKER AND A WINE TANKER

Milk is usually transported to the manufacturer in its raw state. The milk is usually only pasteurised once it has been delivered to the dairy manufacturer – this is possibly when the process of manufacture begins. From this, we may conclude that the transport of milk to the manufacturer does not form part of a process of manufacture. In contrast to this is the transport of wine in a wine-tanker. Juice from grapes must be squeezed out before the wine can be transported in a wine-tanker. The fermentation process usually begins on the farm in storage tanks. It follows that the process of the manufacture of wine has commenced before the grape juice is loaded into the tanker. In this case study, the transport of the wine / grape juice will form part of the process of manufacture, since the process has already commenced and continues in the tanker.

From these case studies there are two distinct differences in transporting the liquid forms:

- The raw milk product has not undergone a change in the product prior to loading, whereas
- The grape juice/wine was squeezed out of the grapes before it was loaded onto the truck/tanker

This highlights the importance of determining when a process of manufacturing has begun. It follows that the transport costs incurred by the dairy producer will not form part of a process of manufacture, and the trucks will not be granted allowances in terms of section 12C of the ITA. In contrast to this, the wine producer, who transports

his grape juice, will be entitled to claim allowances in terms of section 12C for the vehicles transporting his product.

If an 'outside' logistics company (which is not related to the manufacturer of the wine) were to be used to transport the grape juice / wine; it would not be able to claim the allowances in terms of section 12C¹¹⁸ on trucks used for the transport of wine, as the company is conducting a transport service, and is not engaged in the process of manufacture.

The costs that the manufacturing company owes to the logistics company for this service will be deductible by the manufacturing company as a deductible expense incurred in the process of manufacture.

In Income Tax Case 1952, 26 SATC 253 at p 255, Van Winsen J, refers to some of these dicta and he concludes that

“the article claimed to have resulted from a process of manufacture must be *essentially different* from the article as it existed before it had undergone such process”.¹¹⁹

Applying the criteria set out in those cases, it is submitted that what SFW produces, as a result of the operations conducted by it, is a product essentially different from the raw wine which it brought in from the suppliers. It was conceded by counsel for SARS that what SFW produced is a standardised product. That concession was well made; all the evidence established it. That it is produced on a large scale by a continuous process using human effort and specialised equipment is undoubted on the evidence before the court a quo.¹²⁰

¹¹⁸ "Income Tax Act No. 58 of 1962.."

¹¹⁹ *Commissioner for Inland Revenue Services v Stellenbosch Farmers' Winery Ltd.*

¹²⁰ Ibid.

Following from this, we can conclude that the transporting of milk cannot be claimed as a process of manufacture, since the underlying article (milk) was in the *same state* as it existed before the process of manufacturing had commenced.

In contrast to milk is the wine, where we can claim the wear and tear allowances on the wine tanker, as the underlying article (wine) is in a much different state to what it was (grapes) before the process of manufacture had commenced.

The case highlights the importance of whether the service is conducted in the process of manufacture, or before the commencement of conclusion thereof.

It follows that if we are unsure of which tax treatment to apply, we should have a look at what the common law says, and adopt it as such.

a ‘substantial or essential change of the character of the materials’ out of which the ‘manufactured’ article was made but that there can be no fixed criteria as to when any such change can be said to have been effected (see per Galgut AJA in the Safranmark case (supra) at 122B).⁵³ As stated by Williamson JA in the Hersamar case (supra) at 187C-E:54¹²¹

This once again highlights the importance of the change in the substance of the article. However, this might not be a physical change, as a change in the utility of the article can also be sufficient.

‘It was common cause that the *deductions claimed by the appellant* in respect of the cost of the tankers and trucks qualified under section 12(1)(a) and section 12(2)(a) *if they were used by the appellant directly in a process of manufacture* carried on by it. It was contended by the appellant, and conceded by the respondent, that the pasteurisation of milk by the appellant constitutes a process of manufacture, and I shall assume that the concession was rightly made. On this assumption the cardinal question is whether

¹²¹ *Secretary for Inland Revenue v Safranmark (Pty) Ltd.*

the tankers and trucks are used by the appellant directly in the process of pasteurisation. The answer depends on the solution of a further question, vis, at what point does that process begin?’¹²²

Tankers and trucks were used in the process of cooling milk and conveying the milk to depots prior to pasteurisation of the milk. It was held that tankers and trucks were not used directly in a process of manufacture (pasteurisation), therefore not qualifying under section 12(1)(a) and section 12(2)(a) for the manufacturing wear and tear allowances.



Figure 4.1 Milk being delivered from farming operations to the dairy manufacturer

The court further found that there was no essential difference in the chemical composition of the product (milk) whilst being transported; as it has not yet been pasteurised. The milk had therefore not undergone any changes or processing into a different product. This is an indication that it is not a process of manufacture. From this we know that the storage and transport of a product (in this case milk) does not form part of the process of manufacture, if it takes place *before* the process of manufacture has commenced.

¹²² *National Co-Operative Dairies Limited v Commissioner for Inland Revenue.*

However, once the process of manufacture has commenced, and it is necessary to transport or store those goods which are in a 'work in progress' state. These costs will form part of the process of manufacture – as it is necessary to conduct these activities in order to complete the standardised good.

It follows that the court's decision in the *National Co-Operative Dairies Limited v Commissioner for Inland Revenue*¹²³ Case was correct, when it disallowed the taxpayer's claim to the allowances granted to manufacturing, as the transport of milk in that particular case did not form part of the process of manufacture.¹²⁴

4.9 APPLICATION OF MANUFACTURING TO THE CASE STUDY UNDER DISCUSSION

In the protein company case study, (referred to in section 2.2) that manufactures cheese, it is necessary for some of the cheeses to mature (eg: blue cheese and other soft cheeses such as brie or camembert). Once the factory starts to produce these cheeses, the cheese must mature for some time (typically anything from 6 weeks to 6 months). During this time, no physical work is done on the product, however it has not yet been packaged, nor are the goods ready for sale – the goods are *still in the process of manufacture* whilst being *stored* in curing rooms, as the curing process is vital in the manufacture of cheese.

¹²³ Ibid.

¹²⁴ Ibid.



Figure 4.2 and 4.3: Illustrations showing the maturing of cheese

Once the curing has been completed, the goods are packaged and then stored in a cold room for despatch to retailers of the product. Only at this point, has the process of manufacture been completed. Therefore, all machinery used up to the point of packaging the manufactured good will qualify for a section 12C allowance.

The storage of finished goods in the cold room, and the transporting of these goods to buyers of the product, will not form part of the process of manufacture, and the farmer will therefore not be entitled to allowances granted to manufacturers from this stage on.

The above reminds one of how important it is to distinguish amongst individual activities within the context of a single business that is involved in various activities. These individual (underlying) activities dictate what form of trade is being conducted, and will ultimately determine for which tax allowances the tax payer will qualify.

4.10 CONCLUSION

It is evident that each particular 'process of manufacture' needs to be considered individually, as the activities performed may in some instances form part of the process of manufacture, whilst for others they will not. Farmers who also engage in

manufacturing activities, must distinguish where farming activities end (which is usually the source) and where manufacturing activities will commence.

The following chapter will discuss how to determine where farming activities ends and manufacturing activities commences.

CHAPTER FIVE

WHERE DO FARMING OPERATIONS BEGIN / CEASE AND MANUFACTURING OPERATIONS COMMENCE?

5.1 INTRODUCTION

After discussions in Chapter 3 and 4, we can more clearly distinguish between farming and manufacturing activities. Given the current case study of a protein company (discussed in section 2.2), which pursues both farming and manufacturing activities, it is concluded that the taxpayer is both a farmer and a manufacturer. The manufacturing activities are regarded as 'post farming activities' and are incidental to the taxpayer's farming activities, performed within a single business.

In the case study under discussion, we know that there are two privileged categories: a taxpayer conducting farming *and* manufacturing activities simultaneously, with a continual movement of produce between the two. The question then is, which of the activities are farming and which are manufacturing? There is no clear proportion, percentage of sales or production that determines the position. It is a matter of identifying which activities constitute farming, and which do not. Similar to this, which activities constitute manufacturing, and which do not. In the instances where activities start as farming, and transform to manufacturing, it is necessary to determine at which point the cut off is made, and the next activity / operation commences, as these post farming activities are an integral part in realising the taxpayer's (integrated) farming operations.

5.2 APPLICATION OF GENERAL ANTI AVOIDANCE RULES (GAAR)

In this process of determining a reasonable market value at which to transfer livestock or produce from the farming activity to the manufacturing activity, the farmer would need to be aware of the General Anti Avoidance Rules, (GAAR) of the ITA. Put briefly, in this context, GAAR enables SARS to challenge the use of market values that are either unrealistically high or unrealistically low in order to obtain a tax benefit.

‘Tax evasion is of course impermissible and therefore, if a transaction is simulated, it may amount to tax evasion. But there is nothing impermissible about arranging one’s affairs so as to minimise one’s tax liability, in other words, in tax avoidance. If the revenue authorities regard any particular form of tax avoidance as undesirable they are free to amend the Act, as occurs annually, to close anything they regard as a loophole.’¹²⁵

5.3 FARMING PRINCIPLES TO THE CASE STUDY

The livestock owned (and farmed) by the taxpayer clearly constitutes that of farming activities. As explained in section 4.7, the market value of the produce (meat and milk) from the farming operations delivered to the factory (cheese and butchery) would be gross income for the farming activity as this can be seen as a disposal of trading stock. This would specifically relate to milk ‘sold / transferred’ to the cheese factory, and meat transferred from the livestock operations to the butchery. This raises the next question, at what point do the farming operations transfer the produce or livestock to the butchery? It can be argued that either the livestock or the cut-up carcass meat can be

¹²⁵ *Commissioner SARS v Bosch*, 394 40 (2014).

transferred to the butchery. Each of these forms of produce will have a different value attached to it. The value of livestock is different to the value of a carcass / cut up meat.

A farmer is entitled to sell his stock in the most profitable form. In the case of the case study at hand, it would make more financial sense for the farmer to cut-up the meat into 'meat cuts' and to sell these to the butchery operation, as opposed to selling the livestock. The value derived from selling cut up meat will definitely be greater than selling off livestock that still needs to be slaughtered. The reason is that the farmer will have benefited the livestock by cutting it into pieces more immediately useful to the butcher, and will be able to command a higher price. Therefore, if the cutting up of meat is still included in the farming process, the farming activities will end when the carcass has been cut-up into meat cuts to be sold to the butchery. The butchery buys these cuts to further *process* meat into other forms for end users; for example: sausage, marinated cuts, salami and other meat related produce.

It follows that the meat from the farming operations needs to be transferred to the butchery at the price at which a farm would sell meat to a third party at arm's length. It is important that a consistent pricing policy be put in place and applied, as this could potentially be an area that SARS would feel is open to price manipulation and transferring of profits, as mentioned in the section referring to GAAR.

As per section 22(8)¹²⁶ of the ITA, if a taxpayer uses trading stock, other than in the normal course of trade, he is taxed on the market value thereof. BUT: In the case of farming, section 22(8)(v)(B)(c)¹²⁷ of the ITA, states that paragraph 11¹²⁸ of the First

¹²⁶ "Income Tax Act No. 58 of 1962.."

¹²⁷ Ibid.

¹²⁸ Ibid.

Schedule takes preference over section 22¹²⁹. Refer to the Appendix for a full overview on paragraph 11 of the First Schedule¹³⁰. Paragraph 11(iv)(B) of the First Schedule¹³¹ states that this livestock or produce shall be ‘disposed of’ (transferred between operations) at an amount equal to the *market value* thereof.

The price of meat and milk will be calculated by determining what the active market price for a particular good is at a specific point in time. Owing to seasonality of produce and market supply and demand, the price of meat and milk will be based on what a third party would be willing to pay for the raw products, and this price cannot be arbitrarily fixed but must be adjusted to reflect seasonal realities.

5.3.2 Summary on market prices realised for milk and meat in South Africa

There is an active price for milk in SA, based on the supply of milk, and the demand therefor at a given point in time. Farmers are compensated for the *quality* of milk that they deliver. Milk prices will be directly dependent on the yield of the land in a particular area. Milk quality changes from season to season, depending on the natural feed available to the livestock, and the quality thereof. Factors such as drought and animal feed fed to the livestock will have a direct impact on this quality, which will determine the price thereof. Feed with a higher nutritional value will deliver a higher quality yielding milk, which will attract a higher milk price.

The quality of milk is calculated by determining what the milk solids are (fat and protein content). This will differ for each geographic area, as this quality is directly correlated to the diet that the animals are fed. During times when the milk solids (fats and proteins) are higher – typically in the rainfall season, a higher quality of milk will be

¹²⁹ Ibid.

¹³⁰ Ibid.

¹³¹ Ibid.

produced, from which higher yields of cheese can be produced. This consequently leads to an increase in the milk price. However, at these times the supply of milk will also increase, which would mean that the market is slightly flooded, which in turn can drive the price down. It is evident from the above that there are many factors which will impact the price of milk, so that it is not an exact science and will be open to price fluctuations.

The price of milk will not remain constant from month to month, and needs to be calculated for each period in which this milk is purchased, taking into account the quality of the milk, as well as the market supply and demand forces in place at a particular time. The transfer price of this milk from the farming operation to the cheese factory will therefore differ from period to period. The price at which this milk will be transferred from the animals (farming operations) to the cheese operations will be based on the price that a farm would generate, if it were to sell that milk to a third party dairy factory in bulk quantities.

A similar case study arises in the case of meat transferred from the livestock to the butchery. This meat needs to be transferred to the meat processing operations at a market related price similar to what an abattoir or butcher would be willing to pay for it.

The price at which the farming operation transfers the produce and livestock to the manufacturing operations will be the deemed cost price for the cheese factory and butchery. It is at this point that an opportunity arises for a farmer to manipulate where the farming profits should fall in the manufacturing and farming case study, when determining the market value. There is no doubt SARS would be alert to the possibility of abuse in this area.

5.4 APPLICATION OF MANUFACTURING PRINCIPLES TO THE CASE STUDY

Once the manufacturing operations have acquired the produce from the farming operations at a market related value; we have determined that the produce will undergo a change in nature which is essential to the manufacturing process. It is here that the products will be processed into an end product which will be sold to a third party at a market related price.

5.5 TRANSFER PRICING POLICY

From the above case studies, it is evident that the farmer needs to determine a transfer pricing policy within the different operations of the business at a consistent, market related price to be able to refute SARS claims of price manipulation. This is so particularly since the farmer is effectively selling his produce to himself, in his capacity of a manufacturer.

Changing the market value at which meat or milk is shifted from the farming segment to the cheese and butchery segments could enable the farmer to shift profits to make an artificially big profit or loss in a particular segment. It follows that one must ensure that the transfers are done at a market related price. Determining a market value in this case study is not always an easy task as there could be different market values that are acceptable to be used when determining the value of livestock. The market value of meat sold at a butchery will differ from the value of meat sold directly from an abattoir. The 'Red Meat Producers Organisation'¹³² places a value on meat, based on the quality or grading of the meat. For this particular case study, I shall assume that a value is to be placed on the meat similar to that which would be paid by abattoirs.

¹³² "Code of Best Practices," Red Meat Producers Organisation, <http://www.rpo.co.za/best-practices/english/>.

This underlying price will be determined with reference to the Red Meat Producers Organisation grading tables and prices attached thereto.

5.6 PRACTICE OF THE SOUTH AFRICAN REVENUE SERVICE

It appears that SARS, in practice, will regard taxpayers who use their *own* farming produce in a process of manufacture (for example, in winemaking or the processing and canning of fruit) as carrying on only 'farming operations', i.e. even in respect of that manufacturing process. However, if the same taxpayer uses produce from outside sources (such as buying in additional milk to manufacture cheese) to a material extent in his / her process of manufacture, SARS is likely to regard the taxpayer as carrying on two distinct trades (i.e. farming and manufacturing).¹³³

However, we have already determined in our case study that we are conducting two forms of operations: that of farming, and that of manufacturing. Regardless of whether our taxpayer is using his own produce, or that of others to manufacture his goods; he will still be considered to be a farmer and a manufacturer. Based on this he will be entitled to make use of the relevant sections applicable to each taxpayer type. The farmer should challenge any arbitrary SARS policy, such as the one described above, and distinguish between the farming and manufacturing activities using a cogent and defensible transfer pricing policy.

5.7 DISTINCTION OF OPERATIONS WITHIN AN ENTITY

This dissertation has identified numerous challenges that a farmer who is involved in both farming and manufacturing operations will face. From all the discussions, it is evident that one always needs to look at the underlying process / circumstances in a

¹³³ R Katzke, "Farm and factory: An analysis of the distinctions between and fiscal treatment of taxpayers simultaneously carrying on farming operations and manufacturing processes under the Income Tax Act No. 58 of 1962" (University of Cape Town, 2009).

particular case study, as to how a good is made, and where that good comes from (harvest, milk). One then needs to identify which specific activities fall within those of farming, and which do not. A similar approach needs to be followed in a process of manufacture. Since this will differ in every situation, an analysis of the underlying activities, and their consequent tax treatment, will need to be followed.

5.8 FARMERS THAT CONDUCT BOTH FARMING AND MANUFACTURING ACTIVITIES

5.8.1 KVV Case

In the *Kooperatiewe Wynbouers Vereniging van Zuid-Afrika Beperk v Industrial Council for the Building Industry and Others*¹³⁴ (KVV Case), the Appellant (KVV) consisted of a co-operative agricultural company whose membership consisted entirely of farmers. Owing to an increase in the demand for the wine and brandy manufactured by the co-operative, it was their intention to expand the wine making operations in the Cape Winelands area. Large sums of money were paid to increase the capacity of the plant, which included cellars, tanks, stores and press accommodation to deal with the members' produce.

Due to the fact that the membership of the co-operative society consisted entirely of farmers, the appellant attempted to write off the capital expansion project costs of increasing the capacity of the plant by making use of the capital expansion provision available to farmers. The defence argued that KVV was not engaged in farming operations; as a person could only be involved in one operation at a time. The court however held that it was possible to be engaged in more than one industry at a time:

¹³⁴ *Ko-operatiewe Wynbouers Vereniging van Zuid-Afrika Beperk v Industrial Council for the Building Industry and Others* (1949).

*'it was a matter of degree whether a person who admittedly carries on a particular industry is also carrying on one or more other industries.'*¹³⁵

Thus the principle of what constitutes farming operations was already highlighted in this case some seventy years ago:

*'whether a person is employed in "farming operations" turns, not upon the nature of a joint enterprise in which the performer of the operations and his employees are engaged, but upon the nature of the operations performed.'*¹³⁶

Counsel contended that the undisputed facts showed that wine farmers ordinarily provide, as part of their farming operations, storage tanks for their wine co-ops and that consequently persons constructing such tanks are employed in farming operations.¹³⁷

The court however held that:

*'An operation when performed by or on behalf of a farmer may be a farming operation, but when the same operation is performed by or on behalf of a person who is not a farmer, that operation cannot, in my view, be regarded as a farming operation. The construction of wine receiving tanks in the present case is not being performed by or on behalf of a farmer: it is being performed by a cooperative agricultural company who is not a farmer.'*¹³⁸

For the above reason, the appeal was dismissed, and KVV was held not to be a farmer, and therefore not entitled to the capital write off provisions available to farmers.

¹³⁵ Ibid.

¹³⁶ Ibid.

¹³⁷ Ibid.

¹³⁸ Ibid.

5.8.2 Principles arising from KWV

The first relevant principle which may be gleaned from this case is that a taxpayer who carries on one trade may also prove to be carrying on one or more further trades, but this is a question of degree. Factors which may be taken into account in this regard (but should not be decisive on their own) include the aggregate expenditure on the distinct trades, as well as the number of employees respectively dedicated thereto. Further, while a taxpayer may carry on more than one distinct industry or trade (with farming being merely one of them), it may be shown that one of these trades is ancillary to the other(s). This is also a question of degree.

Taxpayers seeking to draw a process of manufacture undertaken by them into the ambit of their farming operations might further bolster their argument if it can be shown that the process is an integral part of their farming operations, without an independent existence ¹³⁹.

The taxpayer could thus argue that the plant is the concluding step of his farming operations (i.e. it is an integral part thereof), and it is strictly intended and used for the processing of his own farming produce (i.e. it has no independent existence, in an operational sense, from his farming operations).¹⁴⁰

Court finding

The Court agreed, firstly, with the principle that a taxpayer may be engaged in two or more industries at the same time, but held further that one such an industry may be

¹³⁹ Ibid.

¹⁴⁰ .Ibid

ancillary to the other.¹⁴¹ The Court found that the test in this regard is a question of degree.¹⁴² The taxpayer needs to prove that he is a farmer conducting farming activities, and that he also needs to conduct manufacturing activities (post farming activities), in order to sell his product.

Conclusion

From this analysis it is clear that the farmer would not be able to realise his final produce without combining farming and manufacturing into his business. The livestock and produce is as integral to the business, as the manufacturing of goods to be sold to the ultimate consumer.

5.9 WHAT A FARMER WHO ALSO ENGAGES IN MANUFACTURING ACTIVITIES HAS TO DO

Firstly, taxpayers who carry on more than one trade simultaneously (with farming being one), may claim that one of their trades is *ancillary* to the other. Relevant factors such as the expenditure incurred, and the number of employees needed to conduct each of these trades, would apply.¹⁴³

A further principle which arose from case law is that post-farming activities should be incidental to (i.e. supplementary to) a taxpayer's farming operations to be potentially included within the ambit of such operations. An argument for the inclusion of a manufacturing process within the scope of a taxpayer's farming operations may also be augmented if such a post-farming process is an integral part of the taxpayer's

¹⁴¹ *Ko-operatiewe Wynbouwers Vereniging van Zuid-Afrika Beperk v Industrial Council for the Building Industry and Others*

¹⁴² *Ibid.*

farming operations, without an independent existence.¹⁴⁴ It follows that the taxpayer needs to conduct these ancillary services / processes after the farming process, in order to 'unlock the value' of the item.

Finally, it has been noted that SARS may in practice support such an argument, but that close regard will nonetheless be had to the taxpayer's factual circumstances (such as whether the taxpayer uses only produce from his own farming operations, or whether he buys in significant volumes of raw product from other producers). However, seeing as SARS' practices are not binding in law, nor will they be upheld by the Courts if considered to be contrary to unambiguous wording of the Act, it is submitted that taxpayers should not rely on the abovementioned practice without putting forth a well-considered argument.¹⁴⁵

Farming capital expenditure qualifying under paragraph 12 of the First Schedule will, of course, not be deductible from manufacturing profits. From this it is apparent that we should identify income that should be allocated to farming, rather than manufacturing, to ensure there is sufficient taxable income available against which to set off the paragraph 12 (capital expansion) expenditure in the year the costs are incurred.

The taxable income of farming operations is combined with the taxable income of 'other operations', to arrive at the taxpayer's taxable income for the year of assessment. We will therefore derive the income earned from pastoral, agricultural or other farming operations *separately* from other forms of income. Income earned from farming operations is to be determined *separately*. However, it is not taxed separately.

¹⁴⁴ Katzke.

¹⁴⁵ Ibid.

It follows that the taxpayer conducting a single business – similar to our case study (in which farming and manufacturing operations are both performed); will calculate a single figure for taxable income for the business in its entirety.

5.10 CHALLENGES THAT THE FARMER ENGAGED IN FARMING AND MANUFACTURING WILL HAVE

Since many of the activities discussed throughout the thesis may fall into a 'grey area', it is always important to try to identify the separate activities within a business to determine which fall into farming, and which fall into manufacturing. Each underlying activity will have different tax consequences related to it. If there is doubt in a particular case study, such as the manufacturing of wine or pressing of fruit juice, we need to look at the underlying activities conducted by the taxpayer to determine which activity he is performing. The biggest challenge in any case study will be to determine which activities comprise that of farming, and which do not, and to categorise them as such.

Some typical challenges would include the following:

- Determining which activities comprise farming, and which do not.
- Investigating the underlying activity which will give rise to the classification of a farming activity.
- Determining whether the ancillary service of manufacture, falls in line with the definition of a process of manufacture.
- Ensuring that the process of manufacture of produce is ancillary to the farming activities, to realise economic value in the sale of trading stock.
- Identifying 'grey areas' in a business where the activity performed can be either farming or manufacturing. It is paramount to identify the underlying processes to determine what type of activity is performed for tax purposes.

5.11 CONCLUSION

In the following chapter I will summarise and expand on the conclusion from the above discussion, namely that meticulous record keeping and a sound basis for decisions is essential for a farmer operating across the often-uncertain line between farming and manufacturing activities.

CHAPTER SIX

PERSPECTIVES AND SUMMARY

6.1 INTRODUCTION

As has been mentioned in the preceding chapters, the significance of this research lies in expanding on the underlying activities performed by a farmer in each individual case study; and by comparing this to what the legislation and case law prescribes to the tax treatment thereof. This research has analysed the concept that it is possible for a farmer to also be engaged in manufacturing activities. All of the components discussed in the preceding chapters are important to an in-depth discussion into allowing a farmer, who is also engaged in manufacturing activities, access to the tax allowances of both farming and manufacturing activities within the context of the SA tax legislation.

6.2 OVERVIEW OF QUESTION / SPECIFIC ANSWERS TO RESEARCH QUESTIONS

What constitutes farming activities? As this writing is related to the tax consequences of farming, one needs to determine whether the taxpayer is entitled to the favourable provisions that farmers may qualify for. In order to do this, one needs to look at the underlying activities performed by the taxpayer, and ensure that these comprise that of farming. A reminder that ancillary activities in relation to farming do not qualify for farming as such.

What type of income qualifies to be included in farming income? Only income that is directly linked to the farming operations will qualify to be included in farming

income. Where income is earned on ancillary activities performed by the farmer (for instance the sales from the manufacturing of produce, or the interest earned on an investment); these sources of income will be excluded from farming income as such.

A discussion of trading stock in farming and the tax treatment thereof. In the farming industry, trading stock is either made up of livestock, or produce or both. For tax purposes, trading stock owned by a farming operation is a special tax category, as it is specifically excluded from section 22 of the ITA. Under normal circumstances, a taxpayer would add back the value of trading stock held at year end to taxable income. For a business engaged in farming operations, there is a slightly different procedure, in that the value of closing livestock is carried at minimal values in terms of the Act. Therefore, a farmer would need to add back an immaterial value to closing stock at year end. The area in which taxpayers could benefit is where they have purchased large quantities of consumables or livestock during the year. The cost price of these items would be allowed as a deduction against taxable income in full. Although many of these items of stock would still be on hand at year end, only a minimal value will be added back for them in the value of closing stock.

A discussion of capital development expenditure in farming and the tax treatment thereof. Farmers are a privileged tax paying class, in that they have more beneficial tax write offs available for capital expenditure. Machinery may be written off at 50% in the year the machinery is brought into use, 30% in the following year, and 20% in the third year on a straight-line basis. In terms of paragraph 12 of the First Schedule, capital development expenditure incurred by the farm, may be written off in full in the year in which it is incurred, provided that there is sufficient *farming* taxable income to set off against this cost. Farming capital development expenditure may not be set off against income that is not derived from farming operations.

What constitutes manufacturing activities? Before one can be considered to be a manufacturer, who manufactures goods; it is paramount to determine whether the goods being produced undergo a change in nature. From case law in SA, six cardinal principles have arisen in the Safranmark case; which are used as a basis in determining whether the taxpayer is involved in a process of manufacture, producing goods with a distinctly different nature to the raw materials. If a taxpayer can show that all six of these principles are complied with in his production of goods, then he can show that he is a manufacturer for tax purposes.

At what price should a farming entity dispose of produce to a manufacturing entity within the bounds of a single business? Every case study will be different, depending on the respective circumstances, and the various goods being transferred. As a rule of thumb, one should always transfer produce between farming and manufacturing segments of a business at a value that approximates the *market value* thereof. In the previous chapter, it was discussed that this value may change depending on the seasonality or market factors that impact the price. The manner in which the value is calculated must always be relevant and consistent, given to the market forces at play, which will directly impact this price.

Where machinery is involved in farming and manufacturing activities, how does the farmer apply section 12C of the ITA as well as paragraph 12 of the First Schedule to machinery used in production? The case study that was discussed in this writing relates to a tanker that can either be classified as a capital expenditure for farming or manufacturing depending on the underlying process in which it was used to transport produce (either the transport of milk or wine). As the machinery under discussion was very similar in nature, it led to a situation where allowances on the item could either be claimed in terms of paragraph 12 of the First Schedule, or in terms of

section 12C of the ITA. In the given case study, it was necessary to look at the underlying activities performed by the particular machinery, to determine into which segment (farming or manufacturing) of the business the capital expenditure fell.

How are overheads such as wages, electricity and other general operating expenditure allocated to the between farming and manufacturing activities within one business? Given the case study at hand, it was shown that certain expenses can be classified as either farming or manufacturing expenses. In practice, one must investigate the underlying event / cause that led to the expense being incurred. As this will often be a grey area, certain costs will pertain to both farming and manufacturing. In these cases, one needs to determine which activity utilises the bulk of the cost item, or one must determine a basis on which to apportion the cost between the various segments.

6.3 CONCLUSION

This research is by no means meant to mislead manufacturers to claim tax allowances that farmers are specifically entitled to. It attempts, however, to illustrate that it is possible for a farmer to also incorporate manufacturing activities within a single business, and to use the specific tax allowances to his best advantage in setting up a tax efficient business.

As a departing remark, it is possible that further inroads into the scope within a farming entity who also conducts manufacturing activities may be made; as there are many possible case studies. Each case study will have different underlying legislative factors to take into account depending on the manner in which farming produce is subsequently manufactured into the end product.

APPENDIX

Extract and Summary of the First Schedule

Paragraph 1 – States that the First Schedule is applicable to anyone who is engaged in *farming activities*.

Paragraph 2 – Farmers to include the value of opening stock and closing stock in the calculation of their taxable income.

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 the end of each year of assessment.¹⁴⁶

Taxpayers conducting farming activities must include the opening and closing stock of livestock and produce in the trading stock section of their income tax return.

Paragraph 3 – This paragraph expands on the opening and closing stock.

3. (1) Subject to the provisions of subparagraphs (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.¹⁴⁷

It follows that:

(i) the value (as determined) of closing stock is added to taxable income and that (ii) opening stock (as held at the end of the previous year) is deducted from taxable income. Note that the stock held in opening and closing stock, will be carried at *standard value*. A short discussion follows on paragraph 5.

¹⁴⁶ "Income Tax Act No. 58 of 1962.."

¹⁴⁷ Ibid.

Paragraph 4 - The opening stock of livestock will equal the value of the closing stock held at the end of the previous year. Added to this, we will add the market value of livestock / produce acquired during the year, otherwise than purchased, natural increase or in the ordinary course of farming operations. A dividend *in specie*, or a donation of livestock would be an example of this.

Paragraph 5 – This paragraph relates to the values at which closing stock will be carried at year end.

5. (1) The value to be placed upon livestock for the purposes of this Schedule shall, subject to the provisions of paragraph 4 (1) as respects livestock held and not disposed of at the end of the year of assessment, be the standard value applicable to the livestock.¹⁴⁸

The values at which this stock is carried at year end, will be carried forward to the following year of assessment as opening stock, and will continue to be held at this *standard value*. It follows that this standard value will be determined in terms of the values placed upon that stock in the Government Gazette. A table that summarises these values is on the next page (Table 1.1).

In most cases, the standard value per livestock item is less than the market value at which that stock can be purchased or sold. This standard value is 'fixed' by regulations in terms of the Act. This standard value of the farmers' livestock on hand, at the end of the tax year, is included in the taxable income as closing stock¹⁴⁹.

In light of the values set out below, it follows that in almost all cases, the purchase price of the livestock (which will be a deduction) will be significantly higher than the value at which the closing stock will be added back for tax purposes. In almost all

¹⁴⁸ Ibid.

¹⁴⁹ "Standard classification and standard values of livestock".

cases, this will lead to a situation in which the value of closing stock will be lower than the value of purchases; which will lead to a reduction in taxable income.

From the table above, it is evident that the value of closing stock will be significantly understated to the market value of the livestock held.

Table 6.1 This table summarises the standard value at which livestock is to be carried:

Standard classification		Standard values (R)
Cattle	Bulls	50
	Oxen	40
	Cows	40
	Tollies and Heifers (2 - 3) years	30
	Tollies and Heifers (1 - 2) years	14
	Calves	4
Sheep	Wethers	6
	Rams	6
	Ewes	6
	Weaned lambs	2
Goats	Fully grown	4
	Weaned kids	2
Horses	Stallions over 4 years	40
	Mares over 4 years	30
	Geldings over 3 years	30
	Colts and fillies: 3 years	10
	Colts and fillies: 2 years	8
	Colts and fillies: 1 years	6
	Foals under 1 year	2
Donkeys	Jacks over 3 years	4
	Jacks under 3 years	2
	Jennies over 3 years	4
	Jennies under 3 years	2
Mules	4 years and over	30
	3 years	20
	2 years	14
	1 year	6
Ostriches	Fully Grown	6
Pigs	Over 6 months	12
	Under 6 months	6
Poultry	Over 9 months	1
Chinchillas	All ages	1

** This table was acquired from the Government Gazette as published by SARS on 18/04/2012; Standard values (R) are presented in Rand.

Paragraph 6 – This paragraph determines what the standard value of the specific class of livestock shall be. If the value of the livestock is not covered in the Government Gazette (for instance, mink), then the farmer may elect his own standard

value; bearing in mind that this may not differ by more than 20% from the standard value in the Government Gazette list.

If there is no standard value available in the Government Gazette, the value of the stock must be agreed by the Commissioner, which is usually the case for exotic animals such as, for example, mink.

Paragraph 7 – This paragraph provides that once a standard value has been chosen by a taxpayer, it must be used consistently in future years of assessment. These values may be varied only, with permission of the Commissioner.

Paragraph 8 – Deals with expenditure incurred in the acquisition of livestock:

8. (1) Where any farmer has during any year of assessment incurred expenditure in respect of the acquisition of livestock, the deduction which may be allowed to him under section 11 (a) of this Act in respect of the cost price of such livestock shall be limited to an amount which, together with the value of livestock held and not disposed of by him at the beginning of such year, does not exceed the income received by or accrued to him from farming during such year and the value of livestock held and not disposed of by him at the end of such year. ¹⁵⁰ (*Emphasis added*)

The above extract makes it clear that you cannot have a negative movement of stock.

8 (2) Any amount which has been disallowed under the provisions of subparagraph (1) shall be carried forward and be deemed to be expenditure incurred by the farmer in respect of the acquisition of livestock during the succeeding year of assessment. ¹⁵¹

Expenses that were disallowed in the previous tax year due to inadequate income being available for set-off may be carried forward to a next year of assessment; until there is sufficient income available against which those expenses can be set-off.

¹⁵⁰ "Income Tax Act No. 58 of 1962.."

¹⁵¹ Ibid.

(3) The provisions of this paragraph shall not apply in (a) in any case where it is shown by the farmer that livestock the cost of which fails to be dealt with under such provisions is no longer held and not disposed of by him; and ¹⁵²

This paragraph means that if a farmer disposes of all of his livestock, and is no longer conducting farming activities, he will no longer be allowed to set off expenditure related to the purchase of livestock against his income. It follows that the farmer who continues to farm would be able to deduct expenditure relating to previous purchases of livestock.

Expenditure in respect of acquisition of livestock is limited to the farmers' taxable income for the specific year under review. Because of the effect of using standard values for livestock (specifically when adding back the closing stock); a farmer could create a large farming loss in the tax year by making large purchases of livestock. Purchases would be deductible under section 11(a); and closing stock would be reflected at reduced standard values. To prevent the creation of a farming loss by means of livestock acquisitions, paragraph 8 limits the deduction in respect of livestock purchased to the proceeds of livestock sales during the year of assessment

Any amount disallowed as a deduction under paragraph 8 shall be carried forward and deemed to be expenditure incurred by the farmer in respect of acquisitions of livestock during the following years of assessment, when there is adequate taxable income from the disposal of livestock to set off against the expenditure or where the livestock no longer exists.

Paragraph 9 – The value of produce included in the return shall be fair and reasonable value as the commissioner may fix. The value of produce included in closing stock

¹⁵² Ibid.

once it has been harvested or reaped shall be carried at a fair and reasonable value.
The farmer's input costs are usually used to determine this value.

Paragraph 10 – Deleted.

Paragraph 11 – Relates to domestic consumption, donation and *in specie* dividends.

11. If during any year of assessment livestock or produce-
- (a) has been applied by the farmer for his private or domestic use or consumption;
 - (b) has, for purposes other than that of the production to the farmer of income from sources within the Republic, been removed by him from the Republic; or
 - (c) (i) has been donated by the farmer;
 - (ii) has been disposed of by the farmer, other than in the ordinary course of his farming operations, for a consideration less than the market value thereof;
 - (iii) where the farmer is a company, has on or after 21 June 1993 been distributed *in specie* (whether such distribution occurred by means of a dividend, including a liquidation dividend, a total or partial reduction of capital (including any share premium), a redemption of redeemable preference shares or an acquisition of shares in terms of section 85 of the Companies Act, 1973 (Act 61 of 1973)), to a shareholder of such company; or (iv) has been applied by the farmer for any other purpose other than the disposal thereof in the ordinary course of his farming operations and under circumstances other than those contemplated in subparagraph (a) or (b) or item (i), (ii) or (iii) of this subparagraph, there shall be included in the income of such farmer for that year of assessment-
- (A) where such livestock or produce has been applied in a manner contemplated in subparagraph (a), an amount equal to the cost price to him of such livestock or produce, or where the cost price cannot be readily determined, the market value of such livestock or produce; or
 - (B) where such livestock or produce has been applied, disposed of or distributed in a manner contemplated in subparagraph (b) or (c), an amount equal to the market value of such livestock or produce:
- Provided that where-
- (a) any livestock or produce so applied, is used or consumed by the farmer in the ordinary course of his farming operations, the amount included in his income under this paragraph shall for the purposes of this Act be deemed to be expenditure incurred in respect of the acquisition by him of such livestock or produce; or
 - (b) the provisions of subparagraph (c) (ii) are applicable and an amount of consideration as contemplated in such subparagraph has been received by or accrued to the farmer,

the amount included in his income in terms of this paragraph shall be reduced by such consideration.¹⁵³

Paragraph 11 of the First Schedule contains provisions similar to those in section 22(8) of the ITA. These provisions are aimed at non-trade disposals of livestock and produce. In the case of domestic consumption; if livestock or produce has been applied by a farmer for private or domestic use or consumption; he shall include the *cost price* of that livestock or produce in his income.

If the farmer is unable to determine this cost price, he shall include the market value of such produce or livestock in his income.

Where livestock or produce is removed from the Republic of South Africa for purposes other than in the production of income, it shall be included in the farmers' income at *market value*.

Where the farmer has disposed of livestock or produce in the following 'non-trade' manners:

- Donated the livestock or produce,
- Disposed of the livestock or produce other than in the ordinary course of farming operations for a consideration less than market value,
- Distributed the livestock or produce as an in specie dividend, or
- Has applied livestock or produce in any other manner, other than the disposal thereof in the ordinary course of farming activities

the *market value (Emphasis added)* of such livestock or produce shall be included in his income. Important to make note of sub paragraph B in the above extract, as further

¹⁵³ Ibid.

reference to this disposal of stock at market value, shall be discussed in further detail in Chapter 5.

Paragraph 12 – Special provisions relating to capital development expenditure – the categories of expenditure listed are capital in nature. However because of the vagaries to which farmers are subject, and as incentive to improve the land, farmers may set these categories of expenditure off against taxable farming income in full in the year in which they are incurred.

12. (1) Subject to the provisions of subparagraphs (2) to (6), inclusive, there shall be allowed as deductions in the determination of the taxable income derived by any farmer the expenditure incurred by him during the year of assessment in respect of-

(a) the eradication of noxious plants;

(b) the prevention of soil erosion;

(c) dipping tanks;

(d) dams, irrigation schemes, boreholes and pumping plants;

(e) fences;

(f) the erection of, or extensions, additions or improvements (other than repairs) to, buildings used in connection with farming operations, other than those used for the domestic purposes of persons who are not employees of such farmer;

(g) the planting of trees, shrubs or perennial plants for the production of grapes or other fruit, nuts, tea, coffee, hops, sugar, vegetable oils or fibres, and the establishment of any area used for the planting of such trees, shrubs or plants;

(h) the building of roads and bridges used in connection with farming operations;

(i) the carrying of electric power from the main transmission lines to the farm apparatus or under an agreement concluded with the Electricity Supply Commission in terms of which the farmer has undertaken to bear a portion of the cost incurred by the said Commission in connection with the supply of electric power consumed by the farmer wholly or mainly for farming purposes;¹⁵⁴

Paragraph 12(1) provides that capital expenditure is allowed as a deduction in determining the taxable income of a farmer, if the expenditure on the list is incurred during the year of assessment as stated above in the extract from ITA. Where the deductions under paragraph 12(1)(c)-(i) exceed the farmers' taxable income from

¹⁵⁴ Ibid.

farming before these deductions, the excess must be added back to farming income and deducted in the following year of assessment (i.e.: carried forward in terms of paragraph 13(3)). The excess is known as unredeemed capital development expenditure.

(3) The amount by which the total expenditure incurred by any farmer during any year of assessment in respect of the matters referred to in items (c) to (j), inclusive, of subparagraph (1) exceeds the taxable income (as calculated before allowing the deduction of such expenditure and before the inclusion as hereinafter provided of the said amount in the farmer's income) derived by him from farming operations during that year of assessment shall be included in his income from such operations for that year and be carried forward and be deemed for the purposes of subparagraph (1) to be expenditure which has been incurred by him during the next succeeding year of assessment in respect of the matters referred to in the said items. ¹⁵⁵

When determining these capital expenses for farming operations, it is imperative to link this to expenses specifically incurred for farming operational use. It follows that expenses incurred on a farm, that are not specifically for farming operational use (for example the tennis court for the farmer's children) will not qualify as farming expenditure, and will therefore not qualify for a deduction in terms of this section.

The Act explicitly states that domestic (living) farming expenditure is disallowed as a deduction from taxable income.

In terms of s 12 B(1)(f) of ITA, farmers qualify for a farming machinery write off of 50% of the cost price in the first year of putting the equipment into use, 30% write off in the second year of use, and 20% write off in the third year of use. Over and above the reduced write off period, another benefit is that this write off period need not be apportioned for parts of a year. The write off is determined on a straight line basis.

¹⁵⁵ Ibid.

Paragraph 13 – Forced sale:

This paragraph provides relief for a farmer who has been forced to sell his livestock due to drought, disease, plague or fire. In essence, the paragraph permits the farmer to deduct the cost of replacement livestock in the year of the forced sale; if he was compensated for this loss. It follows that this paragraph allows the cost to be set off against the compensation receipts. The idea behind this paragraph is that the taxpayer who has suffered a loss due to drought is allowed to deduct the cost of replacement livestock in the year in which compensation is received.

Paragraph 13A – Drought relief provision:

13A. (1) If any farmer has on or after 1 March 1982 disposed of any livestock on account of drought, and the whole or any portion of the proceeds of such disposal has as soon as possible, but in any case within three months after the receipt thereof by the farmer, been deposited by him in an account in his name with the Land and Agricultural Bank of South Africa, so much of such proceeds as has been so deposited by him shall, notwithstanding the provisions of section 23 (e) of this Act but subject to the provisions of subparagraph (3), be deemed not to be gross income derived by such farmer.¹⁵⁶

If a farmer receives compensation from the sale of his livestock due to drought, and has deposited these proceeds with the Land and Agricultural Bank of South Africa within 3 months of receiving those proceeds. Those proceeds, so deposited will not be included in his gross income in that year of assessment. To qualify for this concession, the farmer must make a request to the Commissioner, within the time prescribed time.

(2) Every farmer who desires that the proceeds derived by him from the disposal of livestock shall be dealt with under the provisions of this paragraph shall with his return of income for the year of assessment during which such livestock was disposed of, or within such period as the Commissioner may allow, notify the Commissioner accordingly and submit a certificate containing such information in connection with the disposal as the Commissioner may require.

¹⁵⁶ Ibid.

(3) Any amount, being the whole or any portion of a sum deposited in an account following the disposal of livestock as contemplated in subparagraph (1), shall-

(a) if it is withdrawn from such account before the expiration of a period of six months after the last day of the year of assessment in which such disposal took place, be deemed to be gross income derived by the taxpayer from the disposal of livestock on the date of such disposal; or

(aA) if it is withdrawn from such account after the expiration of a period of six months but before the expiration of a period of six years after the last day of the year of assessment in which such disposal took place, be deemed to be gross income derived by the taxpayer from the disposal of livestock on the date of such withdrawal; or

(b) in the event of the taxpayer's death or insolvency before the expiration of the said period, be deemed to be gross income so derived on the day before the date of his death or insolvency, as the case may be; or

(c) if it is not so withdrawn and the taxpayer does not die or become insolvent before the expiration of such period, be deemed to be gross income so derived on the last day of such period.¹⁵⁷

If the farmer withdraws this money within 6 months after the year of the sale, he shall be taxed as if the concession paragraph did not apply. If the farmer withdraws money after the end of the 6 month period (referred to above); he will be taxed in the year in which the withdrawal is made.

If the farmer leaves the money on deposit for 6 years or longer, those proceeds will be deemed to form part of his gross income on the last day of the 6 year period. In the event of the farmer passing, or becoming insolvent within the 6 year period, the proceeds will be deemed to form part of his gross income on the day before death or insolvency.

Paragraph 14 – Disposal of a farming plantation:

¹⁵⁷ Ibid.

14. (1) Any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income.

(2) Where any plantation is disposed of by a farmer with the land on which it is growing the amount to be included in such farmer's gross income in terms of subparagraph (1) shall-

(a) if the amount representing the consideration payable in respect of the disposal of the plantation is agreed to between the parties to the transaction, be the amount so agreed to; or

(b) failing such agreement, be such portion of the consideration payable in respect of the disposal of the land and the plantation as in the opinion of the Commissioner represents the consideration payable for the plantation.¹⁵⁸ (*Emphasis added*)

Paragraph 14(1) states that the proceeds of disposal of a plantation will constitute farming income and not proceeds of a capital nature.

Paragraph 15 – Deductions allowed for plantation farming.

Paragraph 16 – Definitions relating to plantation farming.

Paragraph 17 – Sugar cane farming. This paragraph provides for an average rate to apply to the proceeds of sugar cane sold ahead of schedule due to fire damage.

Paragraph 18 – Deleted.

Paragraph 19 – Relates to the general rating formula enabling farmers to apply averaging to their taxable income. This provides the mechanism by which the income varying from year to year may be smoothed out. As this formula is not available to companies or close corporations, it will only apply to trusts and individuals.

19. (1) If any taxpayer has made an election as provided in subparagraph (5) which is binding upon him in respect of any period of assessment (hereinafter referred to as the relevant period) during which he or his spouse has carried on farming operations or has derived income from farming operations, and his taxable income derived during the relevant period from farming exceeds his average taxable income from farming as determined in relation to the relevant period in accordance with subparagraph (2), the

¹⁵⁸ Ibid.

normal tax chargeable in respect of his taxable income for the relevant period shall, subject to the provisions of section 5 of this Act, be determined in accordance with section 5 (10).¹⁵⁹

In consequence of the possibility that a farmer's income may fluctuate from year to year he may elect to be taxed in accordance with a rating formula. In terms of this formula the tax rate applied to the taxable income from farming is the rate applicable to the average farming taxable income the current and preceding four years.

Should the farmer elect to make use of this formula it is binding upon him in future years and he is not permitted to make use of the provisions relating to government livestock reduction schemes rating formula for plantation farmers or provisions relating to sugar cane farmers.¹⁶⁰ The farmer will be taxed in subsequent years on a rolling five year average taxable income. This will alleviate major highs and lows and will aim to even out the average taxable income.

Paragraph 20 – Expropriation of farming land. Given that I am discussing the business effects of running a profitable farming business, I will not be expanding on this paragraph.

¹⁵⁹ Ibid.

¹⁶⁰ "Special Concessions to Farmers," TAX.CO.ZA <http://tax.co.za/special-concessions-to-farmers>.

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“It always seems impossible until it's done.”

Nelson Mandela ~