Dear Sir/Madam,

The South African Revenue Service’s draft interpretation note on valuation of stock held by nursery operators issued in February 2014 refers. Please find SAICA National Tax Committee’s response to the request for comments on the draft notice.

Preamble

The word “nursery” is defined in the draft note as “a place where young trees or plants are grown for the purpose of sale”. We notice that in terms of the National Environmental Management: Biodiversity Act, 2004 (Act No. 10 of 2004) “nursery” means “a facility where a listed threatened or protected plant species is sold, artificially propagated or multiplied for commercial purposes”. The Oxford dictionary also refers to “a place where young plants and trees are grown for sale or for planting elsewhere”. A nursery is then similar to a farm used for farming purposes.

The confusion then comes when the phrase “nursery operator” is defined for purposes of the draft note. It is not clear how the person can carry on the “business of a nursery” – surely the intention is that the nursery operator is the person carrying on the activities of growing, etcetera the trees or plants.

We submit that the meaning attached to both the word “nursery” and the phrase “nursery operator” be revisited.

The draft note then uses the word “stock” (in the heading, in the purpose statement and elsewhere in the document). The word “stock” is not used in the Act (Income Tax Act) - the
First Schedule refers to produce (and not stock). We think that the word “stock” is used in its normal meaning of “the goods or merchandise kept on the premises of a shop or warehouse and available for sale or distribution”. In this context it can be read to mean plants acquired for resale and plants grown.

We suggest that the word stock must be replaced with “produce” or “trading stock”.

**Paragraph 4.1: Introduction**

We submit that the operations of a taxpayer in this regard will not be limited to “plants or trees or bulbs” and can in fact also include the production of fertiliser, seeds etc. We agree that the taxpayer will have to prove that the operations are the ones envisaged by section 26 (pastoral, agricultural or other farming operations).

We agree that the buying and selling of other trading stock items will not constitute what is referred to in the note as “farming operations” and that the taxpayer will have to treat them differently (as separate operations). We don’t agree that the “buying and selling of plants or trees from outside sources” would necessarily take the activity outside of “farming operations”. It is accepted where a tree or a bag of fertiliser, for instance, is acquired and immediately on-sold that it would not constitute “farming operations”. The problem is that taxpayers may not in all instances immediately dispose of items so acquired. It is common that the taxpayer will, for a number of reasons, continue still to grow plants so acquired. To this end the taxpayer will for instance have to continue watering the plant etc. We submit that the taxpayer may well then be carrying on “farming operations” in this regard and that the distinction (between the two operations) should be made on that basis.

**The meaning of farming operations**

We agree that the note dealing with produce should also deal with SARS’s practice generally prevailing in this regard.

It is not clear why the draft note uses the words “there must be an overall profit-making intention”.

We agree that “the same test that is used to determine whether a person is carrying on farming operations applies to a nursery operator.” (See our comments with regard to the use of the words “nursery operator”.)

The draft note quotes some obiter remarks made by Judge Heher in *C: SARS v Smith*. We submit that the relevant part of the judgement is found in paragraph 22, quoted below:

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

The factors listed in section 20A(3) are necessary to determine that the trade carried on by the taxpayer constitutes a business in respect of which there is a reasonable prospect of deriving taxable. We submit that this is not relevant to the issue of whether or not the taxpayer can prove (in this instance) that he, she or it had “a genuine intention to carry on farming operations”. We submit that this is a different test, or put differently, the taxpayer would only get into section 20A if a trade was in fact carried on.

**Paragraph 4.2: Nursery produce**

The first sentence of this paragraph reads as follows:

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

It then immediately goes on to refer to “paragraph 2”. We are aware that the word paragraph is defined in the preamble, but we suggest that it would make for easier reading if the words “of the First Schedule” are added here.

**Consumables**

It is not correct to say that “consumables … must not be included as trading stock”. It is true, where the trade is one of farming that section 22 does not apply. That however, does not mean that the items listed as “consumables” are not trading stock – they are. The fact of the matter is that paragraph 2 of the First Schedule only requires of a taxpayer to deal with consumables if they become produce.

We agree that in general “consumables do not constitute produce”, but submit that the statement “…and are therefore not required to be brought to account as opening or closing stock under paragraph 2…” needs to be qualified. To use an earlier example in the draft note, if the taxpayer buys bags of fertiliser it will only be the ones used for purposes of the farming trade that will not be brought into account in terms of paragraph 2. We agree that the ones held solely to be sold will be consumable stores and also trading stock and according that section 22 will apply. The sentence starting with section 23H should be removed from this paragraph, but see our comment dealing with that specifically.

**Section 23H**

We submit that the statement that “…the amount that a farmer may claim as a deduction for consumable stores may, however, be limited under section 23H…” is not correct. Section 23H(1) specifically states that the section does not apply to “…expenditure incurred in respect of the acquisition of any trading stock…” As consumable stores are trading stock as defined
(section 1 of the Income Tax Act) it is clear that it does not apply to consumable stores. We submit that the reference should be to section 23F.

The principle that crops accede to the soil

We agree with the principles listed in the draft note and that “growing crops is excluded…” We did not have access to the case referred to in this regard, but from the Business Aviation Corporation v Rand Airport Holdings we assumed that it dealt with the right of the lessee and not with the income tax concept of produce. We submit that the principle is that it is the fact that the item is still growing that excludes it from being produce. The moment it is removed from the land and is ready for sale, it turns into produce. The test should therefore be whether it is ready for sale.

No mention is made to plants grown in pots, bags or in soil in a container. It is a convenient way to grow them and they do not accede to the soil but are also not ready for sale yet. We submit that in this regard it would then be when the taxpayer makes the item grown in the pot for instance ready for sale that it turns into produce. Before that time it is to be treated similarly to growing crops.

We therefore agree with the following statement in the draft note:

Once they have reached the stage of being marketable, the plants or bulbs will constitute produce and must be brought into account for income tax purposes.

Paragraph 4.3: Valuation of produce

We agree with the use of the word produce in this part.

Paragraph 4.3.1: Valuation method

We accept that in practice SARS does not fix the value, but the taxpayer actually determines the value when the return is submitted.

It is not so much “the value” as the amount fixed by SARS as the “fair and reasonable value” that is subject to objection and appeal.

The draft guide states that the “…reasonable value is considered to be the lower of production cost or market value”, but does not define what market value is for the purpose of nursery produce. We accept that as a starting point the taxpayer will use an arm’s length price, but suggest that the draft note deals with this.
Paragraph 4.3.6: Death – paragraph (a) Income Tax

We agree that the “same principle applies to the final year of assessment of the deceased person with the result that produce will be reflected” at the paragraph 9 value (which in terms of SARS practice general prevailing is the lower of production cost and market value in opening and closing stock in that year).

We are not certain what the authority is for stating that the heir must dispose of “at the earliest opportunity”. We submit that it will be the executor disposing thereof and that it may not always be possible to do so at the earliest opportunity. We submit that the emphasis should rather be on the fact that the heir did not make it “part of a farming operation”.

Paragraph 4.3.6: Death – paragraph (b) Capital gains tax

We are not certain that the discussion in the paragraph is relevant to the overall purpose of the draft note. It is our suggestion that it may be sufficient to refer to the capital gains guide.

If the intention is to add, which the note does, capital gains guide by explaining the practice prevailing, we recommend that the purpose of the note is amended to make this clear.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

Piet Nel CA(SA)
PROJECT DIRECTOR: TAX
The South African Institute of Chartered Accountants