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TAX AND EXCHANGE CONTROL ALERT

INLUDING NEW ADDITION:
Custom and Excise Highlights

IN THIS ISSUE

COMMERCIAL PROPERTY: THREE WAYS TO SAVE TAX

The effective rate of capital gains tax (CGT) has increased dramatically in recent years.

IN VINO VERITAS: AN IMPORTANT CASE FOR THE WINE FARMING INDUSTRY

The South African wine industry is internationally renowned for the quality of wine it produces. From a tax perspective, a specific tax dispensation applies to income derived by a person from “pastoral, agricultural or other farming operations” as contemplated in s26(1) of the Income Tax Act, No 58 of 1962 (Act).

CUSTOMS AND EXCISE HIGHLIGHTS

We will be providing a brief overview of the Customs and Excise environment in our weekly Tax Alert. This is the first instalment of the series.

CLIFFE DEKKER HOFMEYR

COMMERCIAL PROPERTY: THREE WAYS TO SAVE TAX

It has become more important than ever for taxpayers to reduce their tax bill on immovable property.

If you hold the property in your own name you pay less than half the tax you would pay if you held shares in a company which in turn owns the property.

The effective rate of capital gains tax (CGT) has increased dramatically in recent years.

When CGT was introduced in South Africa in 2001 the effective rate for companies was 15%. The effective rate is now 22.4%. So, since 2001 the effective rate of CGT for corporates has increased by nearly 50%.

In addition, when a company distributes a profit after tax to its shareholders, they pay dividends tax at a rate of 15% (unless the shareholders qualify for an exemption, or a reduced rate).

So, when a company realises a capital profit, and distributes the profit to the shareholders the effective tax rate is 34.04%. In other words, more than one third of the profit goes to the taxman.

A close corporation is treated the same way as a company for tax purposes.

It has accordingly become more important than ever for taxpayers to reduce their tax bill on immovable property.

Here are three ways to reduce the tax:

1. **Hold the property in your own name.**

   Natural persons pay CGT at a maximum effective rate of 16.4%. And dividends tax does not apply. So, if you hold the property in your own name you pay less than half the tax you would pay if you held shares in a company which in turn owns the property.

   Naturally, you should not only take into account the incidence of CGT and dividends tax when deciding whether to hold property in your own name or not. For example, if you hold commercial property in your own name and you let the property, depending on the amount of rental you generate, you may need to register and account for value-added tax (VAT).

   Also, you are personally liable for the debts relating to the property. So, if you borrow money from a bank to finance the property, the bank would also be able to attach your other assets – and not only the property – to satisfy its claim.

   You could also hold the property in a trust – an effective vehicle to hold property from a tax and commercial perspective. However, there have been rumblings recently on the part of policy-makers about the way that trusts are taxed and you should exercise caution when thinking about using a trust.

2. **Keep accurate records of costs.**

   Put simply, CGT is levied on a capital gain realised on the disposal of property, that is, on the difference between the proceeds on disposal and the base cost. The base cost is essentially the sum of expenditure incurred to acquire, improve and dispose of the property.

   Clearly, therefore, it is important to ensure that your base cost is determined correctly. To that end you should diligently store records of every amount you incur in relation to the property, notably, the costs of constructing or refurbishing the buildings on the property. Even small amounts add up over time.

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COMMERCIAL PROPERTY: THREE WAYS TO SAVE TAX

CONTINUED

If the company sells the property and distributes the net profit to you, you will put R3,638,400 in your pocket.

3. Sell shares and claims.

Consider the following case: You formed a company to acquire commercial property. The company paid R1,000,000 to buy the property. You lent that amount to the company. Many years later a person offers you R5,000,000 for the property. The share capital in the company is a nominal amount of R1,000.

If the company sells the property and distributes the net profit to you, you will put R3,638,400 in your pocket determined as follows:

CGT in company:

Proceeds	R5,000,000
Base cost	– R1,000,000
Capital gain	R4,000,000
CGT at 22.4% effective rate on capital gain	R896,000

Amount pocketed:

Proceeds	R5,000,000
Loan	– R1,000,000
CGT	– R896,000
Net profit after CGT available for distribution	R3,104,000
Dividends tax at 15%	– R465,600
Net distribution received	R2,638,400
Repayment of loan	R1,000,000
Net amount pocketed	R3,638,400

However, if you sold the shares and loan in the company for R5,000,000 you would realise R4,344,164 determined as follows:

CGT on sale of loan:

Proceeds attributed to loan	R1,000,000
Base cost	– R1,000,000
Capital gain	R0
CGT at 16.4% effective rate on capital gain	R0

CGT on sale of shares:

Proceeds attributed to shares	R4,000,000
Base cost	– R1,000
Capital gain	R3,999,000
CGT at 16.4% effective rate on capital gain	R655,836

Amount pocketed:

Proceeds	R5,000,000
CGT	– R655,836
Net amount pocketed	R4,344,164

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COMMERCIAL PROPERTY: THREE WAYS TO SAVE TAX

CONTINUED

One way of inducing the buyer to take the shares and loan is to reduce the price. In that case you may still pocket a higher amount after tax than would have been the case if the buyer bought the property.

In other words, in the case where you sell the shares and loan in the company, as opposed to the case where the company sells the property and distributes the profit to you, you will pocket R705,764 more.

Now, an astute buyer may be disinclined to buy the shares and loan. First, the purchaser may think that they are taking over a company with skeletons in its closet. For example, the buyer may be nervous about the company's VAT affairs. Second, the buyer would be taking over the "latent" CGT and dividends tax relating to the property. In other words, if the buyer bought the property from the company their base cost would be R5,000,000; if they bought the shares and loan then the company would still retain its base cost of R1,000,000 and the buyer would need to account for dividends tax when the company distributes the net gain to them.

One way of inducing the buyer to take the shares and loan is to reduce the price. In that case you may still pocket a higher amount after tax than would have been the case if the buyer bought the property. The benefit to the buyer is that they would pay less money now which they could use to fund the "latent" CGT and dividends tax in future, and possibly have money to spare.

You could also offer the buyer comprehensive warranties to cater for any hidden liabilities in the company. One could even place a part of the price in trust (escrow) for a period of time. The buyer would not need to go through the hassle of registering for VAT. As a final inducement to the buyer you could offer to restructure the property holding using the corporate relief provisions so that the buyer could hold the property in a new company with your company having been deregistered or wound up.

Ben Strauss

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IN VINO VERITAS: AN IMPORTANT CASE FOR THE WINE FARMING INDUSTRY

The Supreme Court of Appeal handed down judgment where it had to interpret s26(1) and certain paragraphs of the First Schedule.

The South African wine industry is internationally renowned for the quality of wine it produces. From a tax perspective, a specific tax dispensation applies to income derived by a person from "pastoral, agricultural or other farming operations" as contemplated in s26(1) of the Income Tax Act, No 58 of 1962 (Act). To the extent that a person's taxable income is derived from such operations, the First Schedule to the Act will apply. We previously discussed s26(1) and the First Schedule in our Alert of 8 April 2016: The Kluh-ed up taxpayer wins – a decision on s26 of the Income Tax Act.

Avenant, the taxpayer, carried on "pastoral, agricultural or other farming operations" in terms of s26(1) of the Act and filed tax returns which showed that a portion of his overall taxable income was derived from his farming operations.

On 1 June 2016, the Supreme Court of Appeal (SCA) handed down judgment in *Avenant v The Commissioner for the South African Revenue Service* (367/2015) [2016] ZASCA 90 (1 June 2016), where it had to interpret s26(1) and certain paragraphs of the First Schedule. This case forms the subject matter of this article.

Facts

Avenant, the taxpayer, carried on "pastoral, agricultural or other farming operations" in terms of s26(1) of the Act and filed tax returns which showed that a portion of his overall taxable income was derived from his farming operations. The farming income consisted of payments that the taxpayer received from a co-operative (Co-op), of which he was a member, for grapes that he delivered to the Co-op for the purpose of being made into wine. On delivery, the taxpayer's grapes were pressed into a pulp and mixed with the pulp from pressing grapes of the same cultivar and class, such as Sauvignon Blanc and Chenin Blanc, delivered by other farmers, who were also members of the Co-op. These common pools of individual cultivars and classes of grapes were managed by the Co-op.

As at midnight on 28 February 2009, (the end of taxpayer's 2009 year of assessment) all of the taxpayer's harvested grapes had been delivered to the Co-op and pressed into pulp to begin the process of wine making. The Co-op thereafter bottled or packaged the wine, marketed and sold it. The members of the Co-op did not sell their produce, or transfer ownership to the Co-op meaning
it did not become the owner of the produce.

Judgment

The SCA had to decide the following four questions:

Whether the income received by the taxpayer, which is generated by the sale of wine, constitutes income derived from "carrying on pastoral, agricultural or other farming operations" in terms of s26(1) of the Act?

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 operation. The income earned from the sale of wine is therefore also taxable in terms of the First Schedule.

Whether the pressing of the grapes delivered by the taxpayer to the Co-op results in the pulp no longer constituting 'produce' as contemplated in paragraph 2 of the First Schedule?

The taxpayer argued that after the grapes were pressed they no longer existed at midnight on 28 February 2009 and once the resultant pulp was mixed with the pulp

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IN VINO VERITAS: AN IMPORTANT CASE FOR THE WINE FARMING INDUSTRY

CONTINUED

The court held that a contextual and purposive interpretation of the word 'produce' had to be adopted.

from other farmers' grapes, the mixture was a work-in-progress in a process of manufacture, namely the manufacture of wine by the Co-op and therefore not the taxpayer's produce at all. The taxpayer further argued that the process whereby the mixed pulp was treated with chemicals to aid the fermentation process constituted a process of manufacture which substantially changed the character of the materials out of which the wine was made, meaning it no longer constituted 'produce' of the farming operation. The court rejected this argument and agreed with SARS that the pulp was essentially 'wine in process', which fell within the concept of the 'produce' of a wine grape farmer as envisaged by the First Schedule. The principle laid down by the court was that:

> The extent to which the identity of a natural product may be transformed by some form of treatment until it no longer exists as produce, must depend upon the product as well as the nature and extent of the processing, or treatment, to which it is subjected. Each case must be decided upon its own facts.

The extent to which the raw product loses its identity by confusion and survives only as an inseparable portion of a factory product due to the manufacturing process, is an important consideration to take into account to answer this question, but did not apply in this instance.

The court further held that a contextual and purposive interpretation of the word 'produce' had to be adopted. Produce, as in the case of 'trading stock' dealt with in s22 of the Act, includes work-in-progress, and therefore the pulp produced by pressing the grapes falls within the definition of 'produce'.

The SCA held that the principle underlying the inclusion of closing stock in the income tax calculation, being the balancing of the person's tax calculation for that tax year and which also underlies paragraph 2 of the First Schedule, had to be applied by taking into account the existence of the pulp in that tax year.

Whether the pressing into a pulp of the taxpayer's grapes and its subsequent mixing with the pulp of other members of the Co-op, results in what was delivered by the taxpayer no longer being "produce held and not disposed of by him", in terms of paragraph 2 of the First Schedule?

The court stated that just as trading stock is 'held and not disposed of' if the taxpayer has ownership in it, the same principle applied to 'produce'. Here, the taxpayer retained ownership even though the grapes were delivered to the Co-op, meaning they were still 'held' in terms of paragraph 2 of the First Schedule. The SCA held that the taxpayer retained joint ownership, in an undivided share, of the pooled pulp and at a later stage the pooled wine, pro rata to his contribution of grapes to the pool.

As the taxpayer retained ownership of the pulp, the Co-op could never have held it for the purpose of sale by itself. The pulp remained the taxpayer's "own produce derived from his or her farming operations" in terms of paragraph 2 and he therefore had to have accounted for his produce. If this were not the case, farmers could mix their produce together before the year end to avoid having to account for closing stock. Such an interpretation gives effect to the purpose of the legislation, is in accordance with its language, and achieves sensible and business-like results.

CLIFFE DEKKER HOFMEYR

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CONTINUED

The court dismissed the appeal with costs and upheld the decision of the Tax Court to refer the matter back to SARS for re-assessment.

Did the pulp have a value at midnight on the last day of the 2009 year of assessment?

The court had to consider paragraph 9 of the First Schedule, which merely states that the value to be placed on the 'produce', as referred to in paragraph 2, must be 'fair and reasonable'. SARS is not compelled to apply a market value, but may adopt another method provided it is fair and reasonable. The taxpayer argued that the pulp had a negative value as the production costs incurred by the Co-op prior to any grapes being delivered to it, exceeded the pulp's intrinsic value. SARS argued that the value of the pulp was greater than zero, when valued with reference to either the distilling wine price or the pulp's production cost.

The court held that the pulp was not valueless when one considered that the wine to be produced is intended to be sold at a profit and that in each year the taxpayer had received positive returns from the pool. The distilling wine price was an ascertainable value, reflected in wine statistics and publications and was a calculated by using a specific formula. The court found that this method of calculation is practical, workable and realises a positive value for the stock and therefore places a fair and reasonable value on the stock. Regarding the production costs method, the court found that the taxpayer's costs in relation to his wine farming activities were objectively ascertainable based on the evidence before it and this was therefore also an acceptable method of calculation.

Finding

The court dismissed the appeal with costs and upheld the decision of the Tax Court to refer the matter back to SARS for re-assessment. SARS is entitled to re-assess the taxpayer to tax in accordance with the principles set out in this judgment.

Comments

Although the facts of the case relate to the wine farming industry, the SCA's judgment has implications for the broader farming community as well. In essence, where a person conducts operations that fall within the scope of s26(1) of the Act, any produce from these operations that such person has not disposed of at the end of their year of assessment and over which they retain ownership, will have to be included in their income tax calculation for that year of assessment. Furthermore, if the goods produced in terms of the s26(1) operations went through a manufacturing process before being sold as the final product, they will still constitute 'produce'. For the natural product to no longer constitute 'produce', it will have to lose its identity. Whether such loss of identity has occurred will depend upon the product as well as the nature and extent of the processing, or treatment, to which it is subjected.

Based on this principle, a farmer of seeds or nuts who has delivered seeds or nuts to a co-operative where they might go through a cleaning process before being packaged and sold to the public, will most likely have to include any seeds or nuts not yet sold at the end of a year of assessment. On the other hand, a farmer producing grain used in the production of bread or producing mealies to be used in the production of mealie meal, might not have to include the processed, but unsold bread or mealie meal as 'produce' at the end of the year of assessment, if it is found that the grain or mealie meal, has lost its identity due to the extent of the manufacturing process to which it has been subjected.

Louis Botha and Heinrich Louw

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CUSTOMS AND EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs & Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

We will be providing a brief overview of the Customs and Excise environment in our weekly Tax Alert. This is the first instalment of the series.

Below are this week's selected highlights:

- The Republic of Croatia's accession to the European Union Protocol of Trade.
- Rebate item 412.10: Value for *bona fide* unsolicited gifts increased from R400 to R1400. Schedule 1 to the Value-Added Tax Act, No 89 of 1991 has been amended accordingly.
- The Border Management Authority Bill [B9-2016] was tabled in Parliament on 25 May 2016. The aim of the Bill is:

  To provide for the establishment, organisation, regulation, functions and control of the Border Management Authority; to provide for the appointment, terms of office, conditions of service and functions of the Commissioner; to provide for the appointment and terms and conditions of employment of officials; to provide for the duties, functions and powers of officers; to provide for the establishment of an Inter-Ministerial Consultative Committee, Border Technical Committee and advisory committees; to provide for delegations; to provide for the review or appeal of decisions of officers; to provide for certain offences and penalties; to provide for the Minister to make regulations with regard to certain matters; and to provide for matters connected therewith.
- Sub-heading 2004.10 in the tariff book relating to potato products has been amended. The terms of the headings are now more descriptive as additional subheadings have been added.
- The wording of item 260.02 of Schedule 2 have been amended relating to frozen potato chips.
- Note 6 to Schedule 6 relating to Diesel Rebates have been amended. Please enquire for additional information.

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BBBEE STATUS: LEVEL THREE CONTRIBUTOR
Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 3 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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