



BRIEFING NOTE

GUIDELINES – RECOGNITION OF PRODUCE HELD BY WINE FARMERS IN A POOL

The purpose of these guidelines is to assist wine farmers/producers that are participants in pool arrangements (pool participants) to determine their portion of the value of produce held in a pool(s) on their behalf by cooperatives, cellars or other wine producing/marketing entities (pool operators), for purposes of taking such amounts into account in the determination of their income derived from farming operations.

These guidelines *inter alia* address:

- the practical approach to determine the value of pool participants proportion of produce held in a pool;
- eligible taxpayers;
- the effective date of implementation;
- taxpayers who deviate from the proposed methodology;
- the transitional arrangements;
- the reporting obligations of pool operators;
- pool participants who ceased farming operations during a year of assessment;
- production loans; and
- the consequences of failure of pool participants to include the value of stock held in a pool.

These proposed guidelines are available on the SARS website www.sars.gov.za under **What's New** and **Legislation/Policy Documents**.

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1 PURPOSE OF GUIDELINES

The purpose of these guidelines is to assist wine farmers/producers who are participants in pool arrangements (pool participants) to determine their portion of the value of produce held in a pool(s) on their behalf by cooperatives, cellars or other wine producing/marketing entities (pool operators), for purposes of taking such amounts into account in the determination of their income derived from farming operations.

These guidelines will not be applicable in respect of produce held in a pool where the pool participants are no longer regarded as the (joint) owners of the produce after delivery of the produce to the pool operator, i.e. where the pool operator is regarded as the owner of the produce after receipt thereof. In such cases, the value of the produce held in the pool must be taken into account in the determination of the pool operator's income.

2 BACKGROUND

For purposes of these guidelines a pool is classified as the collective produce received from various pool participants for a specific harvest year with reference to a specific cultivar (and if further distinguished by classes or regions, also such sub-classification).

Producer participants in pool arrangements deliver vine produce to pool operators, for example, agricultural co-operatives in terms of pool arrangements. These produce undergo further processing and the final products are usually disposed of by the pool operators on behalf of the pool participants.

Paragraphs 2 and 3 of the First Schedule to the Income Tax Act, No. 58 of 1962 (the Act) provides that –

- the value of produce “held and not disposed of” at the beginning and end of the year of assessment of a farmer must be included in the return of income rendered by a farmer for income tax purposes;
- the value of produce “held and not disposed of” at the end of the year of assessment must be included in the farmer's income for that year of assessment; and
- a deduction will be allowed to the farmer in that year of assessment in respect of the value of the produce “held and not disposed of” at the beginning of the year of assessment.

Paragraph 9 of this Schedule, furthermore, provides that the value to be placed on

produce held and not disposed of shall be such fair and reasonable value as the Commissioner may fix. It is the practice of the Commissioner to accept the lower of production cost or market value as the fair value of produce for stock inclusion purposes.

It has been the practice of pool participants to only include in their income from farming operations income actually received from pool operators. No value relating to produce held in a pool(s) by pool operators on their behalf has been taken into account in the determination of their income from farming operations.

However, it is the view of SARS that where a pool operator processes and/or sells produce as an agent on behalf of pool participants, ownership of the pooled products vests in the pool participants until the produce or the final products that are manufactured from the produce is sold by the pool operator on behalf of the pool participants. The provisions of section 23F will, therefore, not be applicable to these pool participants as the produce is still regarded as being held and not disposed of at year-end.

Deductions in respect of expenditure incurred by a pool participant with regard to produce delivered to a pool, for example, wages of farm workers and costs relating to the replacement of plant material are taken into account in the determination of a pool participant's income from farming operations in the year of assessment when the expenditure is incurred and not only when the produce is sold by the pool operator on behalf of the pool participant.

If no amount with regard to the unsold produce held by the pool operator on behalf of the pool participant is taken into account in the determination of the pool participant's income from farming operations, a deferral of the tax liability of the pool participant will occur.

In principle, the value of produce held by a pool operator on behalf of a pool participant at the end of the year of assessment, therefore, has to be included in the income of the pool participant. A deduction will, furthermore, be allowed in respect of the value of produce held by the pool operator on behalf of the pool participant at the beginning of the year of assessment.

SARS recognises that the determination of the value of produce held by a pool operator on behalf of pool participants may create certain practical difficulties. It is, therefore, prepared to accept the practical approach as set out in paragraph 3 of these guidelines for purposes of the determination of the value of produce held by pool participants in a pool.

The view is held that this practical approach will strike a balance between:

- Unnecessary deferral of the taxable income of wine farmers/producers;
- Having an administratively efficient recording procedure that will be applied consistently to all wine farmers/producers; and
- Obtaining clarity and avoiding ongoing disputes with regard to produce held by pool participants in a pool(s).

3 PRACTICAL APPROACH

3.1 Introduction

A practical approach is proposed for the determination of the value of produce held by pool operators in a pool(s) on behalf of pool participants that are wine farmers/producers. Where a person is a pool participant in respect of more than one pool, the value of the proportionate share of produce owned collectively in respect of each pool must be determined.

In terms of this approach the value of produce held by a pool participant in a specific pool at the end of the participant's year of assessment will be equal to an amount determined by multiplying the production cost relating to the produce delivered to that pool (expressed as a cost per litre) by the participant's proportionate share of the liquid stock held in the pool at the end of the year of assessment of the pool operator that immediately precedes the end of the year of assessment of the pool participant (or at the end of the year of assessment of the pool participant where the pool operator is prepared to provide such information on that date. This principle will apply in all the circumstances contained in these guidelines).

The effect of this approach will, furthermore, be that any proceeds of produce sold by a pool operator, but not yet paid over to the pool participants at the end of the pool operator's year of assessment that immediately precedes the end of the pool participant's year of assessment, less the relevant co-operative costs (e.g. processing, maturing and marketing costs), must also be included in the pool participant's income for that year of assessment.

Payments received from a pool operator must, however, continue to be included whenever they are received and no adjustments must be made to the value of a pool participant's produce held in a pool that must be included in the pool participant's income from farming operations, in respect of any produce sold during the period between the end of the pool operator's year of assessment and the end of the pool participant's year of assessment.

3.2 Eligible taxpayers

The practice as set out in these guidelines will be applicable in respect of the following persons:

- South African resident wine farmers/producers that are participants; and
- Non-resident wine farmers/producers that are pool participants with a South African source of income from wine production,

except where such a person elects not to follow the practical approach.

Eligible taxpayers that elect not to follow the practical approach as set out in these guidelines, are obliged to determine the fair value of their produce “held and not disposed of” at the end of every year of assessment in terms of an alternative method and to include such amount in their income from farming operations, irrespective of whether the produce is held by them or the pool operator.

3.3 Determination of fair value of produce in terms of practical approach

The value to be placed on produce held and not disposed of by the pool operator on behalf of pool participants is the fair and reasonable value as the Commissioner may fix. A fair value is considered to be the lower of production cost or market value (which could comprise a lower realizable value).

In terms of the practical approach the fair value of stock held by a pool participant i.r.o. a specific pool should be determined as follows:

- Step 1: Determine the total produce delivered to the pool operator by all pool participants in respect of the pool (as expressed in litres) [a]
- Step 2: Determine the participant's proportion of the total produce delivered to the pool operator in respect of the pool (as expressed in litres) [b];
- Step 3: Determine the pool participant's production cost pertaining to the produce delivered to the pool operator in respect of the pool, as a cost per litre [c];
- Step 4: Determine the amount of liquid stock held in the pool at the end of the year of assessment of the pool operator that precedes the end of the year of assessment of the pool participant [d];

- Step 5: Determine the participant's proportionate share of the liquid stock held in the pool at the end of the year of assessment of the pool operator that precedes the end of year of assessment of the pool participant by multiplying the participant's proportion of the total produce delivered to the pool operator in respect of the pool (as determined in step 2) by the amount of liquid stock held in the pool at the end of the year of assessment of the pool operator that precedes the end of the year of assessment of the pool participant $([b] \times [d])$;
- Step 6: Determine the value of the participant's proportionate share of the produce held at the end of the year of assessment of the pool operator by multiplying the production cost of the participant as expressed as a cost per litre (as determined in step 3) by the participant's proportionate share of the liquid stock held in the pool at the end of the year of assessment of the pool operator that precedes the end of the year of assessment of the pool participant (as determined in step 4) $[(b) \times (c)]$.

Note:

Pool operators record participants' delivery inputs in metric tons and use that as a basis to distribute pool proceeds and costs. The total liquid stock measured in litres, held by every pool at the end of the year of assessment of the pool operator has to be divided by the pool operator between pool participants in an appropriate manner based on tonnage delivered at inception.

Only direct expenditure incurred until the date of delivery of the produce to the pool operator must be taken into account in the determination of the production cost relating to the produce. Co-operative costs relating to unsold produce will, for example, not be taken into account in the determination of the production cost for purposes of the determination of the value of stock held by a pool participant in a pool. These costs will only be taken into account in the determination of a participant's income from farming operations when income is paid or accrues to the participant from the sale of such produce, i.e. the net amount paid (income less pool operators' expenses allocated) over or accrued to the pool participant from the pool operator will, therefore, be included in the pool participant's income from farming operations.

The following production expenses must, for example, be taken into account in the determination of production cost:

- Productive wages and related costs (excluding administrative staff and labour cost to establish new vineyards, but including production management costs)

- Repairs and maintenance of equipment (e.g. vehicles, irrigation, electrical pruning, crop spraying and harvesting equipment)
- Replacement cost of plant material
- Water and electricity
- Diesel (excluding transport to the market)
- Insecticides and fertiliser

The following expenses/costs must, for example, not be taken into account:

- Depreciation of farm equipment, vehicles, vineyard establishment costs (plant material, irrigation systems, pergola's etc.) and other capital development costs such as roads, electrical supply cables, dams, irrigation works, etc.
- Interest paid
- Short term insurance
- Administrative costs such as bank charges, accounting, auditing and computer charges
- Cooperative costs of enhancement, beneficiation or transformation

3.4 Determination of fair value of produce in terms of an alternative approach

Where there is reason to believe that the value of liquid stock held by a pool operator on behalf of pool participants on the last day of a year of assessment of the pool operator does not constitute the realisable value of the stock if determined in terms of the practical approach, SARS will on application by the pool operator in respect of that year of assessment entertain the use of a market related value of produce held in that pool, where the majority of the pool participants of that pool collectively so decide.

The market related value of the produce will, for example, be determined with reference to the market related guideline prices per litre of specific cultivars negotiated with producers at the beginning of the harvest season or external buyers of produce.

This would be the case where the pool participants are of the view that the cost and administration of determining production cost are too onerous and will cause inordinate delays in finalising their tax returns. Such deviation methodology must, however, be consistently and uniformly applied by all the pool participants of a pool.

Guideline prices supplied by cellars or bulk buyers are often not sustainable. Production costs supplied per region or the current price of distilling wine (“stookwyn”) as per reputable organisations such as SAWIS or VINPRO, may also provide a reasonable method of cost determination.

3.5 Effective date of implementation

The proposed practical approach will be applicable with effect from the 2007 year of assessment of participating wine producers, i.e. all years of assessment ending on or after 1 January 2007. However, taxpayers who have been assessed for any year of assessment ending before 1 January 2007 on a basis different than the proposed practical approach may apply to have such an assessment revised, provided that -

- the assessment has not become prescribed as at the date of application;
- the assessment has not been subject to a settlement and became final; and
- the taxpayer undertakes to follow the application of the proposed methodology in respect of the 2007 and subsequent years of assessment.

3.6 Transitional arrangements

The value of produce “held and not disposed of” at the end of the year of assessment of the pool operator immediately preceding the pool participant’s year end, must be included in a pool participant’s income for that year of assessment. A deduction will, furthermore, be allowed to the pool participant in that year of assessment in respect of the value of the produce at the beginning of the year of assessment (to the extent it was included in a previous year of assessment).

As wine farmers/producers that are pool participants have previously (until the 2006 year of assessment) not included any value in respect of produce held in a pool(s) in their income from farming operations, certain transitional arrangements are proposed with regard to the application of the practical approach in respect of these pool participants.

These transitional arrangements will only be applicable in respect of wine farmers/producers that were pool participants in a pool arrangement(s) during their 2006 year of assessment with respect to the 2006 harvest year.

The value of harvested produce, delivered by a pool participant to a pool during the participant’s 2006 and earlier years of assessment that has not being disposed of by the pool operator by the end of its year of assessment, immediately preceding the pool participant’s year end, does not have to be included in the pool participant’s income for the 2006 year of assessment in terms of the practical approach.

Example:

Farmer X (year-end 28 February) has delivered produce during 2006 to Cellar Y who has a 31 December year-end. At 28 February 2006, he will not yet include unsold produce on hand by the cellar as at 31 December 2005. At 28 February 2007, he will however be required to include produce on hand by the cellar as at 31 December 2006. In the example this stock recognition could be for produce delivered during his 2006 and 2007 tax year (e.g. grapes delivered in February 2006 and March 2007).

No deduction will, logically, be allowed to the pool participant in the 2007 year of assessment in respect of the value of this pool produce at the beginning of the 2007 year of assessment.

The value of the pool participant's proportionate share of produce held in the pool must, in terms of the practical approach for the first time be included in the participant's income for the 2007 year of assessment, i.e. any year of assessment ending on or after 1 January 2007. The value of produce "held and not disposed of" at the end of the year of assessment of the pool operator immediately preceding the end of the year of assessment of the pool participant must, therefore, be included in the pool participant's income for the 2007 year of assessment.

Example:Facts:

Farmer A farms in his own capacity and produces mainly red grapes for wine production. By 28 February 2006 he had not commenced harvesting, but delivered the bulk of his produce to the pool during March and April 2006. The pool operator has a year-end of 31 December. Payments were made to him in May 2006 and May 2007 in respect of these produce deliveries. Certain co-operative costs were also allocated to him when these payments were made. The pool operator, furthermore, informed him that some of the processed produce was sold during November 2007, but payments will only be made in March 2008 in this regard. Certain co-operative costs have been allocated to these amounts.

Effect of guidelines:2006 year of assessment (ending on 28 February 2006):

Income (No amounts were received or accrued (sold but unpaid))	R NIL
Add: Value of produce at end of year of assessment (No value to be included: transitional arrangements)	R NIL
Total income from farming operations carried on in pool	R NIL

<u>2007 year of assessment (ending on 28 February 2007):</u>	
Income received May 2006 (Gross income less allocated co-operative expenses)	R X
Add: Value of produce at end of year of assessment (Value of his proportionate share of the unsold produce held in the pool (in litres) on the last day of the year of assessment of the pool operator (31 December 2006) preceding the last day of his year of assessment (28 February 2007), valued at his cost price expressed per litre)	R Y
Less: Deduction in respect of value of produce at beginning of year of assessment (No deduction will be allowed: transitional arrangements)	R NIL
Total income from farming operations carried on in pool	R X + R Y
<u>2008 year of assessment (ending on 28 February 2008):</u>	
Income received May 2007 (Gross amount less allocated co-operative expenses)	R X
Income accrued November 2007 (Sold but unpaid produce during year of assessment of entity through which pool operated - gross amount less allocated co-operative expenses)	R XX
Add: Value of produce at end of year of assessment (Value of his proportionate share of the unsold produce held in the pool (in litres) on the last day of the year of assessment of the pool operator (31 December 2007) that precedes the last day of his year of assessment (28 February 2008), valued at his cost price expressed per litre)	R YY
Less: Deduction in respect of value of produce at beginning of year of assessment (Amount equal to value of produce at end of previous year of assessment)	R Y
Total income from farming operations carried on in pool	R X + R XX + R YY - R Y

3.7 Income recognition by pool participants that apply the practical approach

In terms of the current practice, wine farmers that were pool participants during the 2006 year of assessment and that elect to follow the practical approach as set out in these guidelines will not have to include any value relating to one of the following in their income derived from farming operations during their 2006 year of assessment:

- Harvest that are growing crops
- Produce that are not marketable in whatever format.

In terms of the practical approach, it is furthermore not necessary to include produce delivered to a pool during that year and previous years of assessment (other than in terms of normal contract of sale) that was not disposed of by the pool operator on the last day of the 2006 year of assessment of the pool participant.

The following must be included by a pool participant in respect of the 2007 and subsequent years of assessment in the income from farming operations carried on in a pool:

- All actual receipts of payments from the pool operator during the relevant year of assessment, irrespective of the harvest year (as was previously required);
- The amounts that accrued to the pool participant in respect of produce delivered to the pool, relating to the current or any previous harvest year, that had been disposed of by the pool operator by the end of its year of assessment but in respect of which payment has not yet been made to the pool participant on the last day of the pool operator's year of assessment, less appropriately allocated cooperative costs (i.e. processing administration and marketing cost) as determined by the pool operator; and
- The pool participant's proportionate share of the liquid stock held in a pool(s) at the year-end of the pool operator immediately preceding the pool participant's year-end valued at the production cost relating to the produce delivered to the pool.

Stock figures for produce determined for inclusion in a specific year of assessment will be brought into account as a deduction in the following year of assessment as prescribed by paragraph 3(1) of the First Schedule.

3.8 The reporting obligations of pool operators

Currently, pool operators are obliged to issue IT 3(e)'s to pool participants whenever payments, other than production loans, are made to such pool participants. These IT3(e)'s must distinguish between gross payments made to participants, relevant cooperative costs deducted from payments made to pool participants and the net payments made to them.

When the new practical approach is followed regarding the determination of the value of produce held by pool participants in a pool, it will, furthermore, be expected from these pool operators to provide each pool participant of a pool with the following information:

- Amounts pertaining to actual proceeds of produce sold on behalf of the pool participants during the year of assessment of that pool operator, but not yet paid over to the pool participant on the last day of the pool operators' year of assessment distinguishing between different harvest years;
- Details of cooperative costs that can reasonably be allocated to these unpaid sales;
- Details of the participant's proportion of the total liquid stock delivered to the pool(s) during the pool operator's year of assessment (expressed as a percentage);
- Details of the participant's proportionate share of the liquid stock held in the pool(s) at the year-end of the pool operator or the year-end of the pool participant, if so agreed to by the pool operator;

The pool operator will be required to repeat the afore-mentioned process in respect of each pool until the pool is closed off.

As regards the reporting by the pool operator of debtors' figures (sold produce but unpaid to producers) of pool operators, the issue of bad debts arises. As debtors finally written off by the cellar will reflect in reduced pay-outs to producers, producers will at that point enjoy the effective write-off for tax purposes.

In order to reduce the administrative burden on pool operators to provide bad debt allowances and their reversals in every period of reporting, it is proposed that this factor not be reported at interim cut-off dates unless there is a material financial failure of a debtor or other commercial reason for debt becoming irrecoverable (e.g. product defects not covered by insurance).

In the latter event, the pool operator will be required to disclose such figures

separately in any statement supplied to pool participants issued in terms of these guidelines.

3.9 Pool participants who ceased farming operations during the year of assessment

For various reasons pool participants can cease farming operations during a year of assessment. Examples of these would be a farmer who carries on farming operations in his or her personal capacity and dies during a year of assessment or a corporate entity which is placed in liquidation or is deregistered during a year of assessment. The liquidation and distribution accounts of these pool participants can only be finalised once the final tax liability of these pool participants is determined. In order to determine such tax liability, it is necessary to determine the value of the pool participants' proportionate share of the produce held in the pool on the date of death, liquidation or deregistration.

Pool operators will, therefore, in the case of the death, liquidation or deregistration of a pool participant during a year of assessment be required to provide the information as discussed in paragraph 5 to the administrator or liquidator of an estate in order to enable him/her to finalise the liquidation and distribution accounts of the estate. This requirement will only be applicable for events occurring on or after 1 January 2007.

3.10 Production loans

Production loans will not be recognised for income tax purposes as income in the hands of the pool participants, provided they are *bona fide* and not disguised advances on produce deliveries.

The following criteria can be applied as guidelines to determine whether a payment can be regarded as a production loan:

- the proven dependence of the recipient on applying such funds for direct production expenses such as vineyard establishment, or running expenses such as wages, fertiliser, irrigation, etc;
- timing of the payment, i.e. well before the time of the expected harvest; and
- the levying of interest could be indicative of a loan as apposed to a production advance.

4. Consequences of failure of pool participant to include value of stock held in pool

Where pool participants fail to determine such amounts and take it into account in the determination of their income from farming operations, SARS may –

- require the appropriate pool operators to furnish appropriate information in order to determine the relevant values; or
- determine estimated values; and
- issue additional assessments to take such amounts into account in the determination of the participant's income from farming operations.

5. Conclusion

It is the view of SARS that the value of produce held and not disposed of by wine farmers be taken into account in the determination of their income derived from farming operations. The success of the implementation and application of these guidelines will largely depend on the cooperation of all parties involved, especially the pool operators in providing the necessary information accurately and timeously.