

**AN INTERNATIONAL COMPARATIVE STUDY OF THE VALUE-ADDED  
TAX IMPLICATIONS OF CHANGE IN USE ADJUSTMENTS BY  
RESIDENTIAL PROPERTY DEVELOPERS**

by

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## **ABSTRACT**

# **AN INTERNATIONAL COMPARATIVE STUDY OF THE VALUE-ADDED TAX IMPLICATIONS OF CHANGE IN USE ADJUSTMENTS BY RESIDENTIAL PROPERTY DEVELOPERS**

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Residential property developers face an ever-increasing problem of disposing of their newly built residential premises. The problem exists because of an oversupply of residential property and a decrease in property sales over the past few years.

The VAT consequences of such a change in use of a property could have catastrophic implications for the property developer in terms of cashflow. In the 2010 budget speech, the Minister of Finance of South Africa acknowledged that harsh VAT legislation exists.

The aim of this study is to determine a way of amending South African VAT legislation to accommodate property developers during the period when residential properties are temporarily let out.

It was concluded that South Africa's current VAT legislation with regard to change in use of residential properties is far worse than that of New Zealand and Australia, but that the proposed amendments will offer some degree of relief. The situation, even after implementing the amendments to legislation, will still not give sufficient relief and another solution is put forward for consideration.

**Keywords:**

Value-added tax

VAT

VAT input tax

VAT output tax

Property developer

Residential property

Change in use

Temporary letting

## OPSOMMING

# **‘N INTERNASIONAAL VERGELYKENDE STUDIE VAN DIE BELASTING OP TOEGEVOEGDE WAARDE IMPLIKASIESVAN VERANDERING IN GEBRUIKSAANPASSINGS DEUR RESIDENSIËLE EIENDOMSONTWIKKELAARS**

deur

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Residensiële eiendomsontwikkelaars staar toenemende probleme met die verkoop van hulle nuutgeboude residensiële eiendomme in die gesig. Die probleem het ontstaan weens die toenemende beskikbaarheid van residensiële eiendomme in die mark, sowel as die afname in die eiendomsmark die afgelope paar jaar.

Die BTW-gevolge van sodanige verandering in gebruik van ’n eiendom mag katastrofiese gevolge vir die eiendomsontwikkelaar inhou wat betref kontantvloei. In die 2010-begrotingsrede het die Minister van Finansies van Suid-Afrika erken dat problematiese BTW wetgewing bestaan.

Die doel van hierdie studie is om te bepaal in watter mate die Suid-Afrikaanse BTW-wetgewing verander kan word ten einde eiendomsontwikkelaars te akkommodeer gedurende die periode waarin hulle eiendomme tydelik uitverhuur word.

Daar is gevolglik vasgestel dat Suid-Afrika se BTW-wetgewing met betrekking tot die verandering in gebruik deur eiendomsontwikkelaars erger is as die wetgewing in Nieu-Seeland en Australië, maar dat die voorgestelde wetswysigings ietwat van ’n verligting sal bied. Die situasie, selfs ná die implementering van die wetswysigings, sal steeds nie voldoende verligting bied nie en ’n ander oplossing word voorgestel.

**Sleutelwoorde:**

Belasting op toegevoegde waarde

BTW

BTW inset belasting

BTW uitset belasting

Eiendomsontwikkelaar

Residensiële eiendom

Verandering in gebruik

Tydlike verhuring

## TABLE OF CONTENTS

|   |    |
|---|----|
| CHAPTER 1 - INTRODUCTION .....                                      | 1  |
| 1.1 BACKGROUND .....  | 1  |
| 1.2 PROBLEM STATEMENT .....   | 4  |
| 1.3 RESEARCH OBJECTIVES .....                                       | 4  |
| 1.4 IMPORTANCE AND BENEFITS OF THE STUDY .....                      | 5  |
| 1.5 ASSUMPTIONS .....   | 5  |
| 1.6 LIMITATIONS .....   | 5  |
| 1.7 STRUCTURE .....   | 6  |
| 1.8 DEFINITION OF KEY TERMS .....                                   | 6  |
| 1.9 CONCLUSION .....  | 8  |
| CHAPTER 2 - A CONCEPTUAL VIEW OF VAT ON RESIDENTIAL PROPERTIES..... | 10 |
| 2.1 INTRODUCTION .....  | 10 |
| 2.2 PROCEDURAL AND ADMINISTRATIVE ISSUES.....                       | 10 |
| 2.2.1 Consumption or investment .....                               | 10 |
| 2.2.2 Timing of consumption.....                                    | 11 |
| 2.2.3 To what extent are occupiers VAT vendors or consumers? .....  | 12 |
| 2.2.4 Impartial treatment of VAT on residential property .....      | 12 |
| 2.2.5 Administration of VAT on residential property.....            | 12 |
| 2.3 VAT ON RESIDENTIAL PROPERTIES .....                             | 12 |
| 2.3.1 Construction of residential properties .....                  | 13 |
| 2.3.2 Leases of residential properties.....                         | 13 |
| 2.3.3 Sale of residential properties.....                           | 13 |
| 2.4 CONCLUSION .....  | 13 |
| CHAPTER 3 - VAT ON RESIDENTIAL PROPERTIES IN SOUTH AFRICA .....     | 15 |

|  |   |    |
|--|---|----|
| 3.1  | INTRODUCTION TO VAT IN SOUTH AFRICA.....  | 15 |
| 3.2  | CONSTRUCTION AND SALE OF NEW RESIDENTIAL PROPERTIES .....                                   | 16 |
| 3.3  | LEASING OF RESIDENTIAL PROPERTIES .....   | 17 |
| 3.4  | CURRENT SITUATION WITH REGARD TO CHANGE IN USE.....   | 18 |
| 3.5  | PROPOSED AMENDMENTS TO SECTION 18.....  | 19 |
| 3.6  | CASE LAW .....  | 20 |
| 3.7  | CASE STUDY .....  | 20 |
| 3.7.1  | Scenario description.....   | 20 |
| 3.7.2  | Acquisition of the land.....  | 21 |
| 3.7.3  | Completion of the construction work.....  | 21 |
| 3.7.4  | Sale of the units.....  | 22 |
| 3.7.5  | Change in use from taxable supplies to exempt supplies.....                                 | 23 |
| 3.7.6  | Letting of residential units .....  | 24 |
| 3.7.7  | Returning to initial intention of making a taxable supply and disposal of the<br>units..... | 25 |
| 3.8  | CONCLUSION .....  | 27 |
| CHAPTER 4 - GST ON RESIDENTIAL PROPERTIES IN NEW ZEALAND ..... |   | 28 |
| 4.1  | INTRODUCTION TO GST IN NEW ZEALAND .....  | 28 |
| 4.2  | CONSTRUCTION AND SALE OF NEW RESIDENTIAL PROPERTIES .....                                   | 29 |
| 4.3  | LEASING OF RESIDENTIAL PROPERTIES .....   | 30 |
| 4.4  | CHANGE IN USE .....   | 30 |
| 4.5  | CASE LAW .....  | 31 |
| 4.6  | CASE STUDY .....  | 32 |
| 4.6.1  | Scenario description.....   | 32 |
| 4.6.2  | Acquisition of the land.....  | 33 |
| 4.6.3  | Completion of the construction work.....  | 33 |
| 4.6.4  | Sale of the properties.....   | 34 |



|  |   |    |
|--|---|----|
| 4.6.5  | Change in use from taxable supplies to exempt supplies.....   | 35 |
| 4.6.6  | Letting of residential units .....  | 35 |
| 4.6.7  | Returning to initial intention of making a taxable supply.....  | 36 |
| 4.7  | CONCLUSION .....  | 36 |
| CHAPTER 5 - GST ON RESIDENTIAL PROPERTIES IN AUSTRALIA ..... |   | 37 |
| 5.1  | INTRODUCTION TO GST IN AUSTRALIA.....   | 37 |
| 5.2  | CONSTRUCTION AND SALE OF NEW RESIDENTIAL PROPERTIES .....   | 38 |
| 5.3  | LEASING OF RESIDENTIAL PROPERTIES .....   | 39 |
| 5.4  | CHANGE IN USE .....   | 39 |
| 5.5  | CASE LAW .....  | 40 |
| 5.6  | CASE STUDY .....  | 41 |
| 5.6.1  | Scenario description.....   | 41 |
| 5.6.2  | Acquisition of the land.....  | 42 |
| 5.6.3  | Completion of the construction work.....  | 42 |
| 5.6.4  | Sale of the properties.....   | 42 |
| 5.6.5  | Change in use from taxable supplies to exempt supplies.....   | 44 |
| 5.6.6  | Letting of residential units .....  | 45 |
| 5.6.7  | Returning to initial intention of making a taxable supply.....  | 45 |
| 5.7  | CONCLUSION .....  | 46 |
| CHAPTER 6 - CONCLUSION AND RECOMMENDATION .....              |   | 47 |
| 6.1  | INTRODUCTION .....  | 47 |
| 6.2  | CONCLUSION .....  | 47 |
| 6.2.1  | The fundamental principles underlying the identified VAT-systems relating to the imposition of VAT on residential properties .....            | 47 |
| 6.2.2  | The relevant sections of the South African VAT Act that are applicable when a property developer start making temporary exempt supplies ..... | 48 |

|       |   |    |
|-------|---|----|
| 6.2.3 | Comparison of the South African VAT legislation with that of New Zealand and Australia with regard to change in use adjustments applicable to property developers .....               | 48 |
| 6.2.4 | A suggestion for a permanent amendment to the VAT Act that will address the problem identified, that is the harsh cash flow consequences for the residential property developer ..... | 51 |
| 6.3   | FUTURE RESEARCH .....   | 53 |
|       | LIST OF REFERENCES .....  | 54 |

## LIST OF FIGURES

|   |   |
|---|---|
| Figure 1: Standard Bank's median house price growth percentages ..... | 2 |
|---|---|

## LIST OF TABLES

|  |    |
|--|----|
| Table 1: Abbreviations .....   | 8  |
| Table 2: Summary of basic VAT and GST rates.....   | 9  |
| Table 3: Total GST claimable on costs when temporarily let out and not actively marketed .....                                     | 40 |
| Table 4: Total GST claimable on costs when temporarily let out and actively marketed .....   | 40 |
| Table 5: The value-added tax effect on ABC Properties at the GST rates applicable to the case study in the selected countries..... | 49 |
| Table 6: The value-added tax effect on ABC Properties at the equivalent of 14% .....   | 50 |
| Table 7: The change in use effect of present and proposed value-added tax on ABC Properties  | 52 |

## LIST OF CALCULATIONS

|  |    |
|--|----|
| Calculation 1: South Africa: Acquisition of land.....  | 21 |
| Calculation 2: South Africa: Completion of construction work .....   | 22 |
| Calculation 3: South Africa: Sale of 15 units.....   | 22 |
| Calculation 4: South Africa: Sale of three units.....  | 23 |
| Calculation 5: South Africa: Sale of two units.....  | 23 |
| Calculation 6: South Africa: Current situation with regard to change in use from taxable to exempt supplies..... | 24 |
| Calculation 7: South Africa: New situation after 36 month relieve has been utilised .....                        | 24 |
| Calculation 8: South Africa: Return to making taxable supplies on three units .....                              | 25 |

|                 |   |    |
|-----------------|---|----|
| Calculation 9:  | South Africa: VAT lost by a property developer when selling three units .....                             | 25 |
| Calculation 10: | South Africa: Return to making taxable supplies on two units .....  | 26 |
| Calculation 11: | South Africa: VAT lost by a property developer when selling two units .....                               | 26 |
| Calculation 12: | South Africa: New situation where two units are sold .....  | 26 |
| Calculation 13: | South Africa: Comparison of VAT lost by a property developer between the current and new situations ..... | 27 |
| Calculation 14: | New Zealand: Acquisition of land.....   | 33 |
| Calculation 15: | New Zealand: Completion of construction work.....   | 33 |
| Calculation 16: | New Zealand: Sale of 15 units.....  | 34 |
| Calculation 17: | New Zealand: Sale of three units.....   | 34 |
| Calculation 18: | New Zealand: Sale of two units.....   | 34 |
| Calculation 19: | New Zealand: Temporary letting of five units .....  | 35 |
| Calculation 20: | Australia: Acquisition of land.....   | 42 |
| Calculation 21: | Australia: Completion of construction work .....  | 42 |
| Calculation 22: | Australia: Sale of 15 units.....  | 43 |
| Calculation 23: | Australia: Sale of three units.....   | 43 |
| Calculation 24: | Australia: Sale of two units.....   | 43 |
| Calculation 25: | Australia: Temporary letting of five units for one year .....   | 44 |
| Calculation 26: | Australia: Sale of three units previously let out.....  | 45 |
| Calculation 27: | Australia: Sale of two remaining units previously let out .....   | 46 |
| Calculation 28: | Australia: Total GST repaid to the ATO .....  | 46 |

## CHAPTER 1

### INTRODUCTION

#### 1.1 BACKGROUND

On 26 May 2009, Statistics South Africa released data that showed that South Africa's gross domestic product (GDP) has gone through two successive quarters of negative growth. Such an occurrence is an indicator that a country is officially in a recession. The fourth quarter of 2008 indicated a decline in GDP of 1.8%, which was followed in the first quarter of 2009 with another decline of 6.4%. This occurrence resulted in South Africa experiencing its first recession in 17 years (Sapa, 2009).

This was South Africa's first recession since the Value-Added Tax Act (89/1991 – commonly called the VAT Act) came into existence on 30 September 1991.

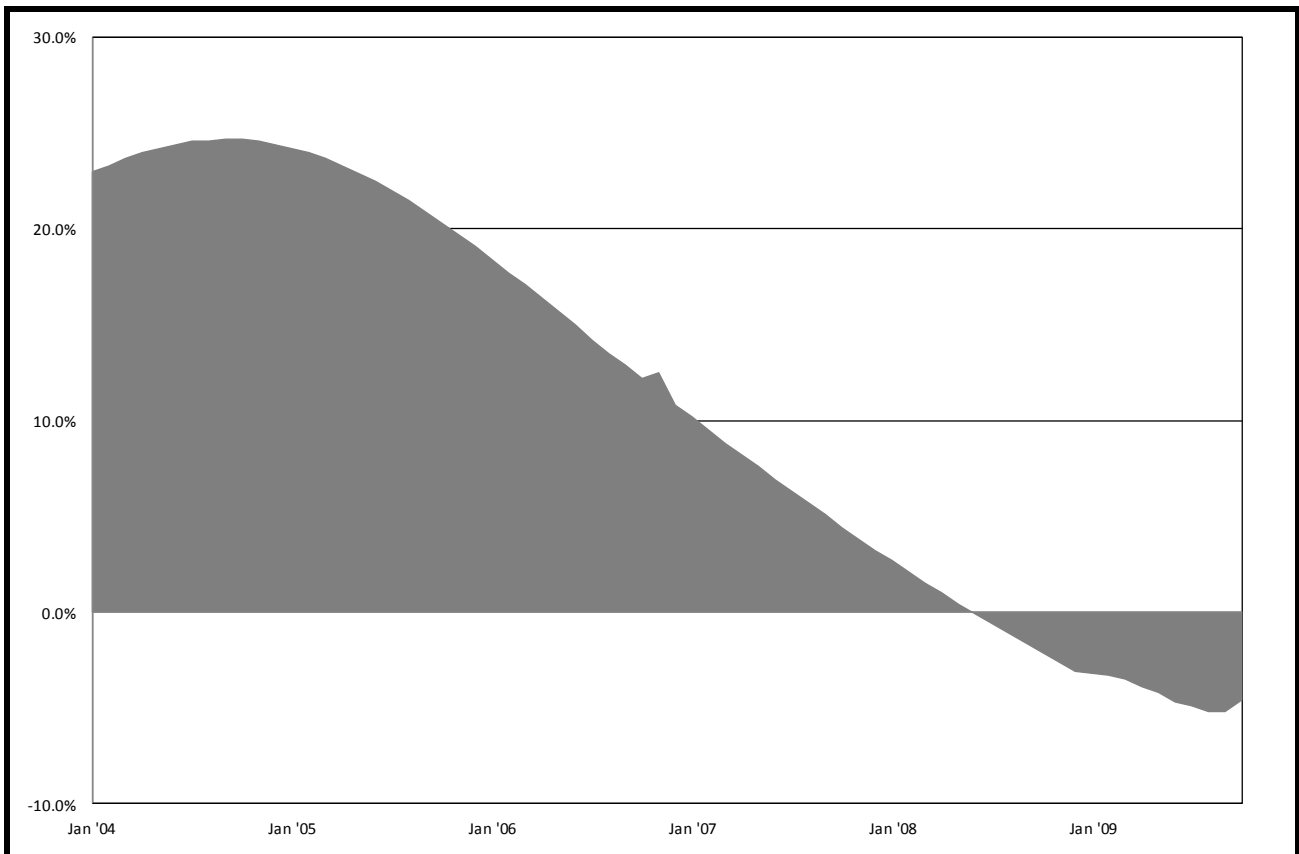
The consequences of the recession have been felt in many industries, including the property market, and property developers will feel the pressure of the recession even more in the light of strict Value-Added Tax (VAT) legislation. Many property developers changed their intentions from a speculative nature, which implies that residential properties are built to dispose of, to an investment nature, which implies that properties are retained to generate rental income. This change in the use of residential property has very specific VAT-consequences.

During the first ten months of 2009, Standard Bank's property book indicated an average monthly decline of 4.3% in the median house price. This median house price benchmark (figure 1) decreased continuously for a period of 17 months (Botha, 2009).

Large municipalities in South Africa recorded a decrease of 44.9% from 2008 to 2009 in the number of residential building plans passed. It was also reported that a decrease of 15.1% was experienced in the completion of residential properties in the period from January to July 2009, compared to the same time in 2008 (Botha, 2009).

Residential building activities are completely restrained due to the building cost inflation exceeding house price deflation. It can therefore be assumed that it will be cheaper to acquire an existing residential property, than to build a new property. Further strain is being place on house prices due to the huge oversupply of unsold residential properties (Botha, 2009).

**Figure 1: Standard Bank’s median house price growth percentages**



Source: Botha, 2009

Due to the current economic recession, property developers temporarily lease the newly constructed dwellings out in anticipation of a sale at a more favourable price. These units may still be held with the ultimate goal of selling them, thereby making taxable supplies. In these instances the property developer needs to make a VAT adjustment with regard to output VAT (Section 18(1) of the VAT Act; SARS, 2011).

VAT News 14 (2000) published an article called: “Temporary letting of residential properties intended for resale”. In this article, the South Africa Revenue Service (SARS) clarifies that where a

property developer lets out a property until he or she is able to sell it; the developer needs to declare output tax on this change in use. Initially, the sale of the property would have given rise to a taxable supply. By letting the property, the taxable supply changes to being an exempt supply and the vendor needs to account for output VAT. The amount of the output VAT must be calculated on the open market value of the property on the date that the lease commences (section 10(7) of the VAT Act).

The Guide to Fixed Property and Construction (SARS, 2011) also states that when the developer subsequently applies the property for the purpose of making a taxable supply, the developer becomes entitled to an input tax credit equal to the output tax previously declared under section 18(1) of the VAT Act.

The explanation contained in the Guide to Fixed Property and Construction contradicts section 18(4) of the VAT Act. In terms of section 18(4) the formula  $A \times B \times C \times D$  is used to determine the input tax. “B” in the formula should be the lesser of adjusted cost or the open market value. Taking into account that property values in the open market have been decreasing for a number of months, the vendor will be disadvantaged by claiming an input tax deduction on the lesser of the original cost or the open market value. This open market value is determined on the day that the vendor decides to use the property for the rendering of taxable supplies.

Should it become evident that the property developer decides to retain the property to continue making exempt supplies, the property developer will become subject to transfer duty (SARS, 2011). The Transfer Duty Act (40/1949), states that transfer duty is not payable if a transaction is a taxable supply in terms of the VAT Act (section 9(15) of the Transfer Duty Act). Due to the property developer continuing with the rendering of exempt supplies, he or she will become liable to pay transfer duty on the value of the property.

During his budget speech on 17<sup>th</sup> February 2010, the Minister of Finance, Mr Pravin Gordhan, emphasized that the temporary letting of residential properties necessitates a full claw-back of the VAT input credits. He also stated that the current situation is disproportionate to the exempt income received by the owners of the properties. Gordhan added that options will have to be

investigated to determine a more reasonable method in dealing with these types of transactions (SARS, 2010).

## **1.2 PROBLEM STATEMENT**

South Africa's residential property developers face harsh consequences when properties constructed for sale are temporarily let out. This practice may occur more frequently when residential property developers experience difficulty finding buyers for their properties due to the economic downturn. In these circumstances a residential property developer has to impose VAT on a deemed supply based on the open market value of the property at the time the property is let out. This results in unreasonable cash flow consequences for the property developer.

When the residential property developer decides to cease his or her letting operations and decides to sell the property again, section 18(4) of the VAT Act only allows an input tax credit, based on the cost price of the property, and not on the initial open market value when section 18(1) was applied. The tax on the value added by the developer becomes a cost to the developer. This is in contrast to one of the fundamental principles underlying any VAT system, namely that the tax should not be borne by the residential property developer, but by the final consumer.

## **1.3 RESEARCH OBJECTIVES**

The objectives of this study are:

- to identify the fundamental principles underlying the identified VAT systems relating to the imposition of VAT on residential properties;
- to analyse the relevant sections of the South African VAT Act that are applicable when this type of change in use occurs;
- to compare the South African VAT legislation with that of New Zealand and Australia with regard to change in use adjustments applicable to property developers; and
- to make a suggestion for a permanent amendment to the VAT Act that will address the problem identified, namely the harsh cash flow consequences for the residential property developer.



## **1.4 IMPORTANCE AND BENEFITS OF THE STUDY**

The outcome of this study will provide clarity for residential property developers and SARS regarding the current South African VAT consequences that arises from the change in use that occurs when a residential property developer temporarily lets out properties that were constructed for sale. The study will further assist the South African legislature in evaluating whether the current South African VAT treatment of such change in use conforms to fundamental VAT principles and the treatment of similar transaction under other VAT jurisdictions.

## **1.5 ASSUMPTIONS**

For the purpose of the case study, the following assumptions are made:

- All property developers are vendors as defined in the VAT Act.
- All currencies are equal. This means that the South African Rand (ZAR) equals the New Zealand Dollar (NZD) and the Australian Dollar (AUD).
- All amounts are rounded off to the nearest Rand.
- The draft Taxation Laws Amendment Bill of 2011 will be promulgated in November 2011.

## **1.6 LIMITATIONS**

Due to the nature of this literature review, only residential properties that are constructed for sale and are subsequently let out by residential property developers will be discussed. Properties that are not of a residential nature, that is commercial properties, will be ignored entirely.

The comparative study will only be made by comparing the VAT jurisdiction of South Africa to that of New Zealand and Australia, and no other country will be taken into account. New Zealand introduced their value-added tax in 1986, South Africa in 1991 and Australia followed this tendency in 2000. All three of these countries value-added tax-systems are based on a modern VAT compared to the traditional value-added tax-systems, mostly seen in Europe.

In South Africa, a very limited amount of information is available on the treatment of change in use adjustments of residential properties where a property developer decides to let out a property until it is feasible to sell such a property. It was also found that no court cases were ever recorded where such a change in use took place.

## **1.7 STRUCTURE**

The study will be set out in the following chapters:

- Chapter 2 – A conceptual view of VAT on residential properties: the underlying principles of a VAT system with relation to residential accommodation as well as the reasons for exempting residential accommodation;
- Chapter 3 – VAT on residential properties in South Africa: the view of SARS with regard to the construction and sale of new residential properties are explained, as well as the treatment of residential accommodation and the change in use of property developers between these two approaches of property development and holding;
- Chapter 4 – GST on residential properties in New Zealand: the IRD regulates GST in New Zealand. Their views on the construction of new residential properties and the change in use to the letting of property are investigated;
- Chapter 5 – VAT on residential properties in Australia: The ATO has a unique way of treating the change in intentions of property developers from their taxable use to their non-taxable intentions; and
- Chapter 6 – Conclusion and recommendation: South Africa, New Zealand and Australia are compared with regard to property developers and their changes in use. A recommendation is made to SARS to review and amend the South African VAT legislation.

## **1.8 DEFINITION OF KEY TERMS**

The key terms and concepts involved in this study relate to legislation and key terms taken from it. The way these key terms are defined for the basis of this study is considered below.

*Commercial property:* “Real estate property that is used for business activities. Commercial properties fall into many categories and include industrial properties, shopping centres, farms, offices or even vacant land” (Answers Corporation, 2011).

*Consideration:* “Any payment made or to be made, whether in money or otherwise, in respect of the supply of any goods or services” (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*Dwelling:* Any building, premises, structure or any other place used primarily as a place of residence of any natural person. This does not include commercial accommodation (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*Enterprise:* Any activity whereby goods are supplied or services rendered continuously or regularly in the Republic of South Africa for a consideration, regardless of the profit made thereon (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*Goods:* Any physical movable things or fixed property, or any other right in any such things or fixed property (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*Input tax:* The VAT levied to a vendor by any other vendor when goods or services are supplied (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*Non-taxable supplies:* Exempt supplies and supplies that are made otherwise than in the course of furtherance of an enterprise (Section 1 of the VAT Act).

*Output tax:* The VAT levied at 14% on the value of a supply of goods or services in South Africa by a vendor in the course of furtherance of an enterprise (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*Property developer:* “A person whose job involves buying and selling buildings and land, and arranging for new buildings to be built” (Cambridge University Press, 2011).

*Residential property:* “Any property that a municipality has designated for single family homes, apartments, co-operatives, townhouses, and any other place where people live” (Farlex Inc., 2011).

*Taxable supplies:* Any supply of goods or services which is chargeable with VAT at either 14% (section 7(1)(a)) or 0% (section 11) (Section 1 of the VAT Act; Huxham & Haupt, 2010).

*The VAT Act:* The Value-Added Tax Act (89/1991, as amended).

*VAT-threshold:* An amount of R1 million (Section 1 of the VAT Act).

*Vendor:* A person who is registered or who is required to be registered for VAT (Section 1 of the VAT Act; Huxham & Haupt, 2010).

**Table 1: Abbreviations**

| <b>Abbreviation</b> | <b>Meaning</b>                |
|---------------------|-------------------------------|
| AUD                 | Australian Dollar             |
| ATO                 | Australian Taxation Office    |
| GDP                 | Gross Domestic Product        |
| GST                 | Goods and Services Tax        |
| IRD                 | Internal Revenue Department   |
| NZD                 | New Zealand Dollar            |
| SARS                | South African Revenue Service |
| VAT                 | Value-added tax               |
| ZAR                 | South African Rand            |

## **1.9 CONCLUSION**

This chapter identified the shortfalls of the South African VAT legislation. In the following chapters, the underlying principles of VAT will be investigated when property transactions are involved and a comparison is made between South Africa, New Zealand and Australia. The VAT rates (Table 2) of the countries are very similar, hence the reason for the comparative study. The three countries also introduced a VAT system within 15 years of each other.

**Table 2: Summary of basic VAT and GST rates**

|  | <b>South Africa<br/>VAT</b> | <b>New Zealand<br/>GST</b>                 | <b>Australia<br/>GST</b> |
|--|-----------------------------|--|--------------------------|
| Percentage on exclusive prices of goods and services | 14%                         | 15% from 1 October 2010, before that 12.5% | 10%                      |
| Percentage on inclusive prices of goods and services | 12.28%                      | 13.04%                                     | 9.09%                    |
| Year VAT was introduced                              | 1991                        | 1986                                       | 2000                     |

The underlying principles of VAT on residential properties will be investigated and analysed, before an analysis is made of the three identified countries' legislation.

## **CHAPTER 2**

### **A CONCEPTUAL VIEW OF VAT ON RESIDENTIAL PROPERTIES**

#### **2.1 INTRODUCTION**

After identifying potential shortfalls in the South African VAT legislation, the underlying principles of a VAT system and its effect on properties, specifically residential properties, need to be investigated.

Residential properties have a complex VAT policy for two main reasons:

- Residential properties are both consumption goods and investment goods. A major part of a person's wealth can be held in property, while the owner of the residential property enjoys the benefits of the property. The separation of the investment element from the consumption portion of residential property for VAT purposes will be problematic. This will make the VAT treatment of the consumption of the property impossible.
- Transactions of acquiring and disposing of residential property are relatively irregular, compared to other types of VAT transactions. These transactions attract higher amounts and the parties to the transactions are usually not VAT vendors (Conrad & Grozav, 2008).

#### **2.2 PROCEDURAL AND ADMINISTRATIVE ISSUES**

The charging of VAT on residential properties will give rise to five issues of procedural and administrative difficulties. These issues will be discussed in more detail below.

##### **2.2.1 Consumption or investment**

No VAT system will levy tax on investments. VAT legislation specifically exempts the charging of VAT on shares, bonds and other financial instruments (Conrad & Grozav, 2008).

Residential properties attract a substantial investment from the investor and a significant amount of the investor's net worth is tied up by such an investment. The residential property may provide longer lasting benefits, with regard to the possible consumption and investment, than the term that the owner possesses or inhabits the property. The consumption benefits and the investment benefits cannot be reliably established and most often cannot be segregated from each other, except for estimates of opportunity costs (Conrad & Grozav, 2008).

### **2.2.2 Timing of consumption**

Theoretically, VAT should not be imposed when the services are rendered or the goods are supplied, but rather when the user consumes the goods or uses the services. In practice though, the opposite is true. Capital goods pose difficulties with this statement. A VAT credit is allowed on capital goods when the supply is made to the VAT vendor, irrespective of the correlation between the present value of the services and the purchase price of such goods. Theory suggests that the VAT input credit should only be granted when the service is consumed by the user and at a credit equal to the cost to the user (Conrad & Grozav, 2008).

In an ideal world the theory would apply that the deemed rental of owner-occupied residential accommodation should be subject to VAT. The economic depreciation and additional investments made by such an owner-occupier would have to be offset against the deemed rental. Practically the supply and the consumption will have noteworthy timing differences (Conrad & Grozav, 2008).

The solution to the problem at hand is to allow a VAT credit to the VAT vendor at the time of the purchase, at the full value of the cost to the purchaser, and to burden a non-VAT vendor with the full cost of the VAT applicable. This methodology will only be feasible if the present value of benefits that the consumer will receive is equal to the price of the residential property and the owner-occupier occupies the residential property until the value of that property becomes zero (Conrad & Grozav, 2008).

### **2.2.3 To what extent are occupiers VAT vendors or consumers?**

Differences in timing and utilisation of residential properties raise VAT issues for VAT vendors and consumers. Theoretically, any person who supplies goods or services should be liable for VAT. Cnossen (1996) included this concept to self-supply as well. Residential properties will therefore be taxable for the consumption thereof (Conrad & Grozav, 2008).

### **2.2.4 Impartial treatment of VAT on residential property**

The desired outcome is to eradicate discrimination and minimise welfare costs to the consumers of residential properties. The theoretical and practical VAT treatments of residential properties are biased. Segregation is made between the treatment of VAT for vendors and for owner-occupiers. The impartial treatment of VAT on residential properties has other consequences, such as the following:

- VAT should not discriminate between a person who is leasing a property and a person who owns a property.
- Incentivising different classes of occupiers of residential properties could be created by non-uniform treatment of VAT (Conrad & Grozav, 2008).

### **2.2.5 Administration of VAT on residential property**

To impose VAT on residential properties will cause problematic administrative issues, that is the submissions of VAT returns, the assessment of these returns by the authorities, as well as the collection of VAT from the vendors. By exempting VAT on residential property on occupational benefits, the VAT administration process is simplified (Conrad & Grozav, 2008).

## **2.3 VAT ON RESIDENTIAL PROPERTIES**

Countries with a VAT system impose either VAT or transfer duties on the gross selling prices of residential properties. When VAT is levied, transfer duties are not imposed, and vice versa (Cnossen, 1996).



### **2.3.1 Construction of residential properties**

Construction activities, such as the sale of construction materials, the rendering of services with regard to the upkeep and repair of buildings, and the erection of new structures, are uniformly taxed at the standard VAT rate (Cnossen, 1996).

### **2.3.2 Leases of residential properties**

Owner-occupied residential property is not subject to VAT. Since the consumption portion of owner-occupied residential properties is not taxed, residential lease values are excluded from the VAT regime, due to the equal treatment rule. The VAT was paid when the residential property was erected and the lessees will inevitably not pay less rent. The exclusion will not alleviate the effects of VAT on repairs and maintenance on lessors or owner-occupiers (Cnossen, 1996).

VAT jurisdictions exempt leases of residential property from VAT, hotel accommodation and the leasing of parking space and camping grounds are taxed at the standard rate. An exemption will, however, apply to hotel accommodation if it is used for residential purposes. In these instances, the authorities apply a period test to establish the entitlement to an exemption (Cnossen, 1996).

### **2.3.3 Sale of residential properties**

Previously occupied residential properties are exempt from VAT in all countries, as long as the previous owner of the residential property was not a VAT vendor. If the previous owner was a VAT vendor, VAT should be levied at the prescribed rate of that particular country (Cnossen, 1996).

## **2.4 CONCLUSION**

It can be concluded that VAT on the sale of residential properties is levied at the prescribed VAT rate, if the seller of such property is a VAT vendor, but that the rental of such properties is exempt

from VAT. Sales of residential properties by a non-VAT vendor are exempt from VAT, but attract transfer duties.

In the following three chapters, the VAT legislation of South Africa, New Zealand and Australia will be analysed in terms of transactions where properties of a residential nature are applicable. A case study will be used to explain the identified countries' applications of their legislation.

## CHAPTER 3

### VAT ON RESIDENTIAL PROPERTIES IN SOUTH AFRICA

#### 3.1 INTRODUCTION TO VAT IN SOUTH AFRICA

VAT on residential properties depends on the type of transaction. Sales of residential properties by VAT vendors are subject to VAT, while the leasing of such properties is exempt from VAT.

The VAT Act came into effect in South Africa on 30 September 1991. VAT was initially levied at 10% and this rate was increased to 14% in 1993. The VAT Act replaced the Sales Tax Act of 1978. (All sections that are referred to in this chapter, refer to the VAT Act, unless otherwise specifically stated.)

In South Africa, a person supplying goods and services in excess of the VAT-threshold of R1 million (prior to 1 March 2009 the threshold was R300 000) during a 12-month period in the course of furtherance of an enterprise is required to register for VAT (section 23). A person who is registered for VAT (or who is required to be registered) is referred to as a vendor (definition of 'vendor' in section 1). An enterprise is defined in section 1 of the VAT Act as any activity, which is carried on continuously, or regularly by a person within the borders of South Africa. These activities will be the supply of goods or services to another person for consideration.

Supplies made by vendors can generally be classified either as taxable or as non-taxable supplies. Taxable supplies are defined in section 1 of the VAT Act as the supply of goods or services that is subject to 14% VAT in terms of section 7(1)(a) or subject to 0% VAT in terms of section 11. Non-taxable supplies include exempt supplies (in terms of section 12) and supplies that are made otherwise than in the course or furtherance of an enterprise.

Output tax is defined in section 1 as the tax charged on the supply of goods and services by a vendor in terms of section 7(1)(a).

Where goods or services are acquired by a vendor for the consumption, use or supply in the course of making taxable supplies, the vendor may be entitled to claim an input tax credit. The input tax credit will equate to the value of VAT that was levied on the goods or services acquired by such a vendor (definition of 'input tax' in section 1 read with section 17(1)). Section 17(1) provides that a vendor is only entitled to an input tax credit to the extent that the goods or services are intended to be used in the course of making taxable supplies.

VAT is payable to SARS when the output tax exceeds the input tax, while VAT will be refunded by SARS where input VAT exceeds output VAT. Vendors are registered in the following six categories for VAT:

- Category A: the period of two months ending on the last day of January, March, May, July, September and November.
- Category B: the period of two months ending on the last day of February, April, June, August, October and December.
- Category C: the last day of each of the twelve months of a calendar year.
- Category D: a period of six months ending on the last day of the months specified by SARS.
- Category E: a period of twelve month ending on the last day of the month specified by SARS.
- Category F: the period of four months ending on the last day of February, June and October (Section 27 of the VAT Act).

### **3.2 CONSTRUCTION AND SALE OF NEW RESIDENTIAL PROPERTIES**

The activities of a property developer should comply with the definition of 'enterprise' in section 1 because a property developer would be making regular or continuous supplies of goods (the definition of 'goods' in section 1 specifically includes fixed property). Where the supplies made by a property developer exceeds the compulsory registration threshold of R1 million during a 12 month period, the property developer becomes liable for registration in terms of section 23(1).

A property developer may claim input tax credits with regard to the purchasing of goods and services, if these goods and services were acquired to make a taxable supply. Although input tax

may be claimed on certain second-hand goods, no credits can be claimed on goods and services acquired from non-vendors (SARS, 2011).

Property developers will be allowed to claim input VAT on the following expenses:

- acquisition of a property or land;
- developing and building costs;
- professional services; and
- marketing expenses (SARS, 2011)

A property developer will advertise the completed property inclusive of VAT and will account for output VAT on each sale. The advertised amount is known as the consideration (section 1). The selling price of the property may be advertised as being exempt from transfer duty, as long as mention is made that the price includes VAT (SARS, 2011).

Where the purchaser acquires a fixed property from a property developer for the purpose of providing residential accommodation, the VAT included in the purchase price becomes a permanent cost to the purchaser (National Treasury, 2011)

### **3.3 LEASING OF RESIDENTIAL PROPERTIES**

Section 12(c) provides that the supply of a dwelling under a lease agreement thereof will be exempt from tax imposed under section 7(1)(a). A dwelling is defined in section 1 as any building, premises, structure, or any other place, or any part thereof, used predominantly as a place of residence or abode, except if the supply is commercial accommodation.

An agreement for letting and hiring is a lease agreement. The characteristics of a lease agreement are as follows:

- the lessee received the right of use of the property;
- regular payments, usually monthly, are made by the lessee to the lessor for the right of use;
- the lessee will return the property to the lessor, and vacate the premises, at the end of the lease term;

- ownership does not pass from the lessor to the lessee; and
- the lease amount usually remains consistent for the duration of the lease term (Anon., 2001).

### **3.4 CURRENT SITUATION WITH REGARD TO CHANGE IN USE**

The making of taxable supplies is the ultimate objective of a residential property developer. To enable the property developer to make such taxable supplies, he or she needs to acquire and develop residential properties. From time to time, a property developer may elect to temporarily let out the property to earn a rental income, to cover the cost of holding such a property until a sale can take place, while the intention of the property developer is still to ultimately dispose of the property (SARS, 2011; National Treasury, 2011).

In instances where residential properties are being used for a purpose other than the making of taxable supplies, section 18 needs to be applied. Section 18 provides for a change in use adjustment. The change in the intended use of the goods or services will trigger a deemed supply on which VAT is levied in terms of section 7(1)(a) (section 18(1); Huxham & Haupt, 2010).

When the property developer subsequently decides to pursue his or her initial intention of making a taxable supply by disposing of the property, a deemed supply must be recognised in the month during which the property developer starts to advertise the sale of the property. At this stage the property developer will start his or her activities of making a taxable supply with regard to the property again. An input tax credit may be claimed in terms of section 18(4). The formula described in section 18(4) is  $A \times B \times C \times D$ , where “B” is the adjusted cost or the open market value of the property, whichever is lower.

A property developer may also decide to retain the property and rent the property out on a permanent basis. The property developer’s activities has now changed to making exempt supplies only, and the property developer will not be rendering any more taxable supplies from the property. A subsequent disposal of this property will then not be subject to VAT because a taxable supply was not made. Transfer duty will be applicable to this transaction (SARS, 2011).

### 3.5 PROPOSED AMENDMENTS TO SECTION 18

On 2 June 2011, the National Treasury of the Republic of South Africa issued an explanatory memorandum on the Draft Taxation Laws Amendment Bill, 2011 (Tax Laws Amendment Bill 2011). The memorandum explains that the existing VAT rules dealing with a change in use adjustment is problematic from both a practical and a legal theory perspective, where a property developer is temporarily letting out residential properties. Practically, the property developer's sustainability becomes uncertain when an earlier than expected VAT charge is levied against him or her, due to circumstances beyond his or her control (National Treasury, 2011).

The theoretical legal issues that need to be considered are:

- purpose versus application: Although the principal purpose of the property developer was to render a taxable supply in disposing of the residential property, he or she is forced to temporarily let out the property. This change in the intention of the property developer is deemed to be a change in the application of the property. This will result in a deemed supply in terms of section 18(1);
- consumption versus recoupment: VAT needs to be levied on the consumption of goods or services. Although the property developer changed the use of the residential property, his or her initial intention of disposing of the property has not changed. The consequence of such a change in use will initiate a VAT event for the property developer.

When a change in use occurs a decision needs to be made about whether to recover the input VAT previously claimed by the property developer or to levy VAT on the use of the property in a way other than in the way initially intended; and

- rental charged for the use of the property: With current legislation, the value resulting from a change in use adjustment is disproportionate to the rental income that a property developer may receive during the period of letting out a property. The objective of the proposed change to legislation is to levy VAT on the monthly rental income received by the property developer, or to recover a portion of the input VAT previously allowed to the property developer (National Treasury, 2011).

While government officials are busy analysing these legal issues, and to avoid property developers from being forced into insolvency, government has agreed to allow temporary relief to property

developers who temporarily let out their residential properties in anticipation of the sale thereof. The temporary relief will be granted for a period not exceeding 36 months, where after a deemed supply needs to be recognised at the market value of the property at the date of the expiration of the 36 month period. The relief provisions will not apply if the property developer decides to retain the property to earn rental income for an indefinite period, and cease his or her intentions to dispose of the property (National Treasury, 2011).

### **3.6 CASE LAW**

It was found that since the inception of the VAT Act no court cases have ever dealt with the circumstances regarding section 18 of the VAT Act.

### **3.7 CASE STUDY**

#### **3.7.1 Scenario description**

ABC Properties develops and sells residential units. During March 2006 ABC Properties acquired vacant land from DEF Brokers for R1 000 000 (excluding VAT) and the transfer was registered in the same month.

ABC Properties commenced developing the land in April 2006 to enable them to build 20 sectional title units on the vacant land. They intend to sell each unit for R500 000 (excluding VAT). GHI Construction won the tender for the construction of the 20 units at a cost of R300 000 (excluding VAT) per unit. JKL Estate Agents undertook the marketing and selling of the units at a commission of 10% on the selling price.

The construction of the units was completed in March 2007 and GHI Construction issued a tax invoice of R6 000 000 (excluding VAT) to ABC Properties. No progress payments were made to GHI Construction during the construction period. During April 2007, JKL Estate Agents managed to sell 15 of the 20 units. They raised a tax invoice to the value of R750 000 (excluding VAT) to ABC Properties.



Due to negative market factors, ABC Properties decided in May 2007 to temporarily let out the remaining five units at R5 000 per month per unit, until the weak markets return to normal. Tenants occupied the five let out units on 1 June 2007. JKL Estate Agents continued to market the properties until they were sold.

In November 2008 ABC Properties decided to dispose of the five let out properties at a lower price of R450 000 (excluding VAT) per unit. During November 2008, three of the five remaining properties were sold and the tenants vacated these three properties on 30 November 2008. JKL Estate Agents raised a tax invoice to the value of R135 000 (excluding VAT) for their commission.

ABC Properties was adamant not to sell the two remaining properties for less than R450 000 (excluding VAT). JKL Estate Agents eventually achieved success in July 2010 and the remaining two units were disposed of.

ABC Properties, DEF Brokers, GHI Construction and JKL Estate Agents are all vendors for VAT purposes as described in the VAT Act.

### 3.7.2 Acquisition of the land

Upon acquiring the land for R1 000 000 in March 2006, ABC Properties will be eligible to claim input VAT to the value of R140 000. At the same time, DEF Brokers need to pay VAT on their disposal of the land. DEF Brokers need to declare output VAT of R140 000 (See Calculation 1).

#### Calculation 1: South Africa: Acquisition of land

|                                    |            |
|------------------------------------|------------|
| Cost price of the land             | R1 000 000 |
| VAT on the land (14% x R1 000 000) | R140 000   |

### 3.7.3 Completion of the construction work

Upon completion of the 20 units, in March 2007, GHI Construction raises a tax invoice in favour of ABC Properties. Once the invoice is raised, GHI Construction needs to pay an amount of R840 000 in respect of output VAT (see Calculation 2).

During the period of construction, from April 2006 to March 2007, GHI Construction was able to claim input VAT credits for their costs of the construction of the units. Input VAT can only be claimed on the costs for services rendered and materials supplied by registered vendors used by GHI Construction.

ABC Properties can claim input VAT for the construction work performed by GHI Construction for R840 000.

**Calculation 2: South Africa: Completion of construction work**

|  |            |
|--|------------|
| Value of the construction work (20 units x R300 000) | R6 000 000 |
| VAT on the construction work (14% x R6 000 000)      | R840 000   |

**3.7.4 Sale of the units**

ABC Properties needs to pay VAT on the disposal of the 15 units that were sold in April 2007. The output VAT will amount to R1 050 000. During April 2007 JKL Estate Agents need to pay VAT on their invoice raised for the commission earned on the sale of 15 units. The output VAT will amount to R105 000 (see Calculation 3).

ABC Properties can claim an input VAT credit to the value of R105 000 in April 2007 with regard to the commission paid to JKL Estate Agents.

**Calculation 3: South Africa: Sale of 15 units**

|   |            |
|---|------------|
| Value of the supply (15 units x R500 000)         | R7 500 000 |
| VAT on the supply of the units (14% x R7 500 000) | R1 050 000 |
| Value of the commission earned (R7 500 000 x 10%) | R750 000   |
| VAT on the commission earned (R750 000 x 14%)     | R105 000   |

A further sale of three units took place in November 2008. Once again, ABC Properties needs to pay VAT on the sale, and will be able to claim the input VAT on the tax invoice raised by JKL

Estate Agents. The output VAT amounts to R189 000, while the input VAT claim is R18 900 (see Calculation 4).

**Calculation 4: South Africa: Sale of three units**

|   |            |
|---|------------|
| Value of the supply (3 units x R450 000)          | R1 350 000 |
| VAT on the supply of the units (14% x R1 350 000) | R189 000   |
| Value of the commission earned (R1 350 000 x 10%) | R135 000   |
| VAT on the commission earned (R135 000 x 14%)     | R18 900    |

The last two units are eventually sold in July 2010. At this stage, ABC Properties needs to account for VAT to be paid to SARS at the amount of R126 000, while an input VAT can be claimed on the commission paid. The input VAT will be R12 600 (see Calculation 5).

**Calculation 5: South Africa: Sale of two units**

|   |          |
|---|----------|
| Value of the supply (2 units x R450 000)        | R900 000 |
| VAT on the supply of the units (14% x R900 000) | R126 000 |
| Value of the commission earned (R900 000 x 10%) | R90 000  |
| VAT on the commission earned (R90 000 x 14%)    | R12 600  |

The new property owners are the end consumers of the properties developed by ABC Properties. They are not allowed to claim any VAT inputs, assuming that their intentions are to either use the properties for their own personal use, or let the properties out to tenants. The sole purpose of the new property owners will be the supply of residential accommodation.

**3.7.5 Change in use from taxable supplies to exempt supplies**

**Current situation**

When, in May 2007, ABC Properties made the decision to temporarily let the five remaining units, a deemed supply took place. The effect of this deemed supply is that ABC Properties needs to declare a further VAT output on the open market value of the properties. The open market value at

this point is R500 000 per unit. Therefore the VAT output on the deemed supply of the properties will be R350 000 (see Calculation 6).

**Calculation 6: South Africa: Current situation with regard to change in use from taxable to exempt supplies**

|   |            |
|---|------------|
| Value of the supply (5 units x R500 000)          | R2 500 000 |
| VAT on the supply of the units (14% x R2 500 000) | R350 000   |

**New situation**

The Tax Amendment Bill 2011 gives a property developer a temporary relief of 36 months to temporarily let out his or her residential properties. Therefore, no adjustment needs to be made in May 2007 when ABC Properties starts to pursue their exempt supplies.

After 36 months, in May 2010, ABC Properties has still not been able to dispose of two of the units. The Amendment Bill states that where the property developer has not returned to making taxable supplies within the 36 month period, a deemed supply needs to be recognised, and ABC Properties needs to account for output VAT to the value of R126 000 (see Calculation 7).

**Calculation 7: South Africa: New situation after 36 month relieve has been utilised**

|   |          |
|---|----------|
| Value of the supply (2 units x R450 000)        | R900 000 |
| VAT on the supply of the units (14% x R900 000) | R126 000 |

**3.7.6 Letting of residential units**

The letting operations undertaken by ABC Properties will not attract any VAT since it is an exempt supply. ABC Properties will not declare any output VAT on the let properties. In the instance where ABC Properties utilises a letting agent to manage the let properties, the VAT on the fees charged by such an agent cannot be claimed, while the agent still needs to pay the output VAT on its fees.

### 3.7.7 Returning to initial intention of making a taxable supply and disposal of the units

#### Current situation

In November 2008, when ABC Properties disposes of the three properties, a deemed input can be claimed on the lesser of the open market value or the adjusted cost price of the properties. Since the initial cost for the land and the erection of the units amount to R350 000 (excluding VAT), while the open market value of the properties decreased to R450 000 (excluding VAT), the developer can only claim an input tax credit on the R350 000 per unit, being R147 000 for the three units (see Calculation 8).

#### Calculation 8: South Africa: Return to making taxable supplies on three units

|  |            |
|--|------------|
| Construction cost per unit (R6 000 000 ÷ 20 units)                   | R300 000   |
| Land cost per unit (R1 000 000 ÷ 20 units)                           | R50 000    |
| Total cost per unit  | R350 000   |
| Value of the properties sold now (3 units x R350 000)                | R1 050 000 |
| Input VAT at the time of return to taxable supply (14% x R1 050 000) | R147 000   |

Due to the differences constituted in section 18(1) and section 18(4) of the VAT Act, the property developer is out of pocket by R63 000 on the three units (see Calculation 9).

#### Calculation 9: South Africa: VAT lost by a property developer when selling three units

|   |          |
|---|----------|
| Deemed output VAT (R350 000 ÷ 5 units x 3 units) (as per calculation 6) | R210 000 |
| Input VAT claimed (As per calculation 8)                                | R147 000 |
| VAT lost by property developer  | R63 000  |

When the last two units are eventually sold in July 2010, the property developer once again needs to claim an input tax deduction. The input tax deduction will be R98 000 (see Calculation 10).

**Calculation 10: South Africa: Return to making taxable supplies on two units**

|  |          |
|--|----------|
| Total cost per unit (as per calculation 8)                         | R350 000 |
| Value of the properties sold now (2 units x R350 000)              | R700 000 |
| Input VAT at the time of return to taxable supply (14% x R700 000) | R98 000  |

Once again, ABC Properties will be out of pocket by R42 000. This result from the differences between sections 18(1) and 18(4) of the VAT Act (see Calculation 11).

**Calculation 11: South Africa: VAT lost by a property developer when selling two units**

|  |          |
|--|----------|
| Deemed output VAT ( $R350\,000 \div 5 \text{ units} \times 2 \text{ units}$ ) (as per calculation 6) | R140 000 |
| Input VAT claimed (As per calculation 10)  | R98 000  |
| VAT lost by property developer   | R42 000  |

**New situation**

As discussed earlier, the Tax Amendment Bill 2011 will offer some benefits to ABC Properties. At the time when the three units are sold, no deemed supply had to be recognised, therefore no input VAT can be claimed at this stage.

The trading of the last two units will result in the claiming of input VAT, since the output VAT was declared on the deemed supply in May 2010. The input VAT claim will be R98 000 (see Calculation 12).

**Calculation 12: South Africa: New situation where two units are sold**

|  |          |
|--|----------|
| Total cost per unit  | R350 000 |
| Value of the properties sold now (2 units x R350 000)              | R700 000 |
| Input VAT at the time of return to taxable supply (14% x R700 000) | R98 000  |

Although the property developer are still out of pocket by R42 000, it is still a whole lot better than being out of pocket by a total of R105 000 (see Calculation 13).

**Calculation 13: South Africa: Comparison of VAT lost by a property developer between the current and new situations**

|   |          |
|---|----------|
| <u>New situation</u>  |          |
| Deemed output VAT (R350 000 ÷ 5 units x 2 units) (as per calculation 6) | R140 000 |
| Input VAT claimed (as per calculation 12)                               | R98 000  |
| VAT lost by property developer on the new situation                     | R42 000  |
| <u>Current situation</u>  |          |
| VAT lost on sale of three units (as per calculation 9)                  | R63 000  |
| VAT lost on sale of two units (as per calculation 11)                   | R42 000  |
| Total VAT lost  | R105 000 |

### 3.8 CONCLUSION

From the case study, it is clear that the property developer is hugely disadvantaged by the current VAT legislation. The Amendment Bill will give some kind of advantage to the property developer. The methods used according to the New Zealand and Australian legislation will be scrutinised before a recommendation can be made on whether the Tax Amendment Bill 2011 gives sufficient relief, and whether the legislation should be adjusted to improve the situation in South Africa.

## CHAPTER 4

### GST ON RESIDENTIAL PROPERTIES IN NEW ZEALAND

#### 4.1 INTRODUCTION TO GOODS AND SERVICE TAX IN NEW ZEALAND

New Zealand introduced their value added tax, Goods and Services Tax (GST), at a rate of 10% on 1 October 1986. On 1 July 1989, the rate was increased to 12.5%. On 1 October 2010, this rate was increased to 15% (Wikipedia, The Free Encyclopedia, 2011).

GST-registered organisations pay GST only on the difference between their GST-liable sales and GST-liable purchases. This in effect means that these organisations only pay GST on the difference between what they sell and what they buy (Wikipedia, The Free Encyclopedia, 2011).

A vendor is required to register for GST if their annual turnover is, or is expected to exceed \$60,000 for a 12-month period. A vendor has a period of 21 days to register for GST, once its turnover exceeds \$60,000. A person with a turnover of less than \$60,000 per year may apply for a voluntary registration (Inland Revenue Department, 2010).

The supply of goods by a registered entity is subject to output tax, while the entity can claim input tax on the acquisition of goods and services. Input tax may only be claimed if goods and services are procured for rendering a taxable supply (Kendons Chartered Accountants Ltd, 2007).

In terms of section 8(1) of the Goods and Service Tax Act of 1985, all supplies of good and services are chargeable with GST, if such a supply is made by a person who is registered and the supply is made in the course or furtherance of a taxable activity. Section 6(1) defines a taxable activity as an activity that is regularly or continuously carried on and is intended to supply goods and services for consideration. A taxable activity excludes any activity that involves making exempt supplies (section 6(3)(d)). (All sections that are referred to in this chapter refer to the Goods and Service Tax Act of 1985, unless otherwise specifically stated.)



The timing of a taxable supply determines when the output tax needs to be declared on the GST return. The time that a supply is made is the earlier of the date that the invoice is issued or the time that actual payment is received (Kendons Chartered Accountants Ltd, 2007).

In an arm's length transaction, the value for tax purposes is the difference between the consideration charged and the GST. The value of transactions between connected persons is determined by the open market value of the item or services that are exchanged between the parties. GST is calculated on this value of payment to the authorities (Kendons Chartered Accountants Ltd, 2007).

#### **4.2 CONSTRUCTION AND SALE OF NEW RESIDENTIAL PROPERTIES**

In the construction industry, the contractor usually receives progress payments at regular intervals during the course of a project. The contractor will be liable for the VAT on the earlier of the receipt of a progress payment or the issuing of an invoice (Kendons Chartered Accountants Ltd, 2007).

The sale of a residential property will be deemed to have been concluded on the earlier of the date that the contract becomes unconditional or the date that a deposit is received for the disposal of the property. The date determined will be the time of supply and will be used to determine when the vendor needs to declare the GST (Kendons Chartered Accountants Ltd, 2007).

The property developer may claim input tax deductions for all materials purchased and services hired in the course of the construction of the residential buildings, as long as the suppliers of the goods and services are registered vendors. The land will most likely not be deductible as an input tax from 1 April 2011. All transactions whereby land will change hands will be taxed at 0% from 1 April 2011, if the following conditions apply:

- the land will be used by the purchaser to make a taxable supply; and
- the purchaser, or any connected person to the purchaser, does not intend to use the land to erect a building that will be used as its primary residence (PwC, 2011).

When a registered vendor acquires second-hand goods to make a taxable supply, the vendor is permitted to deduct one-ninth of the purchase price as an input tax. According to the Courts in New

Zealand land qualifies for this input tax deduction as second-hand goods (Kendons Chartered Accountants Ltd, 2007).

### **4.3 LEASING OF RESIDENTIAL PROPERTIES**

Where a building is used as a private residence, this supply of residential accommodation will be exempt from GST. The exempted accommodation includes:

- the letting of a dwelling, whether it is a house or a flat;
- the letting of a residential flat in a commercial property; and
- the accommodation provided to a night watchman in an industrial building (Kendons Chartered Accountants Ltd, 2007).

### **4.4 CHANGE IN USE**

A property developer, who is registered for GST, may let out a residential dwelling or individual unit while the property is being marketed for the sale thereof. The Inland Revenue Department (IRD) applies a principal purpose test to determine whether an input tax credit will be allowed on the original acquisition of a residential property. Their policy is as follows:

- where the property is purchased for the principal purpose of resale, a 100% input tax credit will be allowed, while no input tax credit will be allowed if the property was acquired to rent out for residential purposes;
- where the property is subsequently let out, until a sale is concluded, an output tax adjustment needs to be made;
- the output tax adjustment will be calculated at one-ninth of the lesser of:
  - the rental value of the property; or
  - 2% of the cost of the dwelling per annum;
- the eventual sale will be treated as a taxable supply and will be subject to GST as if the transaction took place in the normal course of business; and
- in the instance where the property developer decides to continue with his or her letting operation, and not return to the original marketing intention, an output tax needs to be

declared at one-ninth of the open market value of the property (Kendons Chartered Accountants Ltd, 2007).

In terms of section 14(1)(d) the sale of a property used for the supply of residential accommodation, in the course or furtherance of an enterprise, will be exempt of GST if the property was exclusively used to supply such accommodation for more than five years (Office of the Chief Tax Counsel, 2007).

## 4.5 CASE LAW

### *CIR v John David Morris*

John David Morris was a property developer and a building contractor who built two flats with the intention of selling them. While the properties were being marketed, they were let out. Input tax credits were claimed with regard to the constructions costs, since Morris believed that the letting activity was a subsidiary to the main objective of selling the properties. The Commissioner deemed the letting of the properties to be an exempt supply. The IRD assessed Morris in terms of section 21 of the GST Act on the basis that the property was originally acquired for the purpose of making a taxable supply, which was subsequently applied for an exempt supply (*CIR v John David Morris*, 1997).

The Court found in favour of the IRD on 16 September 1997, and confirmed that the letting of the properties was a subsequent supply for purposes other than that of making a taxable supply. The Court stated that the purpose of letting was distinctly different from the purpose of selling of the units. Although the primary objective of the property developer remained, being that of selling of the flats, the flats were used to make a non-taxable supply by way of providing residential accommodation (*CIR v John David Morris*, 1997).

### *CIR v Carswell Investments Co Ltd*

Carswell Investments Co Ltd is a property development company, whose main activity was to acquire vacant land, constructing of houses and disposing of the properties. In this case, there were

20 properties that were subsequently let out as residential accommodation until the properties were sold. The CIR and Carswell Investments Co Ltd agreed on the fact that the principal purpose of the properties were to be held for resale, but that the CIR considered the letting of the houses to be an exempt supply (*CIR v Carswell Investments Co Ltd*, 2001).

Panckhurst ruled in favour of the CIR. Panckhurst reasoned that the test for purpose should be made objectively and that the new purpose is distinctly different from the principal purpose (*CIR v Carswell Investments Co Ltd*, 2001).

Panckhurst stated that the IRD concluded that there was no subsequent purpose for the properties once rental commenced. Although the properties were initially let out for security reasons, and not to derive a rental income from them, the rental income of Carswell Investments Co Ltd was substantial over a three-year period, amounting to \$377 000. He further stated that the company's principal purpose seized to the benefit of receiving rental income (*CIR v Carswell Investments Co Ltd*, 2001).

Another factor Panckhurst considered was the duration of the lease agreements with the tenants. Eight of the twenty properties were let out for the entire three-year period. The average letting period for all the properties was 23 months. Due to the volume, revenue received and the period of letting of these units Panckhurst found that the intention of Carswell Investments Co Ltd changed to making exempt supplies, rather than taxable supplies (*CIR v Carswell Investments Co Ltd*, 2001).

## **4.6 CASE STUDY**

### **4.6.1 Scenario description**

The scenario description in Chapter 3.7.1 will be used for New Zealand. The currency used will be the New Zealand Dollar. Please refer back for details on the scenario.

#### 4.6.2 Acquisition of the land

ABC Properties can claim a \$125 000 input tax credit on the acquisition of the land, while DEF Brokers needs to declare an output tax for the same value. Should this transaction have taken place after 1 April 2011, no VAT would have been payable or claimable in terms of this transaction due to the zero-rating (see calculation 14).

##### Calculation 14: New Zealand: Acquisition of land

|                                       |             |
|---------------------------------------|-------------|
| Cost price of the land                | \$1 000 000 |
| VAT on the land (12.5% x \$1 000 000) | \$125 000   |

#### 4.6.3 Completion of the construction work

GHI Construction raises a tax invoice for \$6 750 000 (inclusive of GST) in March 2007 when the units have been completed. \$750 000 needs to be paid to the authorities in respect of output GST (see calculation 15).

All the input GST on the construction expenses incurred from registered vendors, by GHI Construction, can be claimed during the period of construction, in the month that the expense was incurred.

ABC Properties can claim \$750 000 in March 2007 by as an input tax credit in terms of the invoice received from GHI Construction.

##### Calculation 15: New Zealand: Completion of construction work

|   |             |
|---|-------------|
| Value of the construction work                    | \$6 000 000 |
| VAT on the construction work (12.5% x R6 000 000) | \$750 000   |

#### 4.6.4 Sale of the properties

Since JKL Estate Agents were tasked to sell the residential units, they will receive their commission in April 2007, November 2008 and July 2010. JKL Estate Agents will declare and pay the following amounts as VAT to the IRD:

- April 2007                      \$93 750 (see Calculation 16);
- November 2008                \$16 875 (see Calculation 17); and
- July 2010                        \$11 250 (see Calculation 18).

**Calculation 16: New Zealand: Sale of 15 units**

|  |             |
|--|-------------|
| Value of the supply (15 units x \$500 000)           | \$7 500 000 |
| VAT on the supply of the units (12.5% x \$7 500 000) | \$937 500   |
| Value of the commission earned (\$7 500 000 x 10%)   | \$750 000   |
| VAT on the commission earned (\$750 000 x 12.5%)     | \$93 750    |

**Calculation 17: New Zealand: Sale of three units**

|  |             |
|--|-------------|
| Value of the supply (3 units x \$450 000)            | \$1 350 000 |
| VAT on the supply of the units (12.5% x \$1 350 000) | \$168 750   |
| Value of the commission earned (\$1 350 000 x 10%)   | \$135 000   |
| VAT on the commission earned (\$135 000 x 12.5%)     | \$16 875    |

**Calculation 18: New Zealand: Sale of two units**

|  |           |
|--|-----------|
| Value of the supply (2 units x \$450 000)          | \$900 000 |
| VAT on the supply of the units (12.5% x \$900 000) | \$112 500 |
| Value of the commission earned (\$900 000 x 10%)   | \$90 000  |
| VAT on the commission earned (\$90 000 x 12.5%)    | \$11 250  |

ABC Properties will be allowed to claim an input credit for GST in the same periods as when JKL Estate Agents declared their output GST.

ABC Properties needs to account for output GST in April 2007 on the sale of the 15 units. The GST amounts to \$937 500 (see Calculation 16). A further GST output needs to be declared in November 2008 and July 2010 when the remaining units are sold. The GST will be \$168 750 (see Calculation 17) and \$112 500 (see Calculation 18) respectively.

The end consumers of the properties are the new owners of these properties. They will not be allowed to claim any GST inputs, since GST is an end-consumer tax.

#### 4.6.5 Change in use from taxable supplies to exempt supplies

During May 2007, ABC Properties decides to let out the remaining five units until they can be sold. The intention of ABC Properties remains and the properties are still being advertised and marketed. No output GST adjustment is required when the property is temporarily being let out.

#### 4.6.6 Letting of residential units

A monthly output tax adjustment needs to be made. This is calculated as one-ninth of the lesser of:

- rental value of the property of \$5 000 per unit; or
- 2% of the total building

#### Calculation 19: New Zealand: Temporary letting of five units

|  |           |
|--|-----------|
| Construction cost per unit ( $\$6\,000\,000 \div 20$ units)  | \$300 000 |
| Land cost per unit ( $\$1\,000\,000 \div 20$ units)  | \$50 000  |
| Total cost per unit  | \$350 000 |
| Output GST adjustment per month per unit. One ninth of lesser of:  | \$65      |
| <ul style="list-style-type: none"> <li>• Rental value of the property: \$5 000</li> <li>• 2% of total building cost: <math>\\$350\,000 \times 2\% \div 12 = \\$583</math></li> </ul> |           |
| Output GST when five units are let out (5 units x \$65)  | \$325     |
| Output GST when two units are let out (2 units x \$65)   | \$130     |

ABC Properties therefore needs to declare an output GST of \$325 for every month during which the five units are being let out, from June 2007 to November 2008, and \$130 per month for the letting of two units from December 2008 to July 2010 (see Calculation 19).

#### **4.6.7 Returning to initial intention of making a taxable supply**

Since no GST had to be paid when the properties were temporarily let out, no GST can be claimed when the property developer disposes of the properties and his or her activities returned to marketing of properties.

### **4.7 CONCLUSION**

It is clear from the case study that property developers in New Zealand have a beneficial cash flow situation with regard to the change in the use of the properties, compared to property developers in South Africa. The property developers in New Zealand do, however, need to pay GST on the rental income that they receive during the time of the temporary letting.

Australia's legislation will be investigated in the next chapter. Thereafter a recommendation can be made to SARS to give a more beneficial situation to property developers in South Africa.



## CHAPTER 5

### GST ON RESIDENTIAL PROPERTIES IN AUSTRALIA

#### 5.1 INTRODUCTION TO GST IN AUSTRALIA

Australia's value added tax is called Goods and Services Tax (GST). This tax is levied on the supply of goods and services in Australia. The Australian Federal Government introduced GST with the "A New Tax System Act 1999", which became effective on 1 July 2000. GST is levied on most goods and services at 10%, while certain items are GST exempt (Collins Post, 2011).

The criteria for registering as a GST vendor are that you must be carrying on an enterprise and the turnover of the enterprise needs to exceed A\$75 000. A voluntary registration may also be made, as long as an enterprise is carried on. Upon registering for GST, GST credits may be claimed (Australian Taxation Office, 2011).

When you receive any monetary item for the supply of goods or services, it is called a consideration. The goods and services include rights and property. The consideration is used to calculate the GST turnover and GST payable (Australian Taxation Office, 2011).

A transaction where property is being disposed of will be a supply in terms of legislation if it involves the following requirements:

- the supply of goods, services, advice or information with regards to the property and the transaction;
- change of ownership of the property; or
- change in the seller's right to the property (Fernandez, 2000).

A creditable acquisition allows a vendor to claim the GST on these acquisitions against the GST payable to the authorities. A credit may only be claimed if it complies with the following:

- something is attained to use solely or partly in the enterprise;
- the price of the acquisition includes GST;

- the enterprise needs to pay for the purchase; and
- the enterprise is registered or is required to be registered for GST (Australian Taxation Office, 2011).

GST is paid on all taxable supplies, except from GST-free and input-taxed supplies. No GST is payable on input-taxed supplies and examples are:

- financial supplies;
- private and residential premises to let;
- sale of second-hand residential premises; and
- transactions in certain precious metals (Australian Taxation Office, 2011).

Land and buildings are included in the definition of a residential premises as long as it is capable of being occupied. The disposal of property is deemed to be input-taxed to the extent that it is a residential premises which will be used predominantly for residential accommodation. The sale of new residential premises is not input-taxed (Australian Taxation Office, 2011).

## **5.2 CONSTRUCTION AND SALE OF NEW RESIDENTIAL PROPERTIES**

The determining factor on whether a property developer may claim GST is his or her intentions. If the intentions are to sell the newly constructed residential premises, the developer may claim his or her input GST (Batalha, 2008).

New residential premises are considered 'new' if the property was let out by the property developer, and sold within five years from the commencement date of the leasing contract. A property let out for more than five years may still be considered as new if it has been held with a dual purpose of sale. The dual purpose is that the property has not been held exclusively for input-taxed supplies, but has been marketed for sale while being let out (Australian Taxation Office, 2010b).

The GST calculated on the cost price of the new residential premises will be paid upon the sale of the premises (Australian Taxation Office, 2010b).

### **5.3 LEASING OF RESIDENTIAL PROPERTIES**

If a property owner lets residential accommodation out, he or she is not liable to pay GST on the rental income. Furthermore, the owner cannot claim any GST credits for any purchases made with regard to such a property or accommodation (Australian Taxation Office, 2010a).

### **5.4 CHANGE IN USE**

It was established that property developers could claim GST on their construction costs if they intend to sell the newly developed property. Due to certain constraints in the market, the property developer may decide to temporarily let out his or her property. The previously claimed GST may need to be repaid to the Australian Taxation Office (ATO). The amount that needs to be repaid to the ATO will be determined on whether or not the property developer is actively marketing the property or not (Batalha, 2008).

The ATO deems a property to be actively marketed if:

- it is listed for sale with an estate agent;
- it is advertised for sale; and
- arrangements are made for showing prospective buyers the property (Batalha, 2008).

The ATO will not accept a property as being actively marketed if the listing price is substantially above the market value for the particular property (Batalha, 2008).

If a property is temporarily let out and not actively marketed, the entitlement in terms of GST credits needs to be repaid to the ATO. If subsequently the property is sold by the property developer as a new residential property, a portion of the GST will be claimable from the ATO. The portion claimable will be calculated in terms of the actual sale price and the actual amount of rent received from the property during the period that it was let out (Batalha, 2008).

**Table 3: Total GST claimable on costs when temporarily let out and not actively marketed**

| <b>Intended sale</b>  | <b>Rented and not actively marketed</b> | <b>Sold as new residential property</b>               |
|-----------------------|---|---|
| 100% of GST claimable | 0% of GST claimable                     | Actual sale price ÷ (Actual sale price + Actual rent) |

Source: Bathalha, 2008

Where a residential property developer lets out his or her property on a temporary basis and actively markets the property to dispose of it, the property developer is not required to repay all the GST claimed before to the ATO (Batalha, 2008).

In the period that the temporary letting commences the property developer will have to repay the GST claimed on the estimated selling price and the estimated rent that will be derived from the letting activity. When the property finally sells, a further adjustment needs to be made. This time the actual selling price and the actual rent received will be used for the calculation (Batalha, 2008).

**Table 4: Total GST claimable on costs when temporarily let out and actively marketed**

| <b>Intended sale</b>  | <b>Rented and actively marketed</b>                            | <b>Sold as new residential property</b>               |
|-----------------------|--|---|
| 100% of GST claimable | Estimated sale price ÷ (Estimated sale price + Estimated rent) | Actual sale price ÷ (Actual sale price + Actual rent) |

Source: Bathalha, 2008

## 5.5 CASE LAW

No court cases were found that deals specifically with change in use adjustments. *The Toyama Pty Ltd v Landmark Building Developments Pty Ltd* case deals with the matter of property predominantly used for residential purposes and input GST claims (Toyama Pty Ltd v Landmark Building Developments Pty Ltd, 2006).

Toyama and Landmark were co-owners of a property where 14 units had to be developed and erected. Trustees were appointed to market the land and the contract entered into by the parties

provided that the sale was a taxable supply (*Toyama Pty Ltd v Landmark Building Developments Pty Ltd*, 2006).

A property with two residences was situated on the land at the time of the purchase thereof. The trustees were under the impression that the land will be bought for development purposes and that the residences will be demolished once construction commences (*Toyama Pty Ltd v Landmark Building Developments Pty Ltd*, 2006).

The ATO was approached for two private rulings in this matter and the advice received stated that the sale of the land was input taxed due to the characteristics of the premises and that no enterprise was carried on by the trustees (*Toyama Pty Ltd v Landmark Building Developments Pty Ltd*, 2006) (*Toyama Pty Ltd v Landmark Building Developments Pty Ltd*, 2006).

Landmark claimed compensation from the trustees because they felt that the sale was not a taxable supply and the failure of the trustees to describe the sale as a taxable supply caused a breach of trust. The Court concluded that the sale was a taxable supply and that the trustees failed to act with reasonable care (*Toyama Pty Ltd v Landmark Building Developments Pty Ltd*, 2006).

Judge White ruled that the trustees were carrying on an enterprise because there was a series of similar activities in the form of a business. He further ruled that supplies of property are input taxed to the extent that property is used predominantly as residential accommodation. The intentions of the purchaser or lessee ultimately determine the use of the premises (*Toyama Pty Ltd v Landmark Building Developments Pty Ltd*, 2006).

## **5.6 CASE STUDY**

### **5.6.1 Scenario description**

The scenario description in Chapter 3.7.1 will be used for Australia. The currency used will be the Australian Dollar. Please refer back for details on the scenario.

### 5.6.2 Acquisition of the land

DEF Brokers needs to declare GST of \$100 000 to the ATO in March 2006, on disposal of the land. At the same time ABC Properties can claim GST credits to the value of \$100 000 (see Calculation 20).

#### Calculation 20: Australia: Acquisition of land

|                                     |             |
|-------------------------------------|-------------|
| Cost price of the land              | \$1 000 000 |
| VAT on the land (10% x \$1 000 000) | \$100 000   |

### 5.6.3 Completion of the construction work

GHI Construction raises a tax invoice in March 2007, upon completion of their scope of works. The invoice for \$6 000 000 (excluding GST) will attract \$600 000 in GST which needs to be paid to the ATO. During the period of construction, GHI Construction would have been able to claim their GST credits from the ATO with regard to all the services and goods required to complete their work (see Calculation 21).

ABC Properties will be able to claim GST credits to the value of \$600 000 in March 2007.

#### Calculation 21: Australia: Completion of construction work

|  |             |
|--|-------------|
| Value of the construction work                   | \$6 000 000 |
| VAT on the construction work (10% x \$6 000 000) | \$600 000   |

### 5.6.4 Sale of the properties

JKL Estate Agents managed to sell 15 units and ABC Properties had to raise invoices to a combined value of \$7 500 000. The GST payable to the ATO amounts to \$750 000, but ABC Properties will be allowed to claim the GST credits with regard to the commission paid to JKL Estate Agents from this payable amount in the same month (see Calculation 22).

JKL Estate Agents present an invoice in favour of ABC Properties with a GST amount of \$75 000. JKL Estate Agents need to pay this amount over to the ATO, while ABC Properties will claim the same amount from the ATO (see Calculation 22).

**Calculation 22: Australia: Sale of 15 units**

|  |             |
|--|-------------|
| Value of the supply (15 units x \$500 000)         | \$7 500 000 |
| VAT on the supply of the units (10% x \$7 500 000) | \$750 000   |
| Value of the commission earned (\$7 500 000 x 10%) | \$750 000   |
| VAT on the commission earned (\$750 000 x 10%)     | \$75 000    |

The same procedure will be followed on the subsequent sale of the three units in November 2008. ABC Properties will pay \$135 000 to the ATO while claiming \$13 500, which will be the same amount as what JKL Estate Agents will pay over to the ATO (see Calculation 23).

**Calculation 23: Australia: Sale of three units**

|  |             |
|--|-------------|
| Value of the supply (3 units x \$450 000)          | \$1 350 000 |
| VAT on the supply of the units (10% x \$1 350 000) | \$135 000   |
| Value of the commission earned (\$1 350 000 x 10%) | \$135 000   |
| VAT on the commission earned (\$135 000 x 10%)     | \$13 500    |

When the sale of the balance of the units take place in July 2010, ABC Properties will be liable for GST of \$90 000, while claiming \$9 000 with regard to the commission paid to JKL Estate Agents (see Calculation 24).

**Calculation 24: Australia: Sale of two units**

|  |           |
|--|-----------|
| Value of the supply (2 units x \$450 000)        | \$900 000 |
| VAT on the supply of the units (10% x \$900 000) | \$90 000  |
| Value of the commission earned (\$900 000 x 10%) | \$90 000  |
| VAT on the commission earned (\$90 000 x 10%)    | \$9 000   |

### 5.6.5 Change in use from taxable supplies to exempt supplies

In May 2007, ABC Properties change their initial intention from solely selling the properties, to letting the properties out until they are sold. JKL Estate Agents continue with their mandate to market the properties.

At this time, ABC Properties are still convinced that they will be able to sell the properties for the initial \$500 000 (excluding GST). They estimate that the properties will be sold within the next year. By renting the properties out they will generate \$5 000 per unit per month.

#### Calculation 25: Australia: Temporary letting of five units for one year

|  |           |
|--|-----------|
| Estimated sale price per unit  | \$500 000 |
| Estimated rent for a year  | \$60 000  |
| Estimated sale price ÷ (Estimated sale price + Estimated rent)                         |           |
| $\$500\,000 \div (\$500\,000 + \$60\,000)$   | 89.29%    |
| Construction cost per unit ( $\$6\,000\,000 \div 20$ units)                            | \$300 000 |
| Land cost per unit ( $\$1\,000\,000 \div 20$ units)                                    | \$50 000  |
| Total cost per unit  | \$350 000 |
| GST claimed per unit ( $\$350\,000 \times 10\%$ )                                      | \$35 000  |
| GST claimable based on estimated rent and selling price ( $\$35\,000 \times 89.29\%$ ) | \$31 250  |
| GST repayable to the ATO per unit ( $\$35\,000 - \$31\,250$ )                          | \$3 750   |
| Total repayable to the ATO ( $\$3\,750 \times 5$ units)                                | \$18 750  |

An adjustment will have to be made whereby only 89.29% of the initial GST credits claimed will be claimable. The initial cost to erect the units and each unit's portion of the land was \$350 000. The GST amount per unit was \$35 000. Only an amount of \$31 250 is now claimable from the ATO, which will result in ABC Properties repaying an amount of \$3 750 per unit to the ATO. The total repayment in respect of this change in use is \$18 750 (see Calculation 25).



### 5.6.6 Letting of residential units

The letting of the five units is an input-taxed activity and no GST will be levied, and no GST is paid to the authorities.

### 5.6.7 Returning to initial intention of making a taxable supply

In November 2008, three of the remaining five units are sold. Each of the units were let out for a total of 18 months and generated a rental income of \$90 000. The units were sold for \$450 000 each instead of the estimated \$500 000.

#### Calculation 26: Australia: Sale of three units previously let out

|   |           |
|---|-----------|
| Actual sale price per unit  | \$450 000 |
| Actual rent for a the period under lease (\$5 000 x 18 months)                              | \$90 000  |
| Actual sale price ÷ (Actual sale price + Actual rent)<br>\$450 000 ÷ (\$450 000 + \$90 000) | 83.33%    |
| Total cost per unit   | \$350 000 |
| GST claimed per unit (\$350 000 x 10%)  | \$35 000  |
| GST claimable based on actual rent and selling price (\$35 000 x 83.33%)                    | \$29 167  |
| GST repayable to the ATO per unit (\$35 000 - \$29 167)                                     | \$5 833   |
| Repaid in May 2007  | \$3 750   |
| Still due to the ATO (\$5 833 - \$3 750)  | \$2 083   |
| Total GST payable to ATO (\$2 083 x 3 units)  | \$6 249   |

In November 2008, ABC Properties calculated that only 83.33% of the initial \$35 000 could have been claimed from the ATO. An adjustment and repayment was made in July 2008 to an amount of \$3 750 per unit. A further \$2 083 per unit for three units, totalling \$6 249, needs to be paid to the ATO in terms of adjustments on the GST credits (see Calculation 26).

Finally, in July 2010 the last two units are sold and a further \$13 282 had to be repaid to the ATO with regard to input credits previously claimed (see Calculation 27).

**Calculation 27: Australia: Sale of two remaining units previously let out**

|  |           |
|--|-----------|
| Actual sale price per unit   | \$450 000 |
| Actual rent for the period under lease (\$5 000 x 38 months)             | \$190 000 |
| Actual sale price ÷ (Actual sale price + Actual rent)                    |           |
| \$450 000 ÷ (\$450 000 + \$190 000)                                      | 70.31%    |
| Total cost per unit  | \$350 000 |
| GST claimed per unit (\$350 000 x 10%)                                   | \$35 000  |
| GST claimable based on actual rent and selling price (\$35 000 x 70.31%) | \$24 609  |
| GST repayable to the ATO per unit (\$35 000 - \$24 609)                  | \$10 390  |
| Repaid in May 2008   | \$3 750   |
| Still due to the ATO (\$10 390 - \$3 750)                                | \$6 641   |
| Total payable to the ATO (\$6 641 x 2 units)                             | \$13 282  |

In total, due to the decision to temporarily let out the units, an amount of \$38 281 could not have been claimed from GST and ABC Properties forfeited this amount.

**Calculation 28: Australia: Total GST repaid to the ATO**

|  |          |
|--|----------|
| GST repaid upon starting exempt supply (as per Calculation 25) | \$18 750 |
| GST repaid on sale of three units                              | \$6 249  |
| GST repaid on sale of two units                                | \$13 282 |
| Total GST repaid   | \$38 281 |

## 5.7 CONCLUSION

Although it is evident that Australia's situation in the event of temporary letting of newly constructed residential units is not as beneficial to a property developer as is the case in New Zealand, it is still better than the situation South African property developers face.

A comparison will be made between the three countries' treatment of the issue of temporary letting of units held ultimately for sale, where after a recommendation will be presented to the authorities in South Africa.

## CHAPTER 6

### CONCLUSION AND RECOMMENDATION

#### 6.1 INTRODUCTION

Through this study, and after reviewing the basis for exempting the letting of residential accommodation, the practises in each of the selected countries were evaluated. South Africa is being compared to New Zealand and Australia, and it can be safely said that South Africa has some of the harshest legislation for value-added tax compared to the other two countries.

A side-by-side comparison will be made on the effects that change in use adjustments has on ABC Properties, should ABC Properties be situated in South Africa, New Zealand or Australia.

After comparing the tax effect on ABC Properties, a recommendation will be made to SARS. The recommendation will specifically target section 18 of the VAT Act.

#### 6.2 CONCLUSION

##### 6.2.1 The fundamental principles underlying the identified VAT-systems relating to the imposition of VAT on residential properties

VAT vendors disposing of residential properties in the course or furtherance of an enterprise will levy VAT on the sale of such a property, while a non-VAT vendor will dispose of the property exempt of VAT. The disposal of a property by a non-VAT vendor will attract transfer duties.

The letting supply of residential accommodation in a dwelling is exempt from VAT, mainly due to the fact that a VAT system should not discriminate against people letting their residences, as opposed to owning their own residence.

Should residential accommodation in a dwelling be a taxable supply it will cause major administrative difficulties for the authorities trying to monitor and administer the system.

### **6.2.2 The relevant sections of the South African VAT Act that are applicable when a property developer starts making temporary exempt supplies**

Section 18 of the VAT Act governs change in use adjustments in its entirety. Section 18(1) explains the procedure for when an initial taxable supply is subsequently used as an exempt supply. The focus in section 18(1) is market value. The calculation of the input VAT that needs to be repaid to SARS is calculated on the market value of the supply at the date that such a change in use occurs.

Section 18(4) explains the methodology for when an exempt supply is subsequently used as a taxable supply. In this subsection, the focus is on the initial cost price of the goods or services. This could be catastrophic because the market value was used to determine the initial output VAT adjustment, while the cost price, usually much lower than the market value, is used to claim the input VAT deduction when the intentions of the property developer is reversed.

### **6.2.3 Comparison of the South African VAT legislation with that of New Zealand and Australia with regard to change in use adjustments applicable to property developers**

Chapters 3 to 5 explain the methodologies used in South Africa, New Zealand and Australia when dealing with a change in use adjustment for property developers specifically. It is evident from these chapters that legislation in these countries differ vastly.

Chapter 3 also explains that the new Tax Amendment Bill 2011 will provide some relief for property developers. Table 5 will set out the value-added tax effects of all of ABC Properties' transactions.

**Table 5: The value-added tax effect on ABC Properties at the GST rates applicable to the case study in the selected countries**

|  | South Africa          | South Africa         | New Zealand    | Australia      |
|--|-----------------------|----------------------|----------------|----------------|
|  | Before Amendment Bill | After Amendment Bill |                |                |
|  | ZAR                   | ZAR                  | NZD            | AUD            |
| Acquisition of the land  | (140 000)             | (140 000)            | (125 000)      | (100 000)      |
| Construction of the units  | (840 000)             | (840 000)            | (750 000)      | (600 000)      |
| Sale of 15 units   | 1 050 000             | 1 050 000            | 937 500        | 750 000        |
| Commission on the sale of 15 units                                 | (105 000)             | (105 000)            | (93 750)       | (75 000)       |
| Start letting out the remaining five units                         | 350 000               | 0                    | 0              | 18 750         |
| Letting out five units from June 2007 to November 2008 (18 months) | 0                     | 0                    | 5 850          | 0              |
| End the letting of three units                                     | (147 000)             | 0                    | 0              | 6 249          |
| Sale of three units  | 189 000               | 189 000              | 168 750        | 135 000        |
| Commission on the sale of three units                              | (18 900)              | (18 900)             | (16 875)       | (13 500)       |
| Letting out two units from December 2008 to July 2010 (20 months)  | 0                     | 0                    | 2 600          | 0              |
| Expiry of 36 month relieve period                                  | 0                     | 126 000              | 0              | 0              |
| End letting of two units   | (98 000)              | (98 000)             | 0              | 13 282         |
| Sale of two units  | 126 000               | 126 000              | 112 500        | 90 000         |
| Commission on the sale of two units                                | (12 600)              | (12 600)             | (11 250)       | (9 000)        |
| <b>TOTAL VAT PAID</b>  | <b>372 400</b>        | <b>276 500</b>       | <b>230 325</b> | <b>209 140</b> |
| <b>VAT CONSEQUENCE OF CHANGE IN USE</b>                            | <b>105 000</b>        | <b>28 000</b>        | <b>8 450</b>   | <b>38 281</b>  |

For a clearer understanding of the VAT effect in each of the three countries, all GST rates will be converted to a rate of 14%.

**Table 6: The value-added tax effect on ABC Properties at the equivalent of 14%**

|  | South Africa                   | South Africa         | New Zealand    | Australia      |
|--|--------------------------------|----------------------|----------------|----------------|
|  | Before Tax Amendment Bill 2011 | After Amendment Bill |                |                |
|  | ZAR                            | ZAR                  | NZD            | AUD            |
| Acquisition of the land  | (140 000)                      | (140 000)            | (140 000)      | (140 000)      |
| Construction of the units  | (840 000)                      | (840 000)            | (840 000)      | (840 000)      |
| Sale of 15 units   | 1 050 000                      | 1 050 000            | 1 050 000      | 1 050 000      |
| Commission on the sale of 15 units                                 | (105 000)                      | (105 000)            | (105 000)      | (105 000)      |
| Start letting out the remaining five units                         | 350 000                        | 0                    | 0              | 26 250         |
| Letting out five units from June 2007 to November 2008 (18 months) | 0                              | 0                    | 6 552          | 0              |
| End the letting of three units                                     | (147 000)                      | 0                    | 0              | 8 749          |
| Sale of three units  | 189 000                        | 189 000              | 189 000        | 189 000        |
| Commission on the sale of three units                              | (18 900)                       | (18 900)             | (18 900)       | (18 900)       |
| Letting out two units from December 2008 to July 2010 (20 months)  | 0                              | 0                    | 2 912          | 0              |
| Expiry of 36 month relieve period                                  | 0                              | 126 000              | 0              | 0              |
| End letting of two units   | (98 000)                       | (98 000)             | 0              | 18 595         |
| Sale of two units  | 126 000                        | 126 000              | 126 000        | 126 000        |
| Commission on the sale of two units                                | (12 600)                       | (12 600)             | (12 600)       | (12 600)       |
| <b>TOTAL VAT PAID</b>  | <b>372 400</b>                 | <b>276 500</b>       | <b>257 964</b> | <b>302 094</b> |
| <b>VAT CONSEQUENCE OF CHANGE IN USE</b>                            | <b>105 000</b>                 | <b>28 000</b>        | <b>9 464</b>   | <b>53 594</b>  |

By using the equivalent of 14% for all VAT and GST rates, it is clear to see that the system in New Zealand gives the best advantage to a property developer. Australia's property developers will be worse off than the property developers in New Zealand, while South African property developers, under current legislation bites the bullet the hardest. The relief under the Amendment Bill will put South Africa in a situation between New Zealand and Australia.

The biggest driving force for a property developer to pursue the letting of his or her residential properties is usually of an economic nature. The property developer would rather receive compensation in the form of rental income, than to have the property stand vacant. The property developer incurred all the expenses to build the residential accommodation, and is subsequently burdened by huge payments to SARS, in respect of this change in use.

Although the Tax Amendment Bill 2011 gives some form of relief, the property developer is still affected if the property is not sold within the 36-month relief period.

#### **6.2.4 A suggestion for a permanent amendment to the VAT Act that will address the problem identified, that is the harsh cash flow consequences for residential property developers**

To enable South Africa's government to assist property developers a new section needs to be introduced into the VAT Act and section 18 needs to be amended.

All reference to goods and services in section 18(1) and 18(4) needs to be amended to exclude fixed property supplied as exempt supplies. A new subsection 18(11) needs to be introduced to the VAT Act. The section should specifically treat change in use where fixed property is involved.

Section 18(11) needs to incorporate the following:

- A temporary change in use needs to be defined and a period of not more than five years needs to be allowed. After a period of five years, the normal provisions of section 18 needs to apply; and
- rental income received by a property developer received in that period needs to be subject to an output tax adjustment at the normal VAT rate of 14%.

The new section in the VAT Act should read as follows:

**18. Change in use adjustments.**

(11) Where –

- (a) fixed property is held for making taxable supplies; and
- (b) fixed property is let out for less than five years, in anticipation of making a taxable supply,

output tax needs to be calculated on one fifth of the consideration received by the vendor.

**Table 7: The change in use effect of present and proposed value-added tax on ABC Properties**

|  | South Africa          | South Africa         | South Africa  |
|--|-----------------------|----------------------|---------------|
|  | Before Amendment Bill | After Amendment Bill | New proposal  |
|  | ZAR                   | ZAR                  | ZAR           |
| Start letting out the remaining five units                         | 350 000               | 0                    | 0             |
| Letting out five units from June 2007 to November 2008 (18 months) | 0                     | 0                    | 12 600        |
| End the letting of three units                                     | (147 000)             | 0                    | 0             |
| Letting out two units from December 2008 to July 2010 (20 months)  | 0                     | 0                    | 5 600         |
| Expiry of 36 month relieve period                                  | 0                     | 126 000              | 0             |
| End letting of two units   | (98 000)              | (98 000)             | 0             |
| <b>TOTAL VAT PAID ON CHANGE IN USE</b>                             | <b>105 000</b>        | <b>28 000</b>        | <b>18 200</b> |

From table 7 it is clear that a property developer in the scenario will have a big advantage compared to current legislation, regardless of whether the Tax Amendment Bill 2011 or the new proposal is used. The benefit to the property developer in the new proposal lies in the cash flow advantage. The developer will be able to pay the VAT on the rental income in the month that the rental income



is received. This effectively means that he or she will be able to pay the VAT when the resources are available.

As a developing country, South Africa needs to carefully consider the implications of legislation on its business community. Burdening a residential property developer with excessive tax payments can result in liquidation of such a developer. Ultimately, residential property developers operate for a profit, which will attract income tax in the end. Every taxpayer lost in South Africa, will eliminate potential revenue for the country as a whole. Therefore, the best possible situation needs to be created in which a property developer can operate, achieve a profit and pay taxes.

Only the future will prove whether the South African government will make a change to the harsh legislation that can ruin a business in time of need, or whether government will alleviate the burden for the benefit of its citizens and business community.

### **6.3 FUTURE RESEARCH**

This study considered two developed countries, namely New Zealand and Australia. A suggestion for future research is to compare South Africa's VAT legislation for change in use adjustments for property developers with that of other African countries, since all of the countries in Africa are developing countries.

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