

# Developments in the VAT and residential property realm - part 1

By Ursula Diale-Ali and Jana Krause

5 Oct 2023

In part 1 of this article, we unpack the VAT rules that apply to fixed property transactions in South Africa and complexities that arise, the relief granted when temporarily letting a property, the introduction of permanent relief and an explanation of adjusted costs.



Image source: Avadh from [Pexels](#)

The South African Value Added Tax (VAT) rules that apply to fixed property transactions have never been straightforward and, as noted in the Budget Review 2023, there are some inconsistencies in the provisions of the Value Added Tax Act (VAT Act), which seem to exacerbate the challenges faced by property developers in meeting their VAT obligations.

The sale of fixed property in South Africa is either subject to VAT or transfer duty. VAT applies where the seller of the fixed property is a VAT vendor, that is a person who is, or is required to be, registered for VAT, and the sale is made in the course or furtherance of that vendor's taxable enterprise (business). Where the seller is a non-registered person (who is not required to be VAT registered), the sale would generally attract transfer duty.

While this may sound straightforward, the complexities arise when property developers construct or develop residential properties for sale, which is a taxable activity and forms part of their taxable business, but then let those properties for residential purposes, which is not a taxable activity for VAT purposes.

To clarify, the sale of residential property by a developer is subject to VAT, while the letting of residential property is exempt from VAT and therefore does not form part of a developer's taxable business.

## Supply of residential property by developers

The VAT Act defines a "developer" as a vendor who continuously or regularly constructs, extends or substantially improves

residential property or parts of that property for the purpose of disposal.

During adverse market and economic conditions, buying residential property is a luxury that many cannot afford, and developers often battle to sell all their newly-built residential property stock as intended. This was a stark reality for property developers in South Africa during the Covid pandemic, which forced them to take necessary steps to ensure the continuation of their businesses and being able to service their financial obligations, including towards creditors and staff.



## How to apply VAT relief for property developments

Lisa Tonini & Ahmed Jooma 25 Jul 2023



Many developers therefore sought to generate rental income by letting the properties until the economy stabilised and the properties could be sold. This change in intention (ie. from taxable sale to exempt residential rental) did not necessarily grant relief because of the financial impact on developers that resulted from certain VAT obligations.

## Temporary letting of residential property-deemed disposal

When a developer constructs or develops a residential property for sale, its intention is ultimately to make a taxable supply, which is subject to VAT at the standard rate of 15%. If the developer subsequently decides to rent out the property, there is a change in intention for the use of that property, ie. from sale (which is a taxable supply) to letting (which is exempt from VAT).

This change in intention triggers a deemed disposal for VAT purposes whereby the developer is deemed to have disposed of the property in the course or furtherance of their taxable business and, as a result, has an obligation to account for output tax at the open market value (OMV), ie. the amount which the supply of property would generally fetch if supplied in similar circumstances on a specific date in South Africa, being a supply freely offered and made between unconnected persons, of the property when it is first let.

The cash flow burden placed on the developer is considerable, as the exempt income generated is usually charged over the period of the lease and is substantially less than the OMV of the property.

Due to the effect of the disproportionality between the OMV and the rental income in the developer's pocket, the government proposed a temporary measure that essentially granted relief to developers letting out property on a temporary basis during the period from 10 January 2012 to 1 January 2018 (relief period).

In this regard, the duty placed on the developer to declare output tax on the OMV of the property was suspended for the duration of the relief period. The developer would only be required to declare output tax on the earlier of the date on which the temporary letting period of 36 months had been exceeded or the property was permanently used for a non-taxable

purpose.

## Section 18D - permanent relief introduced

Since the relief period ended on 1 January 2018, there were no immediate alternative relief measures available to developers during and subsequent to Covid. Therefore, the previous dispensation (ie. immediate disposal on the OMV basis) continued to apply until a more permanent solution to the issues faced by developers was introduced.

Section 18D of the VAT Act came into effect from 1 April 2022 and stipulates that a developer is deemed to be making a taxable supply where he, for any reason, temporarily lets out residential property that has been developed for the purposes of sale.

"Temporary" for purposes of section 18D means a period of 12 months or less; anything more than that is regarded as permanent. Therefore, section 18D does not apply to any lease period exceeding 12 months (fixed lease agreement).



Property developers will face cash flow pressure due to VAT on temporary rental of residential units

Chetan Vanmali, Des Kruger and Andile Mya 13 Feb 2018



Currently, under section 18D(2), the developer is still deemed to be making a disposal of the fixed property in the course of his taxable business, but is required to account for VAT at the standard rate on the "adjusted cost" of the construction, extension or improvement of the residential property, as opposed to the OMV of the property.

Furthermore, no output tax is payable on the rental income received by the developer as the amounts constitute consideration that is paid or payable in respect of exempt supplies.

### Adjusted cost

"Adjusted cost" is currently defined in the VAT Act as any cost where VAT has been charged or would have been charged, in respect of which an input tax deduction may be claimed by the developer.

This means that the developer will be deemed to supply the property for an amount equal to the costs incurred by him in constructing, extending, or improving that property, to the extent that the developer's supplier would have charged VAT on the supply to the developer or if the developer would have been entitled to claim an input tax deduction in respect of such costs.

Therefore, any costs incurred by the developer that are not VAT-inclusive and are unrelated to the development of the property would not be included in determining the value of the supply.

As indicated in the South African Budget Speech, it is uncertain under the current provisions whether the phrase "adjusted cost of the construction, extension or improvement of the residential property" includes the cost of the land, as incurred by the developer. If so, the value of the supply would be higher and undoubtedly give rise to a higher output tax.

The general view is that the cost of the land should be included, as it essentially includes the costs associated with constructing the property. This is arguably correct, as there can be no construction of the residential property if there is no land.

Considering the uncertainty of whether costs of land could be regarded as costs for construction, it was proposed in the 2023 Budget Review that the meaning of "adjusted cost" as contemplated in section 10(29) of the VAT Act should be clarified for purposes of its application in section 18D. This is crucial considering the long history of the development of tax

policy as far as property issues are concerned.

Certainty in the interpretation of these provisions is overdue and recognised by Sars in Binding General Ruling (VAT) 64, published on 21 June 2023.

[Read part 2 of this article here.](#)

## ABOUT THE AUTHOR

Ursula Diale-Ali, Associate, and Jana Krause, Tax Counsel, Tax Practice, Baker McKenzie Johannesburg

For more, visit: <https://www.bizcommunity.com>