Tax Law article by Barry Ger, December 2008 issue of De Rebus magazine.

In the 2008 (Aug) DR 52, the relative scarcity of tax incentives for residential property developers and buyers was lamented, especially in these times of economic downturn when property sales, especially residential property sales, are plummeting and reasonably priced rental accommodation is hard to find. It was noted in that article that developers of residential property who build to-let may, however, be able to rely on a long forgotten tax incentive introduced in the early 1980s, set out in s 13ter of our Income Tax Act 58 of 1962 (the Act).

This incentive allows developers to claim a write-off also known as 'capital allowances' of the building costs they incurred as tax deductions from their income provided certain conditions are met.

No sooner had the ink on that article dried, than sweeping changes were announced by the Treasury to rule capital allowances in respect of such built-to-let residential property. It has been proposed in the Revenue Laws Amendment Bill 80 of 2008 that the provocatively named s 13sex will be added to the Act to replace the moribund s 13ter. This new provision gives greater tax advantages to developers than were previously available.

It also partially extends these advantages to buyers of new or unused residential property that is bought to let. Buyers or builders of the so-called low-cost residential property are particularly incentivised under the new regime. This article will consider the proposed provision in some detail.

Background

As a starting point however, it is useful to examine some of the background to the introduction of this new provision.

Historically, the rules relating to claiming tax allowances on immovable property that is used for income producing purposes have been somewhat incoherent and confusing.

The Act has always generally granted depreciation allowances for movable assets used by a taxpayer involved in a form of trade. It has however been selective, in granting such allowances for buildings and other permanent structures. Whether an allowance was permissible in respect of such assets and the amount of such allowance depended on the specific type of trade the building or permanent structure was used in.

For example, hotels could be written off at a rate of 5% per annum whereas capital expenditure for mining was subject to a 100% allowance. Other buildings used for trade not covered by a specific depreciation regime, such as rental properties, were not entitled to any depreciation at all despite their business usage.

In recent years there has been a gradual realisation that this scattershot approach is short-sighted. It is a fact, long recognised in accounting practice, that all permanent structures depreciate due to their limited useful life. Consequently, there seemed to be no reason why the tax system should exclude some commercially used buildings from write-offs for depreciation and not others.

In 2007, s 13quin of the Income Tax Act was introduced which allowed commercial buildings to be written off at a rate of 5% per year to the extent that such buildings fell outside other depreciation regimes. Inexplicably, residential building used for letting were excluded from this new allowance.

In the 2008 round of amendments, this mistake appears to have been acknowledged in the form of the newly proposed s 13sex to the Act, which if adopted, in its current form, will have kicked into operation on 21 October 2008.

In the explanatory memorandum that accompanied the proposed amendment, it was stated that the new pro-

vision represented recognition of the inherent risks involved in the property market and the need to encourage the provision of low cost accommodation. It was also meant to introduce a simpler more comprehensive depreciation regime that was easier to comply with (and to enforce).

The effect of the new residential building allowance

So what is the effect of this new provision? Developers who qualify under the new s 13sex will be able to write off the cost of all new and unused 'residential units' they erect on or after 21 October 2008 at an annual rate of 5%. The 5% write-off applies also to the cost of new and unused improvements to existing buildings.

Furthermore, this allowance is not apportioned for part of year so even if a building is acquired on the last day of a tax year, the full 5% may be claimed as a deduction. It may be noted that this is a faster depreciation rate than the allowances granted under s 13ter which permitted allowances totaling only 12% in the first year in which a qualifying building was occupied and a further 2% in succeeding years. This means building costs can now be written off over a much shorter 20 years with s 13sex instead of the 45 year write-off that s 13ter permitted.

Purchasers of residential units are also entitled to the write-off. However the amount they may write off is limited to 55% of the acquisition price of the residential unit or 30% of the price of an improvement thereon where they have acquired a residential unit or improvement representing only a part of the building. (It must be said that this restriction on purchasers is a somewhat puzzling aspect of the new tax incentive. It appears to prejudice purchasers of new and unused apartments over purchasers of new and unused buildings. Possibly, this is in line with the overall aim of the incentive to encourage large developments).

There is even greater depreciation permitted in the case of so-called low cost accommodation. Residential units that qualify (ie, so-called 'low-income residential units') can be written off at a rate of 10% – that is, over 10 years. Low-income residential units are however strictly defined to refer to buildings that cost up to R200 000, or in the case of apartments, that which do not exceed a cost of R250 000. Furthermore, the owner may not charge a monthly rental rate in excess of 1% of the aforementioned amounts (plus, in the case of buildings, a proportionate share of the cost of the land bulk infrastructure).

The rental charge restriction is apparently in place to ensure that the benefiting properties are used by low-income tenants. The South African Revenue Service has indicated however that it will allow for these rental and cost monetary thresholds to be adjusted over time to take account of annual inflation. It has been proposed, in the legislation, that for purposes of calculating the rental charge, the cost will be increased by 10% for each year subsequent to the year in which the building or apartment is brought into use.

Requirements to qualify for the allowance

So how does one qualify for this new improved tax incentive?

Firstly, it stands to reason that the allowance will apply only to new or unused residential unit or improvements. A residential unit refers to a building or self-contained apartment, mainly used for residential accommodation with the exclusion of structures used by person carrying on the business of a hotelkeeper.

This would mean, for example, that developers of hotels or buyers of flats that had previously been occupied would not qualify for this incentive. This is understandable given that the underlying rationale behind these particular provisions is the encouragement of the building of greater rental accommodation. (It seems odd though that the provision refers to 'new or unused improvements'. Surely, all improvements are 'new and unused'?)

Secondly and most importantly, the residential unit or improvements thereon must be used solely for purpos-

es of the taxpayer's trade. This effectively prevents the allowance being claimed for housing arrangements that are for personal use.

Thirdly, the allowance is available only if the taxpayer owns at least five residential units within South Africa which are all used for the purposes of the taxpayers' trade. Apparently, this condition was put in place in order to encourage substantial projects.

Fourthly, the residential unit must itself be situated in South Africa for the incentive to apply.

Anti-avoidance and recoupment considerations

The provisions contain the standard protections against taxpayers who intend to abuse them for purposes of tax avoidance.

For example, the amount of the deduction is limited to the lesser of the actual cost or the market value of the residential unit. This limitation is in place to prevent unscrupulous taxpayers buying or building the unit at inflated prices from connected parties so as to 'bump up' the amount upon which the allowance is calculated and obtain a greater tax deduction. Furthermore, there will be no deduction permitted if the taxpayer has previously claimed a deduction under another section of the Act (ie, there can be no 'double-dipping' of capital allowances).

Additionally, it should be borne in mind that the allowance is also subject to the normal recoupment provisions. This means that if the building in respect of which the allowance was claimed is sold, the sale proceeds will be subject to normal income tax to the extent that allowances under s 13sex were claimed.

Last word

The proposed provision represents positive news for business people involved in the residential building sector and a definite improvement over the existing s 13ter. It may be recommended that developers and purchasers who think they may qualify for this allowance should pay a visit to their tax advisors.

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