TAX & EXCHANGE CONTROL

ALERT

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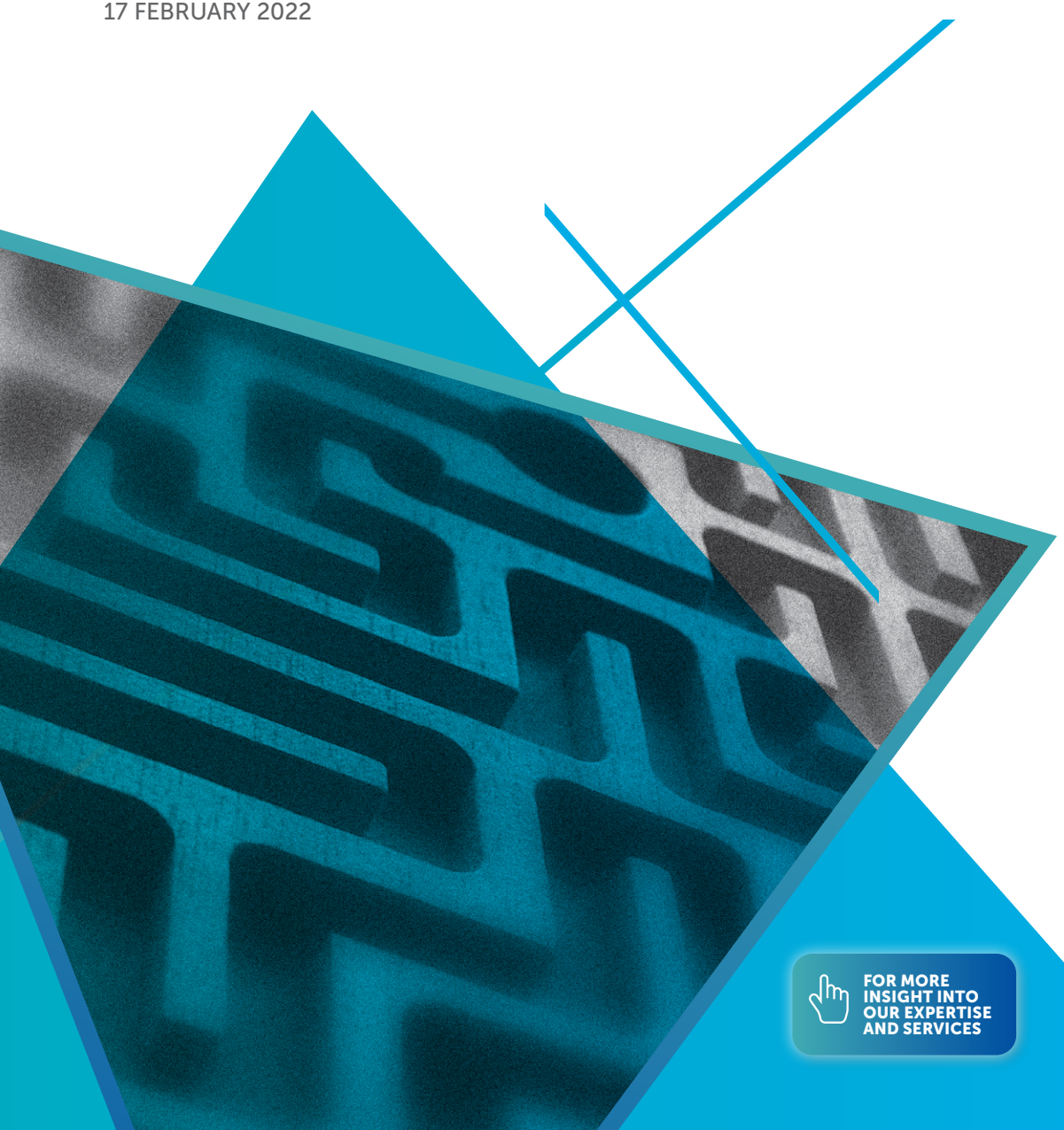

FOR MORE INSIGHT INTO OUR EXPERTISE AND SERVICES

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VAT on temporary letting of residential property by developers: The new rules

The Taxation Laws Amendment Act 20 of 2021 will insert a new section 18D into the Value-Added Tax Act 89 of 1991 (the VAT Act) with effect from 1 April 2022. Section 18D deals with the temporary letting of residential property by a property developer, specifically, the change in use adjustment required to be made by a developer on letting of residential property, the VAT treatment of any subsequent sale of a residential property that has been temporarily let, and the deemed input tax deduction available to developers upon the sale of the property in question.

VAT on temporary letting of residential property by developers: The new rules

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BACKGROUND

Where a property developer who is registered for VAT develops residential properties for sale, the developer is entitled to deduct the VAT incurred on the development costs as input tax, and is obliged to levy VAT at the standard rate on the sale of each developed unit.

Notwithstanding a developers' intention to sell the developed property, it often happens that in adverse market conditions the developer is unable to find a buyer at the required selling price. The developer may then opt to let the property unit temporarily to generate some cash flow until such time as market conditions are more favorable and a suitable buyer can be found.

The letting of residential property as a dwelling is exempt from VAT. Consequently, the moment the units are let, the developer is regarded as having made a change in use of the unit for VAT purposes from a taxable application to an exempt application. VAT then becomes due and payable by the developer in terms of section 18(1) on the open market value of the unit as at the date on which the property is let.

It was recognised in the 2010 Budget Review that the value of this adjustment is disproportionate to the exempt income received by the developers and that options should be investigated to determine a more reasonable dispensation in dealing with the temporary letting of residential properties developed for sale.

Section 18B of the VAT Act was then introduced with effect from 10 January 2012 and granted temporary relief to developers who were then allowed to temporarily let the residential units for a period of up to 36 months before a change in use adjustment was required. However, the temporary relief provided under section 18B ceased to apply on 1 January 2018.

Consequently, residential property developers who then, for the first time, let their properties from 1 January 2018, were once again required to perform the change in use adjustment in terms of section 18(1) on the open market value of the property when the unit was first let as a dwelling. However, the difficulties created by the section 18(1) adjustment which existed prior to the section 18B temporary relief measures remained and developers were once again faced with cash flow difficulties resulting from the disproportionate adjustment.

For a period, the South African Revenue Service (SARS) allowed developers who performed a section 18(1) adjustment and who then subsequently sold the fixed property to deduct the total amount of VAT previously paid under section 18(1), against the output tax payable on the sale price. This was in terms of its VAT News 14 (March 2000). However, when SARS issued Binding General Ruling 55 (BGR55) on 10 September 2020, it took a completely different view, and stated that the subsequent sale of a dwelling

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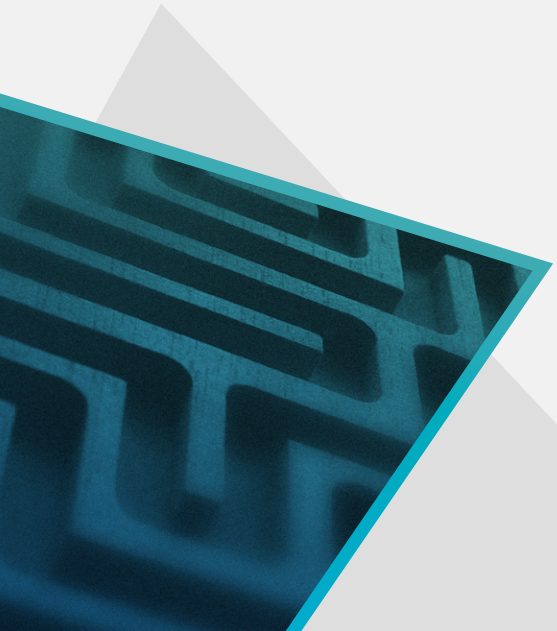

for which a developer performed a section 18(1) adjustment would not be subject to VAT, but rather it would be subject to transfer duty. This was on the basis that the property no longer constitutes an enterprise asset of the developer. The developer was accordingly not entitled to claim any input tax deduction on the subsequent sale of the property.

This led to much confusion amongst property developers. Specifically, regarding whether the change in use adjustment resulted in the subsequent supply of the residential fixed property being permanently removed from the VAT net. Some property developers considered that output tax was still payable when the unit was subsequently sold while others did not.

SECTION 18D

Section 18D, together with sections 9(13) and 10(29), have now been inserted into the VAT Act to clarify the VAT treatment of the temporary letting of residential property with effect from 1 April 2022.

Section 18D(1) defines the term "*developer*" to mean a vendor who continuously or regularly constructs, extends or substantially improves fixed property or part of that fixed property consisting of any dwelling for the purpose of disposing of that fixed property after the construction, extension or improvement.

"*Temporary applied*" is defined to mean the application of fixed property or a portion of a fixed property in supplying accommodation in a dwelling under an agreement, or more than one agreement for letting and hiring thereof, which agreement or agreements, relate to a combined total period not exceeding 12 months. The proviso to the definition states that 'temporarily applied' does not apply to rental agreements which provide for a fixed rental period exceeding 12 months, in which case section 18D will not apply, but rather the provisions of section 18(1) will apply.

Subsection (2) provides for the adjustment and stipulates that where a developer develops residential fixed property for purposes of sale, but temporarily lets such property as residential accommodation in a dwelling, the fixed property is deemed to be supplied by the vendor for a consideration in money equal to the adjusted cost to the vendor of the construction, extension, or improvement of such fixed property or portion thereof. The term 'adjusted cost' is defined in section 1(1) and

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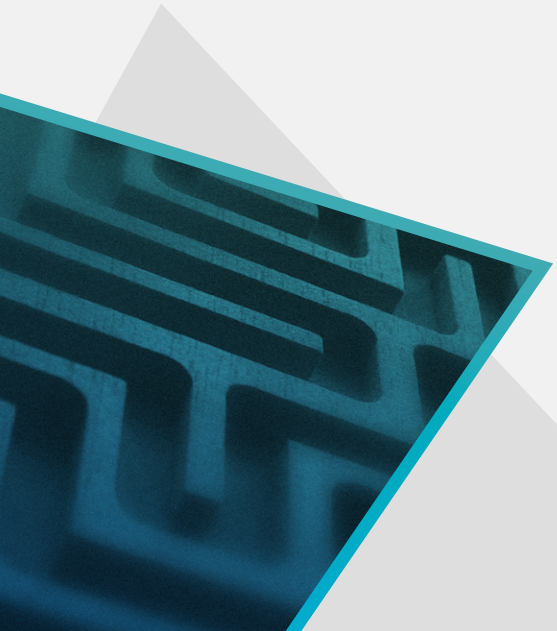

is essentially the VAT inclusive cost of the goods or services in respect of the development of the property. The developer will be required to make the output tax adjustment, being the tax fraction of the adjusted cost, in the tax period in which the lease agreement comes into effect.

Subsection (3) and (4), provides for the VAT treatment of the subsequent sale of the temporarily let property. It provides that where a developer subsequently sells the fixed property in question within the 12-month period that the property was let, the sale is deemed to be a taxable supply in the ordinary course and the vendor must levy and account for VAT on the consideration charged for the property at the earlier of the date of any payment of consideration or registration of the property in the Deeds Registry.

Finally, subsection (5) provides that the developer is entitled to claim a deemed input tax deduction equal to the adjusted cost for the construction, extension or improvement of such fixed property, where the property:

- is sold during the 12 month *"temporarily applied"* period as contemplated in subsection (3),
- is temporarily applied for the 12-month period, and then immediately after the 12-month period is no longer used to supply accommodation in a dwelling; or
- falls within the proviso to *"temporarily applied"*, being property subject to a fixed term lease greater than 12 months, and which was subject to a section 18(1) adjustment.

ANALYSIS

Although section 18D seems to address the difficulties previously experienced by developers, on a closer look, a few questions remain unanswered. Specifically, questions in respect of the deemed input tax deduction.

Firstly, if one considers the provisions as they currently read, specifically section 16(3)(o) read with section 10(29), it appears that a developer will now be allowed a higher input tax deduction equal to the actual adjusted cost of the property and not only of the tax fraction of such adjusted cost. This seems to be incorrect as the input tax deduction should be equal to the output tax previously accounted for, which is the tax fraction of the adjusted cost. This will hopefully be corrected or clarified before the new section takes effect.

Secondly, the position is clear that where a developer has a lease for a fixed period exceeding 12 months, the developer is required to perform a change in use adjustment in terms of section 18(1) and will then be entitled to claim a deemed input tax deduction in terms of section 18D(5) read with section 16(3)(o). However, it is not clear what the position is when the property developer already made an adjustment in terms of

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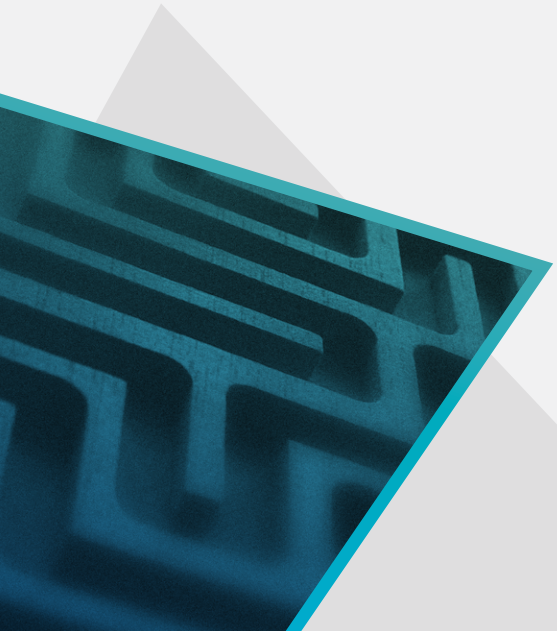

section 18D(2) based on the intention to only let the property for a period not exceeding 12 months but, due to a change in circumstances, the lease period is extended beyond 12 months.

In this instance, the developer will have already made a deemed supply in terms of section 18D(2) and cannot be required to make another adjustment in terms of section 18(1). However, the subsequent deemed input tax deduction will not be permitted in terms of section 16(3)(o) as the requirements of section 18D(5) will not have been met. It does not seem to be correct that in this instance, that the developer is not entitled to claim any input tax deduction upon the sale of the property. In these circumstances, it seems that the vendor should then be permitted to claim an input tax deduction once the property is sold in terms of section 18(4) calculated on the lesser of the adjusted cost or the open market value of the property. This position would however need to be clarified by SARS.

Lastly, section 18D(5)(a) entitles the developer to claim a deemed input tax deduction where a property is sold within the 12-month temporarily applied period, at the time that such property is sold. However, the position regarding the deemed input tax deduction allowed in the remaining two circumstances is less clear. As it currently reads, sections 18D(5)(b) and (c) state that the deduction is allowed upon the expiration of the 12-month temporarily applied period where the property is no longer let to supply residential accommodation, or, where a section 18(1) adjustment was applied where the property was subject to a fixed term lease exceeding 12 months. This seems to imply that the input tax deduction may be claimed either once the 12-month period expires and the developer no longer lets the property, or once the 18(1) adjustment is performed, as the case may be, and does not clearly specify that such deduction may only be claimed when the property is subsequently sold in these instances.

Notwithstanding the omission to clarify the timing of the deemed input tax deduction, it appears that the intention is, in each of the circumstances provided for under section 18D(5), for the deemed input tax deduction only to be claimed upon the sale of the property by the developer. Section 18D however does not explicitly provide for this, and this will also need to be clarified.

CONCLUSION

While section 18D seems to have been developed with the correct objective in mind and does indeed provide some clarity on the VAT treatment of the temporary letting of residential property by developers and some cash flow relief, the provision is still in need of further 'construction, extension or improvement' to provide further clarification. It is advisable that developers should seek expert VAT advice to ensure compliance once the provision comes into effect.

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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