The value-added tax implications of the temporary change in use adjustments by residential property developers: an international comparative study

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A B S T R A C T

Residential property developers sometimes struggle to dispose of newly built residential premises, because of an oversupply of residential property in the market and decreased sales in recent years. Many developers have switched from speculation (when residential properties are built to be sold) to investment (when properties are retained to generate rental income). Some developers only lease out newly constructed dwellings temporarily in anticipation of selling them later at a more favourable price. Units may be held with the ultimate goal of selling them, creating taxable supplies. In South Africa, these changes in the use of residential property have value-added tax (VAT) consequences that result in a negative cash flow. In the 2010 Budget Speech, amendments to the harsh VAT legislation were proposed.

This study examined the South African VAT legislation applicable to property developers during the period when residential properties are let out. The findings suggest that the current South African VAT legislation relevant to changes in the use of residential properties is harsher than that in New Zealand or Australia, but that the proposed amendments offer some degree of relief. However, even with these amendments, there is insufficient relief, and another possible solution is proposed.

Key words: value-added tax, residential property, change in use, temporary letting

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Introduction

In his Budget Speech on 17 February 2010, the then Minister of Finance, Mr Pravin Gordhan, indicated that the temporary letting of residential properties necessitates a full clawback of value-added tax (VAT) input credits. He added that under the current dispensation, the VAT payable is disproportionate compared to the exempt income received by the owners of the properties that are let. Gordhan suggested that a more reasonable method for dealing with these types of transactions would have to be investigated (SARS 2010).

The Minister's comment related to the harsh consequences faced by South Africa's residential property developers when properties constructed for sale are temporarily let out. This practice occurs more frequently when residential property developers struggle to find buyers for their properties because of an economic downturn. In such circumstances, a residential property developer has to impose VAT on a deemed supply, based on the open market value of the property when the property is let, in terms of section 18(1) of the *Value-Added Tax Act, 89 of 1991* (hereafter called the *VAT Act*) (RSA 1991). This results in unreasonably high negative cash flow consequences for property developers. In section 139 of the *Taxation Laws Amendment Act of 2011* (hereafter the *Amendment Act*) (RSA 2011b), section 18B of the *VAT Act* was amended to include special relief in order to alleviate such unreasonable cashflow consequences, but this relief is only applicable for 36 months, commencing on or after 1 January 2012 and expiring on 1 January 2015.

Once the special relief is no longer available (the deemed VAT output must be paid) and the residential property developer decides to cease letting operations and to revert to the original intention of selling the property, section 18(4) allows an input tax credit based only 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 then becomes a cost to the developer.

The aim of this article is to explore the question of whether the current South African VAT treatment of the change in use that occurs when a residential property developer temporarily lets out properties originally constructed for sale conforms to the treatment of similar transactions under the Australian and New Zealand jurisdictions. New Zealand was deemed an appropriate jurisdiction for this comparison because the original South African *VAT Act* was based to a large extent on the legislation in New Zealand (Van der Zwan & Stiglingh 2011). Australia was chosen for this comparison because its economy is based on mining and agriculture (Australia on Net 2007), similar to the South African economy. A secondary aim of the article is to provide clarity for residential property developers and the South African Revenue Service (SARS) on the current South African VAT consequences (in the form of the special relief, and the situation after 1 January 2015) that arise from this change in use.

In order to address the primary and secondary aims of this article, the doctrinal research method was used to analyse the relevant legislation of South Africa, New Zealand and Australia. The analysis was applied to a case study to compare the application of the legislation as found in the specific country.

Literature review: VAT on residential properties in South Africa

VAT was introduced in South Africa in 1991 in terms of the *Value-Added Tax Act, 89 of 1991*. The VAT rate is currently 14%. In essence, VAT is a tax levied on transactions. Therefore, VAT is calculated in each phase of production, and the consumer (Stiglingh 2014) finally pays it.

In South Africa, the VAT payable on residential properties depends on the type of transaction involved. Sales of residential properties by VAT vendors are subject to VAT, but the leasing of such properties is VAT-exempt.

Construction and sale of new residential properties

Property developers' activities should comply with the definition of an "enterprise" in section 1 of the *VAT Act*, because property developers make 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 exceed the compulsory VAT registration threshold of R1 million during a given 12-month period, a property developer becomes liable for registration for VAT in terms of section 23(1) of the *VAT Act*. A property developer may claim input VAT credits with regard to the purchasing of goods and services if these goods and services are acquired to make a taxable supply. Although input VAT may be claimed on some second-hand goods, no credits can be claimed on goods and services acquired from non-VAT vendors (SARS 2011).

Property developers are allowed to claim input VAT on the following expenses: the acquisition of a property or land, developing and building costs, professional services, and marketing expenses (SARS 2011). Developers advertise the completed property inclusive of VAT, and must therefore account for output VAT on each sale. The advertised amount is known as a consideration (section 1 of the *VAT Act*). The selling price of the property may be advertised as being exempt from transfer duty, as long as the advertisement mentions that the price includes VAT (SARS 2011). Where the purchaser acquires a fixed property from a property developer for the purpose of providing residential accomodation, the VAT included in the purchase price becomes a permanent cost to the purchaser (National Treasury 2011).

Leasing of residential properties

Section 12(*c*) of the *VAT Act* provides that the supply of a dwelling under a lease agreement thereof is exempt from VAT imposed under section 7(1)(*a*) of the *VAT Act*. A dwelling is defined in section 1 of the *VAT Act* 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.

Change in use: special relief for 36-month period (1 January 2012–1 January 2015)

On 27 January 2012, the South African National Treasury issued an explanatory memorandum (National Treasury 2012) on the *Taxation Laws Amendment Bill 2011* (RSA 2011a). The memorandum explains that, where property developers temporarily let out residential properties, the existing VAT rules dealing with a change in use adjustment are problematic from both a practical and a legal theory perspective. Practically, property developers' sustainability becomes uncertain when a VAT charge is levied against them earlier than expected, due to circumstances beyond their control (National Treasury 2012).

While government officials are analysing the legal issues that need to be addressed 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 selling the properties. This temporary relief has been granted for a period not exceeding 36 months. Thereafter 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. To qualify, the rental contract must be entered into after 1 January 2012, but before 1 January 2015. The special relief does not apply if a property developer changes his/her intention, and decides to retain the property to earn rental income for an indefinite period, and gives up the intention to dispose of the property (National Treasury 2012).

Change in use: situation after 1 January 2015

A property developer may elect to temporarily let out a property to earn a rental income in order to cover the cost of holding such a property until a sale can take place, while the developer's intention is still ultimately to dispose of the property (National Treasury 2011; SARS 2011).

The special relief period expires after 36 months, or on 1 January 2015, whichever is applicable. It is assumed that the legislation will revert to section 18 of the *VAT Act* after 1 January 2015. In instances where residential properties are being used for a purpose other than making taxable supplies, section 18 of the *VAT Act* needs to be applied. Section 18(1) provides for a change in use adjustment. The change in the intended use of the goods or services will then trigger a deemed supply on which VAT is levied in terms of section 7(1)(*a*) of the *VAT Act*.

When a property developer subsequently decides to pursue his/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 commences to advertise the sale of the property. At this stage, the property developer will recommence the making of taxable supplies with regard to the property. An input VAT credit may be claimed in terms of section 18(4). The formula described in section 18(4) is A x B x C x D, where B is the adjusted cost or the open market value of the property, whichever is lower. (A is the tax fraction; C is the percentage by which the taxable use of the goods or services has increased; D applies if the goods are second-hand, in which case it is the percentage of the consideration that has been paid [Stiglingh 2014]).

A property developer may also decide to retain the property and rent it out on a permanent basis. The property developer's activities have then changed to that of making exempt supplies only, and the property developer is not making any more taxable supplies from the property. A subsequent disposal of this property is then no longer subject to VAT, because a taxable supply has not been made. Transfer duty is applicable to such a transaction (SARS 2011).

Case study for South Africa

A case study is presented to demonstrate the effects of the legislation under the South African jurisdiction. Corresponding case studies are presented for the New Zealand and Australian situations.

Scenario description

ABC Properties develops and sells residential units. During March 2011, ABC Properties acquires vacant land from DEF Brokers for R1 000 000 (excluding VAT), and the transfer is registered in the same month. ABC Properties commences developing the land in April 2011 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 wins the tender for the construction of the 20 units at a cost of R300 000 (excluding VAT) per unit. JKL Estate Agents undertakes the marketing and selling of the units at a commission of 10% on the selling price. The construction of the units is completed in March 2012, and GHI Construction issues a tax invoice for R6 000 000 (excluding VAT) to ABC Properties. No progress payments are made to GHI Construction during the construction period. In April 2012, JKL Estate Agents manages to sell 15 of the 20 units for R 7 500 000 (R500 000 × 15). They raise a tax invoice to the value of R750 000 (excluding VAT) to ABC Properties as their commission.

Due to negative market factors, ABC Properties decides in May 2012 to let out the remaining five units temporarily at R5 000 (excluding VAT) per month per unit until the weak markets return to normal. Tenants occupy these five let-out units on 1 June 2012 (this date is also assumed to be the date of entering into the lease agreement). JKL Estate Agents continues to market the properties until they are sold. In November 2013, ABC Properties decides to dispose of the five let-out properties at a lower price of R450 000 (excluding VAT) per unit. During November 2013, three of the five remaining properties are sold, and the tenants vacate these three properties on 30 November 2013. JKL Estate Agents raises a tax invoice to the value of R135 000 (excluding VAT) for their commission. ABC Properties is adamant that it will not sell the two remaining properties for less than R450 000 per unit (excluding VAT). JKL Estate Agents eventually achieves success in July 2015, and the remaining two units are disposed of. The letting of the final two units continues until 31 July 2015.

ABC Properties, DEF Brokers, GHI Construction and JKL Estate Agents are all vendors for VAT purposes as described in the *VAT Act*. It is assumed that all the VAT consequences are addressed correctly with regard to the acquisition of land, construction work and commission paid. A timeline summary is provided in Table 1 to clarify the chronological tax events for the case study.

VAT implications of the case study transactions when section 18B of the *Amendment Act* is applicable (South Africa)

The input VAT claimed on acquisition of the land is R140 000 (R1 000 000 × 14%) and R840 000 (R6 000 000 x 14%) paid on construction of the properties.

ABC Properties needs to pay VAT on the disposal of the 15 units sold in April 2012. The output VAT amounts to R1 050 000 (R7 500 000 × 14%).

When a property developer changes his/her intention from a taxable supply to an exempt supply, section 18B of the *Amendment Act* provides temporary relief to the property developer from declaring a deemed output VAT for 36 months. This relief is available to lease agreements entered into after 1 January 2012, but before 1 January 2015. Therefore, no adjustment needs to be made in May 2012 when ABC Properties starts to pursue its exempt supplies (letting out the property).

Table 1: Tax events in a timeline summary for the case study

Events	Timeline
Acquisition and commencement of development of the land	March–April 2011
Construction of 20 units completed	March 2012
South African special relief period (section 18B) commences	1 January 2012
Sale of 15 units	April 2012
Decision to let out five units	May 2012
Occupation of five units by tenants (rental contract is entered into and 36-month period is initiated for South African purposes)	1 June 2012
First adjustment period for Australia	30 June 2012
Balance date for New Zealand GST adjustment purposes First adjustment period	31 March 2013
Second adjustment period for Australia	30 June 2013
Change of decision from letting to selling Sale of three units	November 2013
Balance date for New Zealand GST adjustment purposes Second adjustment period	31 March 2014
Third adjustment period for Australia	30 June 2014
Balance date for New Zealand GST adjustment purposes Third adjustment period	31 March 2015
End of 36-month special relief period with respect to section 18B (South Africa)	30 May 2015
Fourth adjustment period for Australia	30 June 2015
Sale of final two units	July 2015

The sale of three units takes place in November 2013 for R1 350 000. ABC Properties needs to pay output VAT on the sale of the three units to the amount of R189 000 (R1 350 000 × 14%).

In May 2015, the 36-month special relief period expires. ABC Properties must declare a deemed output VAT on the open market value of the two remaining unsold units. The amount is R126 000 (R900 000 × 14%). At the time of the sale of the two units during July 2015, ABC Properties may claim an input VAT adjustment on the lesser of the open market value or the adjusted cost price of the properties. The claim amounts to R98 000 (R350 000 × 2 × 14%) (section 18(4)).

When section 18B of the *Amendment Act* is not applicable, sections 18(1) and 18(4) of the *VAT Act* apply. To illustrate the effect of these sections, the facts of the current case study are used.

When ABC Properties decides in May 2012to let the five remaining units temporarily, a deemed supply takes place, with the effect that ABC Properties needs to declare a 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 five units is R350 000 (R2 500 000 × 14%).

In November 2013, when ABC Properties disposes of the three units, a deemed input can be claimed on the lesser of the open market value or the adjusted cost price of the properties. The initial cost of the land and the development of the units amounts to R350 000 (R1 000 000/20 + R300 000) (excluding VAT), and the open market value of the properties decreases to R450 000 (excluding VAT). The developer can only claim input VAT on the lesser of R350 000 and R450 000 per unit, in other words, the input VAT to be claimed amounts to R147 000 (R350 000 × 3 × 14%) for the three units.

When the final two units are eventually sold in July 2015, the property developer once again needs to claim an input VAT deduction. The input VAT claimable is R98 000 (R350 000 x 2 x 14%).

Case study conclusion for South Africa

The special relief of section 18B of the *Amendment Act* limits the cash outflow for ABC Properties due to the VAT payable, which amounts to R28 000 (R126 000 less R98 000). When sections 18(1) and 18(4) of the *VAT Act* are applied, the cash outflow is R105 000 (R63 000 plus R42 000), a difference of R77 000 (see Table 2).

General Sales Tax (GST) on residential properties in New Zealand

New Zealand introduced its version of VAT, which is called General Sales Tax (GST), on 1 October 1986. The current rate is 15% (New Zealand 2014b). GST-registered organisations pay GST only on the difference between their GST-liable sales and GST-liable purchases. In effect, this means that these organisations only pay GST on the difference between what they sell and what they buy (New Zealand 2014b).

Construction and sale of new residential properties

In the construction industry, contractors usually receive progress payments at regular intervals during the course of a project. Contractors are liable for the GST on the earlier of the receipt of a progress payment or the issuing of an invoice (in terms of section 9(1) of the *Goods and Services Tax Act, No 141 of 1985* (hereafter called the

GST Act) (New Zealand 2014a). The sale of a residential property is deemed to have been concluded on the date when the contract becomes unconditional, or the date when a deposit is received for the disposal of the property, whichever comes first. The date determined is the time of supply, and it is used to determine when a vendor needs to declare the GST (section 9(1) of the *GST Act*).

A 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. Land is classified as second-hand goods for GST purposes (New Zealand 2014b). All transactions whereby land changes hands are 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 person connected to the purchaser, does not intend to use the land to erect a building that will be used as its primary residence (section 11(1)(mb) of the *GST Act*).

Leasing of residential properties

Where a building is used as a private residence, this supply of residential accommodation is exempt from GST according to section 14(1)(cb) of the *GST Act*.

Change in use

The change in use adjustment requires taxpayers to distinguish between the intended use of the goods and the actual use. When there is a difference between these two concepts, an adjustment is required (sections 21, 21A and 21B of the *GST Act*). Adjustments are made in a specific adjustment period (section 21G(2)). At the end of each adjustment period, a taxpayer needs to establish whether an adjustment is necessary. Adjustment periods are allocated to the situation based on the value of the goods (section 21(G)(4)(a)). The first adjustment period commences on the date of acquisition and ends on the first balance date (the date most commonly used is 31 March as most entities use this date for their financial year-end). The adjustment periods then follow every 12 months. There is no limit to the number of adjustment periods for land (New Zealand 2014b).

There are three circumstances in which an exclusion from applying the adjustment occurs:

- where the *de minimis* provisions in section 20(3D) apply – this section provides for the situation where the value of the exempt supply is no more than the lesser of \$90 000 or 5% of the total consideration for all taxable and non-taxable supplies;
- where section 21(2)(b) provides relief for goods and services acquired for the GST-exclusive value of \$5 000 or less; and/or
- where, in terms of sections 21(2)(c) and (d), the adjustment is calculated, and the adjustment is at least 10 percentage points *or* the total value of the adjustment is more than \$1 000 (only one of the two requirements needs to apply; if not, then the adjustment may be excluded from the GST calculation).

A property developer registered for GST may let out a residential dwelling or individual unit while the property is being marketed for sale. The concurrent use of land requires the application of a special rule according to section 21E of the *GST Act*. Section 21E(3) provides a formula for the apportionment of input tax, namely:

$$\frac{\text{Consideration for taxable supply}}{\text{Total consideration for supply}} \times 100\%$$

"Consideration of taxable supply" is defined in section 21E(4)(a) as the amount received from the disposal of the land or, if the land is not disposed of, then the market value.

"Total consideration for supply" is defined in section 21E(4)(b) as the total of "consideration of taxable supply" plus the rental income received.

In New Zealand, in terms of section 14(1)(*d*) of the *GST Act*, the sale of a property used for the supply of residential accommodation, in the course or furtherance of an enterprise, is exempt from GST if the property is exclusively used to supply such accommodation for more than five years (New Zealand 2014a).

Case study for New Zealand

The same scenario used to illustrate the situation in South Africa is analysed for New Zealand. For the purposes of illustration, exchange rates are not applied, and the same values are simply reflected in New Zealand dollars. Assume that the balance date for ABC Properties is 31 March.

Sale of the properties

ABC Properties needs to pay GST on the disposal of the 15 units sold in April 2012. The GST amounts \$1 125 000 (\$500 000 × 15 × 15%).

The sale of three units takes place in November 2013. ABC Properties needs to pay GST on the sale of the three units to the amount of $202 500 ($450 000 × 3 × 15%).

At the time of the sale of the two units during July 2015, ABC Properties needs to pay GST to the amount of $135 000 ($450 000 × 2 × 15%).

Change in use from taxable supplies to exempt supplies

The initial intention of the taxpayer is to make 100% taxable supplies. Therefore, 100% of the input tax is claimed during the construction of the 20 units and the development of the land. During May 2012 the taxpayer decides to let out the remaining five units while marketing the property. This is a concurrent use of land, and the section 21E special rule applies.

The first two exclusions do not apply to this case study.

First adjustment period: 31 March 2013

In May 2012, ABC Properties decides to let out the remaining five units until they can be sold. The intention of ABC Properties remains to sell the units, and the properties are still being advertised and marketed. As this is concurrent use of land, the section 21E(3) formula is used:

- "Consideration of taxable supply" = Market value = $500 000
- "Total consideration for supply" = Market value plus rental income
  = $500 000 + ($5 000 x 10 months)
  = $550 000

$$\text{Applying the formula} = \frac{\$500\ 000}{\$550\ 000} \times 100\%$$
$$= 90.91\%$$

The percentage adjustment is 9.09% (100%–90.91%). This is less than the 10% required according to Exclusion 3. The value of the adjustment is 9.09% of $45 000 ($300 000 × 15%) (excluding land because it is zero rated). This amounts to $4 091, which is more than the $1 000 requirement of Exclusion 3. Therefore the adjustment must be declared. The adjustment is applicable to the remaining five units. The total adjustment on 31 March 2013 is thus $20 455 ($4 091 × 5).

In November 2013, at the time of the disposal of the three units, an adjustment for input tax can be made. The formula to be used is:

Tax fraction x consideration × (1-actual deduction/full input deduction)
= 3/23 × \$450 000 × (1– \$40 909/\$45 000)
= \$5 336 limited to \$4 091

The result is that ABC Properties may claim \$12 273 (\$4 091 × 3) of input tax at the time that it disposes of the three units.

Second adjustment period: 31 March 2014

During this period, the concurrent use of land still applies for the remaining two units. Therefore a further adjustment needs to be calculated:

- "Consideration of taxable supply" = Market value = \$450 000
- "Total consideration for supply" = Market value plus rental income
  = \$450 000 + (\$5 000 × 22 months)
  = \$560 000

Applying the formula $= \frac{\$450\ 000}{\$560\ 000} \times 100\%$
$= 80.36\%$

The percentage adjustment is 10.55% (90.91% – 80.36%). This is more than the 10% required by Exclusion 3. The value of the adjustment is 10.55% of \$45 000 (excluding land, which is zero-rated). This amounts to \$4 748, which is more than the \$1 000 requirement of Exclusion 3. Therefore the adjustment must be declared. The adjustment applies to the remaining two units. The total adjustment on 31 March 2014 is \$9 496 (\$4 748 × 2).

Third adjustment period: 31 March 2015

During this period, the concurrent use of land still occurs for the remaining two units. Therefore a further adjustment needs to be calculated:

- "Consideration of taxable supply" = Market value = \$450 000
- "Total consideration for supply" = Market value plus rental income
  = \$450 000 + (\$5 000 × 34 months)
  = \$620 000

Applying the formula $= \frac{\$450\ 000}{\$620\ 000} \times 100\%$
$= 72.58\%$

The percentage adjustment is 7.78% (80.36% – 72.58%), which is less than the 10% required by Exclusion 3. The value of the adjustment is 7.78% of $45 000 (excluding land, which is zero-rated). This amounts to $3 501, which is more than the $1 000 requirement of Exclusion 3. Therefore the adjustment must be declared. The adjustment applies to the remaining two units. The total adjustment on 31 March 2015 is thus $7 002 ($3 501 × 2).

In July 2015 at the time of the disposal of the two units, an adjustment for input tax can be made. The formula to be used is:

Tax fraction x consideration × (1–actual deduction/full input deduction)
= 3/23 × $450 000 × (1 – $32 660/$45 000)
= $16 096 limited to $12 340

The result is that ABC Properties may claim $24 680 ($12 340 × 2) input tax when it disposes of the final two units.

Case study conclusion for New Zealand

There are cash flow consequences when a change in use event occurs. The legislation provides the taxpayer with no adverse GST effects in these particular circumstances of change in use. The situation leads to a neutral position for the GST vendor (see Table 2).

General Sales Tax (GST) on residential properties in Australia

GST is levied on the supply of goods and services in Australia. The Australian Federal Government introduced GST with *A New Tax System (Goods and Services Tax) Act 1999* (hereafter called the *GST 1999*) (Australia 1999), which became effective on 1 July 2000. GST is levied on most goods and services at 10%, but according to the Australian Tax Office (ATO), some items are GST-exempt (ATO 2013).

Construction and sale of new residential properties

The determining factor as to whether property developers may claim a GST credit is their intention. If the intention is to sell newly constructed residential premises, a developer may claim a GST credit (ATO 2013). New residential premises are considered "new" if the property has been let out by the property developer, but is 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 new if it has been held with a dual purpose. According to the ATO, the dual purpose means that the property has not been held exclusively for input-taxed supplies, but has been marketed for sale while being let out (ATO 2010b).

Leasing of residential properties

If a property owner lets out residential accommodation, GST is not payable on the rental income. Furthermore, the owner cannot claim any GST credits for any purchases made with regard to such a property or accommodation (ATO 2010a).

Change in use

Property developers can claim a GST credit on their construction costs if they intend to sell the newly developed property. Due to certain constraints in the market, a property developer may decide to let the property temporarily. The change of use is deemed a change in creditable purposes (ATO 2013).

In the period that the temporary letting commences, the property developer has to calculate whether an increased or decreased adjustment needs to be made in terms of section 129-40 of the *GST 1999*. This is done in the first adjustment period that ends on 30 June, within a 12-month period (section 129-20 of the *GST 1999*). In order to calculate the increased or decreased adjustment, the taxpayer needs an estimated selling value and the rental income derived from the letting activity. An actual application percentage needs to be calculated as follows:

$$\frac{\text{Estimated selling value of the property}}{\text{Estimated selling value of the property} + \text{rental income}}$$

(section 129-40 of the *GST 1999*)

The actual application percentage needs to be compared to the intended or former application percentage. This is normally the percentage of GST initially claimed with regard to the property (section 129-40 of the *GST 1999*). The result is either an increased or a decreased adjustment.

Annually on 30 June of the consecutive years, an adjustment increase or decrease must be calculated. When the property is finally sold, a final adjustment must be made. At that time, the actual consideration and the total rent received are used for the calculation (Australia 2009).

Case study for Australia

The same scenario used to illustrate the situation in South Africa is analysed for Australia. For the purpose of illustration, exchange rates are not applied, and the same values are simply reflected in Australian dollars.

Sale of the properties

JKL Estate Agents manages to sell 15 units, and ABC Properties has to raise invoices to a combined value of $7 500 000. The GST payable to the ATO amounts to $750 000.

The same procedure is followed on the subsequent sale of the three units in November 2013. ABC Properties has to pay $135 000 ($450 000 × 3 × 10%) to the ATO.

When the balance of the units are sold in July 2015, ABC Properties is liable for GST of $90 000 ($450 000 × 2 × 10%).

Change in use from taxable supplies to exempt supplies

In May 2012, ABC Properties changes its initial intention from solely selling the properties to letting the properties out until they are sold. At this time, ABC Properties is still convinced that it will be able to sell the properties for the initial $500 000 (excluding GST). By renting out the properties, ABC Properties generates $5 000 per unit per month.

The first adjustment period ends on 30 June 2012. The actual application percentage is 99%, calculated as $500 000 / ($500 000 + $5 000). The intended application percentage is 100%. Therefore an increased adjustment of 1% needs to be declared (section 129-70 of the *GST 1999*). The increased adjustment for the first adjustment period is $1 750 ($350 000 × 1% × 10% × 5).

The second adjustment period ends on 30 June 2013. The actual application percentage is 88.5%, calculated as $500 000 / ($500 000 + $65 000). The former application percentage was 99%. Therefore an increased adjustment of 10.5% (99% – 88.5%) needs to be declared (section 129-70 of the GST 1999). The increased adjustment for the second adjustment period is $18 375 ($350 000 × 10.5% ×10% × 5).

At the time of the sale of the three units in November 2013, the final adjustment for the three units needs to be calculated. The actual application percentage is 83.3%, calculated as $450 000 / ($450 000 + $90 000). The former application percentage was 88.5%. Therefore an increased adjustment of 5.17% (88.5% – 83.3%) needs to be declared (section 129-70 of the *GST 1999*). The final adjustment period for the three units is an increased adjustment of $5 430 ($350 000 x 5.17% × 10% × 3).

The third adjustment period ends on 30 June 2014. The actual application percentage is 78.26%, calculated as $450 000 / ($450 000 + $125 000). The former application percentage was 88.5%. Therefore an increased adjustment of 10.24% (88.5% – 78.26%) needs to be declared (section 129-70 of the *GST 1999*). The increased adjustment for the third adjustment period is therefore $7 168 ($350 000 × 10.24% × 10% × 2).

The fourth adjustment period ends on 30 June 2015. The actual application percentage is 70.87%, calculated as \$450 000 / (\$450 000 + \$185 000). The former application percentage was 78.26%. Therefore an increased adjustment of 7.39% (78.26% – 70.87%) needs to be declared (in terms of section 129-70 of the *GST 1999*). The increased adjustment for the fourth adjustment period is \$5 174 (\$350 000 × 7.39% × 10% × 2).

At the time of sale of the last two units in July 2015, the final adjustment needs to be calculated. The actual application percentage is 70.31%, calculated as \$450 000/ (\$450 000 + \$190 000). The former application percentage was 70.87%. Therefore an increased adjustment of 0.56% (70.87% – 70.31%) needs to be declared (in terms of section 129-70 of the *GST 1999*). The adjustment for the three units in the final adjustment period is an increased adjustment of \$390 (\$ 350 000 × 0.56% × 10% × 2).

Letting of residential units

The letting of the five units will constitute the letting of residential property and no GST will be levied and paid to the authorities.

Case study conclusion for Australia

There are cash flow consequences when a change in use event occurs. In terms of the legislation, the taxpayer has a total output GST payment of \$38 287 (see Table 2).

Case study: a comparison of the change in use adjustments applicable to property developers in South Africa, New Zealand and Australia

VAT/GST vendors dispose of residential properties in the course or furtherance of an enterprise, and levy VAT/GST on the sale of such a property, while non-VAT/ GST vendors dispose of the property exempt of VAT/GST. However, the disposal of a property by a non-VAT/GST vendor attracts transfer duties. The letting supply of residential accommodation in a dwelling is exempt from VAT/GST (section 12c of the *VAT Act*) (RSA 1991), mainly because a VAT/GST system should not discriminate against people who rent their residences, as opposed to owning their own residence where owning a residence is an exempt supply.

Table 2 provides a comparison between the legislation of the three countries. The effect of the change in use event in each country is summarised in this table.

Table 2: Case study comparison of the change in use legislation

Tax event	South Africa (special relief)	South Africa (after 1 January 2015) (no relief)	New Zealand	Australia
Currency	**R**	**R**	**NZ$**	**AUS$**
VAT / GST percentage	14%	14%	15%	10%
Occupation of five units by tenants (rental contract was entered into – 36-month period is initiated for South African purposes)		350 000		
First adjustment period for Australia				1 750
First adjustment period for New Zealand			20 455	
Second adjustment period for Australia				18 375
Change of decision from letting to selling Sale of three units		(147 000)	(12 273)	5 430
Second adjustment period for New Zealand			9 496	
Third adjustment period for Australia				7 168
Third adjustment period for New Zealand			7 002	
End of 36-month special relief period of section 18B (South Africa)	126 000			
Fourth adjustment period for Australia				5 174
Sale of final two units	(98 000)	(98 000)	(24 680)	390
Total change in use effect on VAT/ GST payable	**28 000**	**105 000**	**0**	**38 287**

If an equivalent 14% for all VAT/GST rates is used, in Australia the comparative amount would be R53 601. Australia's property developers are thus worse off than property developers in New Zealand, while South African property developers are in the worst position in terms of the legislation applicable after 1 January 2015. However, the current special relief under section 18B of the *Amendment Act* puts South African developers in a position between those in New Zealand and Australia.

Recommendation

The biggest driving force for a property developer to pursue the letting of residential property is usually economic. Property developers would rather receive compensation in the form of rental income than have property stand vacant. Although the *Amendment Act* proposes some relief, property developers are still affected negatively if property is not sold within the 36-month relief period. To enable the South African government to assist property developers, a new section could possibly be introduced into the *VAT Act* with an amendment to section 18. All references to goods and services in sections 18(1) and 18(4) need to be amended to exclude fixed property supplied as exempt supplies. A new subsection 18(11) could be introduced and the current section 18B deleted. The section should specifically deal with change in use treatment where fixed property is involved.

The proposed new section 18(11) needs to incorporate the following:

- a definition of temporary change in use and an allowance of a period of not more than five years; after a period of five years, the normal provisions of section 18 need to apply; and
- the stipulation that rental income received by a property developer during that period be subject to an output tax adjustment at the normal VAT rate of 14%.

The new section in the *VAT Act* might 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 nee*ds *to be calculated on one fifth of the total consideration received by the vendor.*

Table 3 provides an illustrative comparison between the current and the proposed legislation for South Africa. The cash flow consequences are demonstrated using the facts from the case study.

Table 3 shows that the property developer in the case study would benefit from the proposed amendment. This benefit is clear when the effects of the proposed amendment to the special relief are compared with the situation after 1 January 2015. The benefit to the property developer in the proposed new amendment lies in the cash flow advantage, because the developer would be able to pay the VAT on the rental income in the month that the rental income is received. This effectively means that VAT can be paid when the resources are available.

In any economy, it is to everyone's advantage to keep businesses solvent and motivated to expand. National Treasury should take note of the adverse effects of the current legislation, as it is to the country's benefit to create legislation that will stimulate the economy.

Table 3: Change in use effect of present and proposed VAT on ABC Properties

	Situation after 1 January 2015	Special relief	New proposal
Start letting out the remaining five units	350 000	0	0
Letting out five units from June 2012 to November 2013 (R5 000 x 18months x 5units = R450 000 / 5 = R90 000 x 14% = R12 600)	0	0	12 600
End letting out of three units	(147 000)	0	0
Letting out two units from December 2013 to July 2015 (R5 000 x 20 months x 2 units = R200 000 / 5 = R40 000 x 14% = R5 600)	0	0	5 600
Expiry of 36-month relief period	0	126 000	0
End letting of two units	(98 000)	(98 000)	0
Total VAT paid on change in use	**105 000**	**28 000**	**18 200**

Conclusion

As a developing country, South Africa needs to consider very carefully what the implications of its legislation might be for its business community. Burdening residential property developers with excessive tax payments could result in the liquidation of such developers. Ultimately, residential property developers operate in order to make a profit, which in turn attracts income tax. Every taxpayer lost in South Africa reduces potential revenue for the country as a whole. Therefore, the best possible conditions need to be created to allow property developers to operate, achieve profits and pay taxes. It is therefore to be hoped that in the future, the South African government will amend harsh legislation that could ruin a business in time of need, and will alleviate the burden for the long-term benefit of its citizens and business community.

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