

CAPITAL ALLOWANCES AND RESIDENTIAL PROPERTY

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The authors of many popular Real Estate Books often use the availability of tax allowances on the capital cost of an investment property as one of the more important advantages of investing in properties. In several countries, tax laws allow for a write-off of the capital cost of properties over a specific number of years.

Capital Allowances and Real Estate

A capital allowance is a deduction allowed in terms of tax law where a taxpayer may deduct a portion of the cost of an asset against income over a certain period of time. A popular capital allowance is 'wear & tear' allowances against the more common assets such as furniture. In terms of furniture, a taxpayer may deduct 20% of the cost of the asset (furniture) annually against income, until the full cost of the asset has been claimed – this would equate to a five-year right-off in this example.

Unfortunately, capital allowances on residential properties are rather limited in South Africa, and the qualifying criteria are specific and onerous. Despite the limitations, the use of capital allowances on residential property should be explored and utilized where possible as its tax savings can be substantial.

Capital Allowance in terms of Section 13sex of the Income Tax Act

In terms of s13sex, a taxpayer may claim an annual allowance of 5% of the cost of a new and unused residential unit (or improvement) which the taxpayer owns until the entire cost of the asset has been written off (ie: 20 years). The qualifying criteria are as follows:

The taxpayer must have acquired the unit on or after 21 October 2008

A taxpayer includes individuals, trusts or companies.

Units acquired before this date might qualify under Section 13ter of the Income Tax Act of 1962.

The unit or improvement must be used by the taxpayer solely for the purposes of a trade which he carries on

A property investor who purchases property for the purpose of letting the unit qualifies as a trade.

It is important to note that the deduction is also allowed on an improvement on a property. For example, the cost of the addition of a garage to an existing property can also qualify for the deduction.

The unit must be situated in South Africa

The taxpayer must own at least 5 residential units in South Africa, which are used by the taxpayer for the purposes of a trade carried on by the taxpayer

The units may be situated anywhere in South Africa.

It seems that not all of the 5 residential properties need to qualify in order to claim the deduction on the unit that does qualify. For example, the taxpayer may already own 4 residential properties, all of which were not new and unused and therefore do not qualify for the s13sex deduction. Assuming the 5th property purchased is a qualifying property in terms of s13sex, the taxpayer may claim the 5% allowance on the 5th property.

Where all 5 of the properties are qualifying properties, the 5% allowance can be claimed on the cost of all the properties but the deduction may only commence on the acquisition of the 5th property.

Recoupment Taxes

Deductions of this nature are expected to be used by taxpayers who intend to own the property for the long term. In so doing, recoupment taxes are part and parcel of claiming capital deductions or allowances. A recoupment tax is a mechanism whereby the taxman is able to recoup taxes that were previously claimed by the taxpayer under certain conditions.

For example, a taxpayer claims a s13sex deduction of R50,000 on a property he purchased for R500,000 which he then sells for R550,000. The taxman may then recoup or 'recover' the R50,000 (R500,000 – the tax value of R450,000) claimed under s13sex as the asset was ultimately sold for more than the 'tax value'. The taxpayer will also be liable for Capital Gains Tax on another R50,000 (R550,000 – R500,000).

Final Thoughts

Assuming a taxpayer acquires 5 qualifying properties with an average purchase price of R600,000 per unit, the taxpayer will be permitted in terms of s13sex to claim R150,000 per annum against income. This would equate to a total deduction of R1mil in under 7 years, or a real tax saving of up to R400,000 depending on tax rates and the entity in which the deduction is claimed.

Despite the tax allowances on residential property being fairly limited, good tax planning for property investors is integral in ensuring long-term tax efficiency and an increase in cash-flow. Combined with good cash-flow planning, tax savings can aid in the growth of the investor's property portfolio.

Source - www.finserve-trusts.com/articles/capital_allowances.htm