How tax can affect your residential property investment

Returns, pitfalls and tax breaks in a nutshell
Tax can make or break the potential returns from an investment in residential property. To benefit from possible tax breaks while avoiding the pitfalls, investors should be aware that different investment vehicles can significantly increase or reduce their tax liability. In this article we focus on the purchase of property for the purpose of earning a return rather than for use as a primary residence.

Three main investment vehicles are generally used in South Africa to house residential property and two of these work reasonably well from a tax point of view – these are to buy a property in your own name or in that of a trust formed for this purpose.

Looking purely at the tax implications, the third option, ownership through a company, is not as good an option in most circumstances. Whereas the total effective tax rate for the first two options is 0% to 13.3% in the case of ownership in one's own name and 26.6% in the case of ownership by a trust, the total effective rate for companies is 30.8%, including 15% dividends tax. These rates exclude transfer duty or VAT on acquisition of the property.

This further assumes that you are buying the property as a long-term investment, with the aim of letting it out and earning rental income. If you are purchasing property speculatively, intending to sell it off for a profit, the tax rates would be even higher because the proceeds would be of a trading rather than of a capital nature.

Speculators pay the price

For a company making a speculative investment, the total effective tax rate, exclusive of transfer duty or VAT on original acquisition, would shoot up to 38.8% on disposal of the asset, inclusive of 15% dividends tax. For an individual investing speculatively, the rate could be anywhere between 0% and 40%, depending on where you fall on the income tax table. As for a trust buying property as a speculative investment, the tax rate rises to 40% on disposal of the asset. Speculators certainly pay a price.

There are several other important considerations that investors need to weigh up in their choice of holding vehicle.

The pros and cons of a trust

One major advantage of buying a property through a trust is that the assets in the trust are separate from your personal assets. This provides protection against your creditors, which cannot pursue you in your personal capacity for assets owned by the trust, except to the extent that you have a loan owing to you by the trust.

Another advantage of a trust is that growth in the trust is protected from estate duty (at 20%) in the event of death.

The flip side of the coin is that rental income in the hands of a trust is taxed at 40% less deductible expenses. Also, as mentioned above, trusts pay a higher rate of capital gains tax on the sale of property than do individuals.

Buying property in your own name

Depending on where you fit into the income tax table, rental income that individuals earn can be taxed at rates that vary between 0% and 40%. Capital gains tax on the disposal of the asset is between 0% and 13%, also depending on your band on the tax table.

However, individual investors do not qualify for protection from creditors if the investment turns sour. They also have no protection from estate duty.

The third option, buying a residential property through a company, makes little sense in the majority of situations. The fully taxed rate (including 15% dividends tax) is higher than for trusts and individuals, and shares held by individuals in companies are subject to estate duty.

Your choices in a nutshell

In most circumstances then, investors have two main choices when buying residential property: doing so in their personal capacity or through a trust. This is not necessarily a simple toss-up, and I would urge investors to do their sums properly before taking a final decision.

Investors would also do well to keep an eye on changes to the tax regime.

For example, trusts currently have the flexibility to distribute net income for a particular year to a beneficiary. The beneficiary, and not the trust, will then be taxed – at a lower rate into the bargain. Similarly, a trust can elect to distribute proceeds from the sale of an asset to a beneficiary, who will pay a lower rate of capital gains tax. However, the tax authorities have indicated that they will be revisiting this situation in the not-too-distant future, with a view to possibly doing away with these benefits for trusts. The use of trusts to avoid estate duty may also come under increased scrutiny.

It pays to have an up-to-date knowledge of the tax implications of investing in residential property and a clear understanding of how the different investment vehicles work.

Happy house hunting!

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