Is Capital Gains Tax bad news for property?

By Erwin Rode
27 February 2000

The government's announcement of the introduction of capital gains tax (CGT) as from next year will have a profound impact on the way investors behave. This includes the property market.

To recap, capital appreciation after 1 April 2001 will be taxed in the case of capital assets like shares, businesses and property. Exemptions will be first homes, cars, lump sums from life assurance and endowment policies and small-business assets sold to finance the owner's retirement.

Individuals must add 25% of the capital gain to their taxable income. Normal income tax rates then apply. At the maximum marginal rate of 42%, this translates into a 10,5% rate. All other taxpayers (including trusts) must add 50% of the capital gain to their taxable income and will get taxed at the corporate rate of 30%.

So let's try to gauge the impact of CGT on property:

- Everything in life is relative, including inter-asset-class returns. So, because other capital asset gains are also going to be taxed, property will not be affected negatively *relative* to investments like shares and bonds. In fact, property typically shows a lower capital growth than shares, given its higher income yield, so property will, as a generalisation, be less affected by CGT than shares (but more than bonds).

- Investors will in future think twice before buying a second house or business property that they might have to sell in the medium term. This is so because the capital loss after tax and inflation might be significant. For instance, when selling a property after a year, the seller will require a nominal capital appreciation of 8% (to neutralise core inflation) plus a minimum of 7% (to cover agent's commission, etc), resulting in a required appreciation of about 15% before tax. The CGT will be about 10% on this 15% "gain", resulting in a required total after-tax and after-inflation appreciation of at least 16,5%. Agent's commission, transfer duty, conveyancing fees, etc. will of course play a smaller role in this calculation if these are amortised over a longer period than a year.

- It also follows that renting – rather than buying – holiday accommodation will become a more attractive option in many instances. This is not necessarily a bad thing.

- Speculation and trading in business property and second homes will largely be eliminated. However, this never was a significant factor in the market, given the danger of being classified as a trader by the *fiscus.*

- The value of (second) homes in holiday resorts will probably suffer, especially in the medium term, until investors get used to the idea. And they will, because holiday homes are normally bought for the long haul, so it is the heirs who will in all likelihood pay the CGT when they sell one day. Conversely, some wealthy individuals may further capitalise their first homes, rather than spending money on assets of which the capital gains will be taxed. But this point is pure speculation, and taxpayers may soon get used to this tax and their behaviour may revert to the situation *ex ante*.

- It follows that if fewer houses are going to be bought, then agents and conveyancers will be affected negatively. This will especially apply to holiday towns.

- Family trusts have been created until now for two reasons, viz. to take capital gains on assets out of the estate (thereby minimising the tax-take of the state) and to protect these assets against creditors (for just in case). It looks like the first of these reasons is no more. Quite a clever move, I would say.

To sum up, in principle I do not find much fault with CGT. The problem is that in a country like South Africa, where inflation is still running at about 8%, it is iniquitous for taxpayers to pay tax on inflation "gains". Since the *fiscus* is going to go to the trouble of setting up the administration for this cumbersome tax, it might as well go one small step further and make a fair adjustment for inflationary gains. To illustrate the point, imagine a situation like Zimbabwe, with rampant inflation, and getting taxed on these ghost gains. ■