PROPERTY DEVELOPERS BEWARE: DEEMED ACCRUALS CAN SERIOUSLY DISRUPT YOUR CASH FLOW

“Never take your eyes off the cash flow because it’s the lifeblood of business” (Richard Branson)

A recent Supreme Court of Appeal (SCA) judgment has confirmed that when a property developer enters into an agreement with a buyer to transfer the property, even if the developer only actually gets paid in a subsequent tax year, the income is deemed to have accrued to the developer at that date. The developer must therefore include the full proceeds of the sale in its income tax return for the year the agreement was signed.

This has the effect of the property developer paying tax before receiving the proceeds of the sale, putting the developer out of pocket until transfer to the purchaser takes place.

A R1.9m tax assessment challenged:

A property developer in Cape Town entered into sales agreements for 25 units. Each agreement called for a deposit of R5,000 with the balance of the money to be paid on completion of the development. Purchasers could take possession once the full sale price had been secured or within 60 days of the sale. By the end of the first year 18 purchasers had taken possession and in all 25 cases the purchase price had been fully secured.

Transfer of the properties took place in the next tax year. The developer did not include the sale proceeds in his tax return for the year of concluding the agreements but showed the proceeds in the next tax year.

The Court upheld the decision by SARS to tax the developer in full in the first tax year. The assessment at just under R1.9m was based on taxable income of R6.8m.

Why the developer lost

Property developers assume a substantial risk when they undertake a development – they spend millions of Rand upfront and if they can’t sell the developed properties they make a considerable loss. They mitigate this risk by selling the properties upfront – usually before they commit to building. Clearly they will not get paid until the property is transferred, so they accept a deposit plus a guarantee (usually from the purchaser’s banker) for the balance of the selling price, or alternatively the buyer placing the funds in the conveyancer’s trust account.

Once the developer is assured of selling the properties it then proceeds with the development. On this basis, banks will advance the cost of the development to the developer.

However, in terms of the law as now confirmed by the SCA, the proceeds of the sale of the properties are deemed to have accrued to the developer and are taxable in the year the agreement is signed.

Developers need to be aware of, and plan for, the cash flow implications.