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The tax implications of selling your primary residence

The decision to sell your home is a big one that generally involves both emotional and financial factors. Often it coincides with a change in circumstances – such as a new job requiring relocation, a baby on the way, or perhaps children leaving the nest. The reasons for selling your home are many and varied - nonetheless it is important to consider the tax implications so that you are prepared for any potential liability that may arise.

Jeremy Burman of Private Client Holdings says that tax on capital gains was introduced with effect from 1 October 2001 and applies, subject to certain exclusions, to gains made on the disposal of capital assets from this date.

"Although we often hear the term 'capital gains tax' bandied about, this is a misnomer as no separate tax applies to capital gains, rather a portion of the gain (40% in the case of individuals) is included in your taxable income and subject to income tax according to the sliding scale along with your other earnings for the tax year. The effective tax rate payable on a capital gain is dependent on the income tax bracket into which you fall and can range from 0% for individuals under the tax threshold to 18 % for those who have income in excess of R 1.5 million (40% of the gain x 45% marginal tax rate)."

How it is calculated

According to Burman, a capital gain for tax purposes is calculated as the difference between the proceeds i.e. the selling price and the base cost. The base cost of a property would include all costs of acquiring the property (purchase price, transfer duty, legal costs etc.), the cost of capital improvements to the property (these will exclude the costs of maintaining the property) and selling costs such as advertising or agent's commission. Since only the gain after 1 October 2001 is taxable, the portion of the gain that relates to the period prior to this date (for properties acquired before this date) is excluded. This is calculated by using either the market value as at 1 October 2001 or an amount determined in terms of a time based formula.

R2 million exclusion on primary residence

"Certain exclusions within the Income Tax Act provide for some tax relief when it comes to the disposal of a primary residence by a natural person," says Burman. "Where the selling price of the property is less than R2 million the entire capital gain or loss must be excluded for tax purposes. The Act also provides that the first R2 million of a capital gain or loss on disposal of a primary residence must be disregarded. Where a property is jointly held, such as in the case of a married couple, the gain as well as the R2 million exclusion must be 'shared' equally by the owners."

By way of example: If Mr and Mrs Smith dispose of their house with a base cost of R 3 million for a selling price of R 5.5 million, their capital gain will be equal to R 2.5 million. After deducting the joint R 2 million exclusion they will be left with a net gain of R 500 000. They will each then include R 250 000 of this gain in their return. Individual taxpayers are also currently entitled to an annual general capital gain exclusion of R 40 000 on top of the primary residence exclusion thus potentially bringing each portion of the final net gain down to R 210 000.

Therefore Mr and Mrs Smith would then each have R 84 000 (40% x R 210 000) included in their taxable income. If Mr Smith is in the 26 % tax bracket and Mrs Smith in the 41 % tax bracket, the tax payable on their capital gain would be R 21 840 and R 34 440 respectively. In this case their combined tax works out to be about 1% of the selling price as the primary residence exclusion and the inclusion rate assist in keeping the effective tax on the disposal relatively low.

Secondary properties and capital gains

"It is important for home owners to bear in mind that only one house may be regarded as a primary residence at any one time. Therefore if the property disposed of by the Smiths was their weekend holiday home, SARS would not regard this as their primary residence and they would be unable to claim the R 2 million exclusion. They would each therefore declare a net gain of R 1.24 million (R 2.5m x 50% less R 40 000 annual exclusion each) which would result in R 496 000 being included in their taxable income. Their tax liabilities from the disposal would increase substantially to a minimum of R 128 960 and R 203 360 respectively, possibly more as this additional income could push them into a higher tax bracket– resulting in a combined tax equal to at least 9.5% of the selling price," advises Burman.

Home based businesses and capital gains

"Furthermore, if a home owner carried on business from the property and has claimed a portion of household expenses against his income earned in this regard then the gain from the property must be split between the portion that relates to the business and the portion that relates to the primary residence. Only the latter may be offset by the R 2 million primary residence exclusion. For example: Susie has set up a room in her home from which to run her consulting business. This room comprises 15 % of the floor space of the house. She sells this property and makes a capital gain of R 1.5 million. Ordinarily, if she had not carried on a business from her home, there would be no tax implications on this disposal as the gain falls below the R 2 million exclusion. However, in this case she will be taxed on the portion that relates to her business, therefore she will need to declare a capital gain of R225 000 (15% of R 1.5 million). From this she can deduct the annual exclusion to arrive at a net gain of R 185 000. This will result in an amount of R 74 000 being included in her taxable income to be taxed at her marginal rate."

Burman says that the above scenario should not discourage a home owner from deducting home office expenses when they carry on a business from home as the tax savings to be gained from the deductions over the years will usually exceed any capital gains tax liability that will arise in the future.

Owning your house through a trust

A common question is whether it makes sense for your company or your family trust to be the owner of your home.This is a very complex area of legislation that is currently under review and is in a state of flux Burman recommends that you consult an expert like the team at Private Client Holdings who are up to date with regards to changes and that although there may be reasons other than tax considerations why this may be appropriate in certain circumstances, it is not generally a tax efficient solution from a capital gains perspective for two reasons: Firstly, the primary residence exclusion is only available to natural persons and not to companies or trusts; secondly, the lower inclusion rate for natural persons (40%) compared to that for trusts and companies (80%) means that in all cases the effective tax rate on capital gains will be lowest in the hands of an individual.

The importance of keeping records

"With the general growth in house prices over time, it is likely that a capital gain

rather than a loss will be generated when disposing of a property that has been held for a number of years. In order to minimise this gain and the resultant tax it is important for home owners to keep a record of the cost of all renovations and improvements incurred on the property over the years so that these can be included in the base cost when the property is eventually disposed of. It is also worthwhile consulting your tax adviser when considering a move to establish any potential tax liability that may need to be factored into your decision," concludes Burman.

Ends