

IS THERE A VIABLE WAY TO TAX THE CONSUMPTION OF IMMOVABLE PROPERTY THAT IS MORE CONSISTENT WITH THE ECONOMIC OBJECTIVE OF THE VAT?

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ABSTRACT

The design of value added tax (VAT)[†] systems is generally based on an assumption known as the 'prepaid method'. Under this method, it is assumed that the value of goods at the time of purchase (the first transaction) is equal to the value of the use and enjoyment (consumption) by the owner of the goods. VAT is imposed on the first purchase of goods, and later sales of goods from consumer to consumer are not subject to VAT. This generally produces the correct result. However, the general appreciation in the value of immovable property may result in the value of total consumption of owner-occupied housing being greater than the value that was taxed at the time of first purchase. This is inconsistent with the economic objective of VAT, which is to tax the flow of consumption. A possible alternative would be to subject imputed rent (the net value of services rendered by a house to its owner-occupier for which they would otherwise pay cash rent to a landlord) to VAT. Imputed rent has been regarded as part of the tax base for income tax purposes in many countries. However, no country includes imputed rent in its VAT base. This article outlines some of the practical considerations that would be involved in including imputed rent in the VAT base.

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[†] Whilst VAT was the traditional name for the broad-based consumption tax that was implemented in the European Union (EU), some Anglo countries such as Australia, Canada, Malaysia, New Zealand and Singapore, which have more recently introduced this system of consumption tax, have called the tax a goods and services tax (GST). As VAT is the traditional name used for this type of consumption tax, and it is the term most commonly used in the international sphere, it will be the term that will be used throughout this article, except when any GST system is referred to (for example, the GST system in New Zealand).

I INTRODUCTION

The research question to be answered in this article is whether there is a viable way to tax the consumption of immovable property that is more consistent with the economic objective of VAT (which is to tax the flow of consumption) as compared to the current approach. The current approach to the VAT treatment of immovable property will first be considered in Section II of this article. It will be noted in this section that the design of VAT systems is generally based on an assumption that is known as the 'prepaid method'. It is assumed that the value of goods at the time that they are first purchased is equal to the total value of the use and enjoyment (consumption) of those goods.¹ Therefore, VAT is generally imposed on the first purchase of goods, and later sales of goods from consumer to consumer are not subject to VAT.

In Section III, the particular challenge posed by the VAT treatment of owner-occupied housing under the prepaid method will be discussed. The general appreciation in the value of immovable property² may result in the value of total consumption of owner-occupied housing being greater than the value that was taxed at the time of first purchase. This is inconsistent with the economic objective of VAT, as it may produce a result where there are flows of consumption of owner-occupied housing that are not subject to VAT.

It has been recognised in the VAT literature that the theoretically correct approach for VAT purposes would be to include the imputed rent of a house or apartment in the VAT base.³ Section IV of this article will discuss the concept of imputed rent. This is the hypothetical rent that an owner-occupier would pay to him or herself for living in his or her own home.⁴ Imputed rent has been regarded as part of the tax base for income tax purposes in many countries.⁵ However, it has generally been considered that including imputed rent in the VAT base would be too difficult. This has primarily been because of concerns about how to value imputed rent, and concerns as to how such a proposal would

¹ David F Bradford, *Blueprints for Basic Tax Reform* (Tax Analysts, 2nd ed, 1984) 108; Wei Cui, 'Objections to Taxing Resale of Residential Property under a VAT' (November 2012) *Tax Notes* 777, 779; and Robert F van Brederode, *Systems of General Sales Taxation: Theory, Policy and Practice* (Kluwer Law International, 2009) 183.

² The term 'immovable property' is generally understood in the tax literature to mean land, buildings and fixtures, both residential and commercial: Satya Poddar, 'Taxation of Housing Under a VAT' (2009) 63 *Tax Law Review* 443, 445–6. In Anglo countries, including Australia, immovable property is known as real property. However, owing to the international importance of this article, immovable property is referred to by its most common name.

³ See, for example, Robert Albon, 'The Appropriate Tax Treatment of Owner-Occupiers' (1984) 1(4) *Australian Tax Forum* 391, and Rita de la Feria and Richard Krever, 'Ending VAT Exemptions: Towards a Post-Modern VAT' in Rita de la Feria (ed), *VAT Exemptions Consequences and Design Alternatives* (Wolters Kluwer, 2013). In relation to the purest theoretical VAT treatment of goods more generally, see Richard Krever, 'Designing and Drafting VAT Laws for Africa' in Richard Krever (ed), *VAT in Africa* (Pretoria University Law Press, 2008) 24.

⁴ Marsh provides a similar explanation. See Donald B Marsh, 'The Taxation of Imputed Income' (1943) 58(4) *Political Science Quarterly* 514, 514.

⁵ See Steven C Bourassa and William G Grigsby, 'Income Tax Concessions for Owner-Occupied Housing' (2000) 11(3) *Housing Policy Debate* 521; Paul E Merz, 'Foreign Income Tax Treatment of the Imputed Rental Value of Owner-Occupied Housing: Synopsis and Commentary' (1977) XXX(4) *National Tax Journal* 435; and Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International, 2003).

affect low-income earners and those who do not earn income. As there is no example of any country including imputed rent within its VAT base, this article will consider two historic examples of imputed rent being included within the income tax base (see Section V). These examples will demonstrate some of the problems that have arisen from such an approach. Section VI will then consider whether the concerns that have arisen regarding including imputed rent within the VAT base are still realistic concerns today.

II VAT TREATMENT UNDER THE PREPAID METHOD

In order to answer the research question, this article first considers the current approach. Under the prepaid method, VAT is currently imposed on the original purchase price of goods as a measurement of the present value of all future consumption.⁶ Later sales of goods from consumer to consumer are not subject to VAT, although theoretically later consumers pay VAT as future consumption is assumed to be built into the price at which second-hand goods are sold.

The current use of the prepaid method yields an appropriate result where goods provide immediate gratification to a consumer, such as a cup of coffee.⁷ In this case, the value of goods at the time that they are first purchased is the present value of their future use, and the VAT on the initial purchase corresponds with all future consumption. Use of the prepaid method also generally yields an appropriate result where goods are sold partway through their useful lives.⁸ The owner of a washing machine, for example, who sells it for, say, half the purchase price when it is halfway through its life recovers half the VAT that he or she originally paid to the revenue authority. The purchaser of a second-hand washing machine bears an effective burden equal to the present value of the VAT on the remaining consumption that is yielded by the washing machine. The market value of used goods such as second-hand washing machines is the VAT-inclusive value. This includes a portion of the VAT paid by the first purchaser.⁹

The purchase of a good is a form of savings, not consumption.¹⁰ Expenditure is recognised as goods waste through usage or the effluxion of time. Cui has recognised this where he has written that '[t]he act of purchase is not itself an act of consumption. Instead,

⁶ The following sources provide similar explanations: Bradford, above n 1; Sijbren Cnossen, 'VAT Treatment of Immovable Property' in Victor T Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol 1, 233–4; Cui, above n 1, 799; Rebecca Millar, 'Echoes of Source and Residence in VAT Jurisdictional Rules' in Michael Lang, Peter Melz et al (eds), *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD, 2009); Rebecca Millar, 'VAT and Immovable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences' in Rita de la Feria (ed), *VAT Exemptions Consequences and Design Alternatives* (Wolters Kluwer, 2013) 253; Christine Peacock, 'Taxing the Consumption of Owner-Occupied Residential Property' (2013) 5 *International VAT Monitor* 299, 299; and van Brederode, above n 1, 183.

⁷ This has been recognised by van Brederode: Robert F van Brederode, 'Theory and Practice of VAT Treatment of Real Estate' in Robert F van Brederode (ed), *Immovable Property under VAT: A Comparative Global Analysis* (Kluwer Law International, 2011) vol 37, 1.

⁸ Krever has recognised this: Krever, above n 3, 24.

⁹ This was earlier recognised in Peacock, above n 6.

¹⁰ *Ibid.*

consumption happens when a durable good is used.’¹¹ Many consumer durables are goods that waste in value over time.¹² Therefore, for many consumer durables the VAT on the initial sale price will generally be approximately equal to the present value of all future consumption.

However, where a durable good appreciates, upfront taxation does not correspond to the present value of all future consumption. If the market value of a durable good increases over time, the value of savings will rise, and yield more consumption. Final consumption will therefore be greater than the original present value that was ascribed to the good. Owners who retain appreciating goods therefore bear less VAT than the amount that corresponds with the increased consumption value of the good. This is problematic, as it is inconsistent with the economic objective of VAT, which is to tax the flow of consumption.¹³ It presents a situation where the legal design of VAT as a tax on transactions does not achieve this economic objective. For simplicity reasons, expenditure is generally currently used as a proxy for consumption. In effectively describing the operation of the prepaid method, Millar has explained that:

while the objective of a VAT is to tax consumption, in its legal design it is a tax on transactions, in which future consumption is predicted. Consumption is measured by reference to consumption expenditure (the price paid to acquire goods or services for the purpose of consuming them, whether immediately or in the future).¹⁴

Generally, there are time of supply rules that are imposed in countries that have a VAT, which have the effect that VAT is accounted for at the time that ownership of a good is transferred.¹⁵ This will generally be regarded as the time that a transaction takes place. For example, in New Zealand there is a general ‘time of supply’ rule that states that GST should be accounted for at ‘the time an invoice is issued by the supplier or the recipient or the time any payment is received by the supplier in respect of the supply.’¹⁶ Similarly, in the European Directive (EU) Directive 2006/112 it is written that ‘on each transaction, value added tax ... shall be chargeable’.¹⁷

¹¹ Cui, above n 1. See also Alan Schenk, Victor Thuronyi and Wei Cui, *Value Added Tax: A Comparative Approach* (Cambridge University Press, 2nd ed, 2015), and van Brederode, ‘Theory and Practice of VAT’, above n 7.

¹² Krever, above n 3.

¹³ The economic objective of the VAT is recognised by Millar. See Millar, ‘VAT and Immovable Property’, above n 6. See also Robert F Conrad, ‘Value Added Taxation and Real Estate’ (Discussion Paper DRD224, Development Research Department Economics and Research Staff World Bank, February 1987); Alan A Tait, *Value Added Tax: International Practice and Problems* (International Monetary Fund, 1988) 80; and van Brederode, ‘Theory and Practice of VAT’, above n 7.

¹⁴ Millar, ‘Echoes of Source’, above n 6. See also OECD, *Consumption Tax Trends 2016: VAT/GST and Excise Rates, Trends and Policy Issues* (OECD Publishing, 2016).

¹⁵ Millar describes the time of supply rules in more detail: Millar, ‘Echoes of Source’, above n 6.

¹⁶ *Goods and Services Tax Act 1985* (NZ) s 9.

¹⁷ European Union Directive 2006/112 Article 1. New Zealand and the EU are mentioned here as the VAT/GST systems in these countries are considered international models of VAT design: John F Due, ‘The New Zealand Goods and Services (Value-Added) Tax – A Model for Other Countries’ (January–February 1988) 36(1) *Canadian Tax Journal* 125; Andrew Maples and Adrian Sawyer, ‘The New Zealand GST and its Global Impact: 30 Years On’ (2017) 23(1) *New Zealand Journal of Taxation Law and Policy* 9, 25; Christine Peacock, ‘Why Simple GST Treatment of Real Property Is Important’ (2010) 13(4) *The Tax Specialist* 216; Adrian Sawyer, ‘GST Reform: Can New Zealand Offer Constructive Guidance to Inform the Australian

James has observed that using 'expenditure on consumption as a proxy for consumption' is considered best practice design.¹⁸ She has written that it is generally thought 'necessary to identify some taxable transactions ... such as the supply of a good or service, that triggers the expenditure on consumption and therefore the liability to pay VAT'.¹⁹ According to Ecker, '[c]onsumption itself is not directly observable but what we can hope to observe is ... spending'.²⁰

However, this article suggests that it is no longer necessary to identify taxable transactions in order to subject the consumption of immovable property to VAT. This article therefore fits within the increasing body of literature where the current general design of VAT systems is being questioned, and where it is being suggested that it is now possible to tax some consumption that has generally not been subject to VAT in the past. In particular, there is an increasing body of literature where the rationale for the use of standard exemptions from VAT, are being questioned.²¹ This is particularly in light of the experience in VAT jurisdictions with the problems caused by the use of exemptions, such as the often-difficult issue of determining which supplies of goods and services are taxable and which are exempt. Further, as noted by the European Commission, there is a need to review standard exemptions 'in the light of economic and technological changes'.²² The focus of this article is on the VAT treatment of residential premises. Currently sales and leases of residential premises are generally regarded as exempt from VAT, or outside the scope of VAT when a vendor is not registered for VAT (see Section III).

III THE PROBLEM WITH THE VAT TREATMENT OF OWNER-OCCUPIED HOUSING

The particular challenge posed by the VAT treatment of owner-occupied housing under the prepaid method will be discussed in this section, after consideration of the VAT treatment of immovable property more generally. Unlike most consumer durables that depreciate over time, the value of immovable property generally appreciates.²³ Cui has attributed this appreciation to '[u]rbanization, the building of new transportation pathways and amenities, unexpected rises in income in the local population, and so forth'.²⁴ Other factors affecting the general appreciation in the value of immovable property may include population growth, particularly in jurisdictions with immigration.²⁵

Debate?' (Paper presented at the Visiting Professor Seminar Series, QUT Business School, Brisbane, Queensland, Australia, November 2014); and Thuronyi, above n 5, 313.

¹⁸ Kathryn James, *The Rise of the Value-Added Tax* (Cambridge University Press, 2015) 41.

¹⁹ Ibid 41–2.

²⁰ Thomas Ecker, *A VAT/GST Model Convention* (IBFD, 2013) 100.

²¹ Liam Ebril et al, *The Modern VAT* (International Monetary Fund, 2001) 100.

²² European Commission, 'Green Paper on the Future of VAT: Towards a Simpler, More Robust and Efficient VAT System' (2010) <http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/common/consultations/tax/future_vat/com%282010%29695_en.pdf>.

²³ This has been recognised by Cui: Wei Cui, 'Learning to Keep the Consumption Tax Base Broad: Australian and Chinese VAT Design for the Housing Sector' in Christine Peacock (ed), *GST in Australia: Looking Forward from the First Decade* (Thomson Reuters, 2011). See also Cui, 'Objections to Taxing Resale', above n 1, 779.

²⁴ Cui, 'Objections to Taxing Resale', above n 1, 779.

²⁵ This was recognised in Peacock, 'Taxing the Consumption', above n 6, 300.

Appreciation in the value of immovable property can also arise due to other circumstances relating to the property, such as a change of zoning.²⁶

Van Brederode has noted that other than immovable property 'art, antiques and some other collectibles'²⁷ can also appreciate. To achieve consistency, the VAT treatment of these other durable items that may also experience a change in real values should also be considered. However, this is beyond the scope of this article, which focuses on the VAT treatment of immovable property. This is because it is more common for people to purchase immovable property than these other items, as this form of property is considered more of a necessity, and immovable property is the most frequently consumed asset to appreciate. The importance of the VAT treatment of immovable property also lies in the fact that expenditure on housing services often comprise a large percentage of an individual's total consumption.²⁸ In this regard, Millar has written that '[i]mmovable property is the most widely held and traded appreciating asset and a purchase of immovable property is more often than not the single most important acquisition a person will make in his/her lifetime.'²⁹

The general appreciation in the value of immovable property is not so problematic when it comes to supplies of commercial property, as business consumers are entitled to deduct VAT on the purchase or lease of commercial property, as the property is used as an input into the purchaser's production.³⁰ Therefore, there is no VAT net effect for revenue authorities as a result of supplies of commercial property being subject to VAT. The general appreciation in the value of immovable property is also not a problem that affects the VAT treatment of residential rents, as residential rents are generally exempt from VAT.³¹

The VAT treatment of owner-occupied housing is, however, problematic. Under the prepaid method, the first sale of residential premises from a developer to a consumer is subject to VAT. Subsequent sales of residential premises from consumer to consumer are generally regarded as exempt from VAT, or outside the scope of VAT when a vendor is not registered for VAT.³² In theory, it is assumed that the initial sale price of residential premises will include the present value of all future consumption of the residential

²⁶ Cui, 'Objections to Taxing Resale', above n 1, 779.

²⁷ van Brederode, 'Theory and Practice of VAT', above n 7.

²⁸ Ibid 1.

²⁹ Millar, 'VAT and Immovable Property', above n 6. See also Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (George Allen & Unwin, 1978) 54, and Poddar, above n 2.

³⁰ See Krever, above n 3, 24; Ine Lejeune, Jeanine Daou-Azzi and Mark Powell, 'The Balance Has Shifted to Consumption Taxes – Lessons Learned and Best Practices for VAT' in Michael Lang, Peter Melz et al (eds), *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD, 2009); and van Brederode, 'Theory and Practice of VAT', above n 7.

³¹ This is so as to achieve tenure neutrality between homeownership and residential rents, as sales of used residential premises are not subject to VAT: Sijbren Cnossen, 'Improving the VAT Treatment of Exempt Immovable Property in the European Union' (Working Paper 10/19, Oxford University Centre for Business Taxation, 2010) 1; Lejeune, Daou-Azzi and Powell, above n 30; Millar, 'VAT and Immovable Property', above n 6; and M Stewart, 'Taxation Policy and Housing' (2012) 7 *International Encyclopedia of Housing and Home* 152.

³² van Brederode, 'Theory and Practice of VAT', above n 7.

premises.³³ However, Cnossen has described the current VAT treatment under the prepaid method as a 'second-best approach' as changes in the value of residential premises are not included in the VAT base.³⁴ Over time, the value of a house or apartment generally rises above the consumer price index. Applying the prepaid method to the VAT treatment of owner-occupied housing may therefore mean that the value of total consumption of owner-occupied housing may be greater than the value that was taxed at the time of first purchase.³⁵ Future purchasers of a used residence will have an effective tax burden equal to the present value of the VAT at the time of acquisition, not the new value of future consumption.

IV THE CONCEPT OF 'IMPUTED RENT'

It has been recognised in the VAT literature that the theoretically correct approach for VAT purposes would be to include the imputed rent of a house or apartment in the VAT base.³⁶ Marsh has described imputed rent as 'the net value of the services rendered by a house to its owner (occupier) for which he would otherwise pay cash rent to a landlord.'³⁷ Imputed rent falls within the broader taxation concept of imputed income, which Marsh has defined as a 'flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf.'³⁸ If imputed rent were included within the VAT base, then it would not be subject to VAT at the time that transactions between parties take place, but instead, a value would be placed on the imputed rent of a home for a specific period, such as a month or year, and this value could be updated as the immovable property appreciates.

Cnossen has observed that subjecting imputed rent to VAT would involve regarding the owner-occupier of a home as making a self-supply of the services in a home to him or herself.³⁹ He has explained that by purchasing a home, an owner would become a producer of housing services. The owner could sell the housing services to a tenant who would act as a consumer of the housing services. A theoretically correct approach would be for the tenant to pay VAT on the rental charge. Alternatively, the owner could put the home to his or her own disposal.⁴⁰ This would be equivalent, Cnossen has argued, to making a self-supply of housing services. He has recommended that VAT should be

³³ de la Feria and Krever, above n 3.

³⁴ Sijbren Cnossen, 'A Proposal to Improve the VAT Treatment of Housing in the European Union' in Rita de la Feria (ed), *VAT Exemptions Consequences and Design Alternatives* (Wolters Kluwer, 2013) 225; Sijbren Cnossen, 'Global Trends and Issues in Value Added Taxation' (1998) 5(3) *International Tax and Public Finance* 399; and Sijbren Cnossen, 'Is the VAT's Sixth Directive Becoming an Anachronism?' (2003) 43(12) *European Taxation* 434. See also de la Feria and Krever, above n 3.

³⁵ This was recognised in: Cnossen, 'A Proposal to Improve the VAT Treatment', above n 34; Cui, 'Learning to Keep the Consumption Tax Base Broad', above n 23; de la Feria and Krever, above n 3, 453; and Institute for Fiscal Studies, *Tax by Design: The Mirrlees Review* (Oxford University Press, 2011) 380.

³⁶ See, for example, Albon, above n 3, 391, and de la Feria and Krever, above n 3. In relation to the purest theoretical VAT treatment of goods more generally, see Krever, above n 3, 24.

³⁷ Marsh, above n 4, 514.

³⁸ *Ibid.*

³⁹ Cnossen, 'Improving the VAT Treatment of Exempt Immovable Property', above n 31, 1.

⁴⁰ *Ibid.*

charged on the consideration for this self-supply.⁴¹ Such an approach would involve widening the VAT base, to include residential rent and imputed rent.

While imputed rent has been regarded as part of the tax base for income tax purposes in many countries including Australia, Austria, Belgium, Denmark, Finland, Germany, Greece, Israel, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom,⁴² there is no country that includes or has included imputed rent in its VAT base.⁴³ The next section considers two historic examples of when imputed rent was included within the income tax base. These examples will illustrate some of the problems that have arisen from such an approach.

V HISTORICAL EXAMPLES OF IMPUTED RENT BEING SUBJECT TO INCOME TAX

Imputed rent was assessed for income tax purposes at a national level in Australia, from 1915 until 1923.⁴⁴ Where applicable, the income of any person included:

five per centum of the capital value of land and improvements thereon owned and used or used rent free by the taxpayer for the purpose of residence or enjoyment and not for the purpose of profit or gain, less the interest paid on a mortgage of that land.⁴⁵

Simons wrote in particularly positive terms about this experience in 1938 in the course of discussing the ‘comprehensive concept of income’ and ‘income in kind’.⁴⁶ However, it appears that he mistakenly viewed this as a simple system under which imputed rent was calculated on a net basis, without further deductions allowed for depreciation or repairs.⁴⁷ For example, he wrote that ‘[a] conspicuous advantage of this method lies in the avoidance of the depreciation problem – which ... is very inadequately handled under rules of the kind prescribed in Schedule A of the English law’⁴⁸ (the operation of Schedule A in the United Kingdom will be discussed below). Albon has explained that the Australian system was, however, more complex than this. He has written that, ‘[f]rom the “five per centum of the capital value”, owner-occupiers could deduct for repairs, rates, land taxes and mortgage interest.’⁴⁹

⁴¹ Ibid.

⁴² See Bourassa and Grigsby, above n 5; Merz, above n 5, 435; New Zealand Treasury, New Zealand Government, *Issues Paper – Tax Review 2001* (2001) 39; and Thuronyi, above n 5.

⁴³ Richard M Bird and Pierre-Pascal Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press, 2007), and Cnossen, ‘VAT Treatment of Immovable Property’, above n 6.

⁴⁴ South Australia included imputed rent in its income tax base from 1885 until 1930, Victoria from 1895 until 1936, and Queensland from 1920 until 1923: B F Reece, ‘Taxing Imputed Rent: Australian Precedents’ (1975) *Community* 6.

⁴⁵ *Income Tax Act 1915* (Cth) s 14(e).

⁴⁶ Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938).

⁴⁷ This is noted in Robert Albon, ‘Housing and Taxation – Commonwealth Issues’ (1990) 7(3) *Australian Tax Forum* 337 and Barry Reece, ‘Simons’ Account of Australian Taxation of Imputed Rental Income’ (1985) 2(2) *Australian Tax Forum* 239.

⁴⁸ Simons, above n 46.

⁴⁹ Albon, above n 47, 337. See also Reece, ‘Simons’ Account’, above n 47.

The previous system of including imputed rent in the income tax base in the United Kingdom, which existed from the beginning of its income tax system in 1799 until 1963,⁵⁰ has been cited in the tax literature as an example of the administrative difficulties that can arise in assessing imputed rent for income tax purposes.⁵¹ Income tax was levied on the annual value of the property that was owner-occupied.⁵² The annual value of owner-occupied property was regarded as the amount that it was 'worth to be let by the year'.⁵³ Revaluation of owner-occupied property was to occur every five years.⁵⁴ However, no revaluations took place in the United Kingdom between 1936 and 1963 due to war conditions and post-war difficulties.⁵⁵ Merz has written that, '[t]he fear of significant increases in income tax liability following establishment of realistic values by reassessment was the major factor in the cessation of income tax on this form of income'.⁵⁶

VI INCLUDING IMPUTED RENT WITHIN THE VAT BASE

Following on from the historical experiences of Australia and the United Kingdom in including imputed rent in the income tax base, administrative concerns have also arisen in the more recent theoretical VAT literature that has discussed whether imputed rent could be included in the VAT base (see Section V above). For example, in 1996 Cnossen wrote that 'the computation of all rental values, would present formidable administrative problems that a VAT should not take on'.⁵⁷ However, while valuing assets in general may have been problematic historically (for instance, for income tax purposes in the United Kingdom, as discussed above), this does not appear to be the case today. In 2011, Holmes wrote that, from an income tax perspective,

[t]here seems to be little justification for omitting imputed rent from owner occupied housing on the basis of measurement difficulties in a climate of increasingly sophisticated valuation methodology for local authority rating (and other) purposes.⁵⁸

Tax administrations have become more capable over time of administering increasingly more complex tax laws. These administrations have more sophisticated technology now compared to what they have had in the past. Further, real values of residential property are utilised for other taxation purposes (including local council rating) in many jurisdictions and these systems of valuation could potentially be adapted so that they could be used to determine how to value imputed rent.

⁵⁰ Kevin Holmes, *The Concept of Income: A Multi-Disciplinary Analysis* (IBFD, 2001).

⁵¹ See Government of Canada, *Report of the Royal Commission on Taxation* (1966) vol 3, 48; Richard Goode, *The Individual Income Tax* (The Brookings Institution, revised ed, 1976) 118; and Merz, above n 5.

⁵² Government of Great Britain, 'Royal Commission on the Taxation of Profits and Income: Final Report: Presented to Parliament by Command of Her Majesty' (Her Majesty's Stationery Office, 1955) 246.

⁵³ *Ibid* para 8.11.

⁵⁴ *Ibid* para 8.12.

⁵⁵ Merz, above n 5, 7.

⁵⁶ *Ibid*.

⁵⁷ Cnossen, 'VAT Treatment of Immovable Property', above n 6, 233–4. See also Cnossen, 'Global Trends and Issues in Value Added Taxation', above n 34.

⁵⁸ Holmes, above n 50.

In the Australian state of Victoria, a Net Annual value is stated on the Notice of Valuation, Rates and Charges that is issued to property owners by local councils. This Net Annual value is 5 per cent of the capital-improved value, which is the value of the land and any capital improvements, including buildings. For the purpose of including imputed rent within the VAT base, the Net Annual value on this Notice of Valuation could be regarded as the value of imputed rent that would be subject to VAT on an annual basis. However, a potential problem with such an approach is that the values of residential property that are currently utilised for tax purposes are sometimes not revised regularly, and hence become outdated (as happened in the United Kingdom when imputed rent was subject to income tax).

Alternatively, VAT could be charged based on the average market rental in different regions, and these figures could be adjusted over time for inflation, and in accordance with the features of a home. For example, two-bedroom homes could be valued more than one-bedroom homes; and the standard valuation allocated to a home could be adjusted based on the size of the property. However, such a system would be far more complex to administer than the proposal mentioned above relating to regarding the capital-improved value as the value of imputed rent. A potential problem with both of these potential ways to calculate imputed rent is that sometimes the values that are used in valuation systems even in year one do not reflect the actual value of the property, given the broad valuation metric that is used. There would therefore be compliance and administrative costs associated with any system of valuation that may be used to value imputed rent.

Another concern that has been raised in the tax literature is that if the consumption of housing were taxed on an annual basis then people on lower incomes or no income may be at a disadvantage financially. For example, in considering the possibility of an annual tax levied on housing services, the authors of the Mirrlees Review Report wrote that '[t]here would clearly be a large number of losers from a reform of this kind. The losers would include those, often older people, on low incomes who live in expensive houses.'⁵⁹ Likewise, when discussing the possibility of including imputed rent within the income tax base, Bourassa and Grigsby wrote that,

[t]he tax bears little relationship to capacity to pay, weighing more heavily on lower-income, elderly homeowners ... Substantial exclusions would be required to protect retired homeowners being taxed out of their own homes.⁶⁰

However, older people living in expensive houses are often exercising a choice to enjoy a high-imputed rent rather than cash flow or investing in other assets such as shares. If their imputed rent were subject to VAT, they may not necessarily experience hardship, given their capacity to use the equity in their home (the difference between the value of the property and how much is owed on any mortgage) to obtain a loan that could be used to pay VAT on the imputed rent.

Taxing imputed rent for VAT purposes may, however, have the potential to impact negatively on first home buyers in particular. This may especially be the case during a time of declining homeownership rates due to inflation in house prices. Perhaps there

⁵⁹ Institute for Fiscal Studies, *Tax by Design*, above n 35, 390.

⁶⁰ Bourassa and Grigsby, above n 5, 528.

could be ways to deal with this issue. For example, accompanying social assistance could be considered for those who could genuinely claim that they would be unreasonably disadvantaged (as occurred in New Zealand, when the very comprehensive GST was introduced – in that case to combat regressivity).⁶¹ The authors of the Mirrlees Review Report have suggested that ‘it would be possible to allow people, in specified circumstances, to roll up liabilities (with interest) either until the property is sold or until death, in order to alleviate cash-flow problems.’⁶² If governments collected the additional revenue from including imputed rent within the VAT base and redistributed some of this, then people disadvantaged by such a proposal could be compensated. For example, in Australia the first homeowner’s grant was introduced to offset the effect of the VAT on homeownership.

VII CONCLUSION

Given that housing is so frequently consumed, the appropriate VAT treatment of immovable property is particularly important. In the past, using expenditure on consumption as a proxy for consumption, as occurs under the prepaid method (discussed in Section II) has been considered best practice design. However, the current VAT treatment of immovable property under the prepaid method produces a result that is inconsistent with the economic objective of VAT (which is to tax all consumption). Under the prepaid method, the consumption of immovable property is only taxed once, at the time that the property is first sold to a consumer. Therefore, any appreciation in the value of immovable property is not captured within the VAT base. This produces a result where there may be a flow of consumption that is not subject to VAT. The research question that this article therefore set out to answer was whether there is a viable way to tax the consumption of immovable property that is more consistent with the economic objective of VAT.

In this article, the current VAT treatment of immovable property under the prepaid method was compared to the result that would be achieved if imputed rent were subject to VAT. Including the imputed rent of owner-occupied housing within the VAT base, along with rentals of housing to tenants, would produce a result that is more consistent with the economic objective of VAT. Subjecting imputed rent to VAT would involve subjecting the consumption of immovable property to VAT on a more regular basis. The value of immovable property that is subject to VAT as part of this process could be updated regularly to reflect its appreciation.

In the VAT literature, the idea of including imputed rent in the VAT base has been considered the theoretically correct approach. However, it has generally been considered that this might result in measurement difficulties in determining the value of imputed rent (as occurred when imputed rent was considered part of the income tax base in the United Kingdom: see Section V). It has also been considered that low-income earners and those with no income would be at a financial disadvantage if they were required to pay VAT on their imputed rent (see Section VI).

⁶¹ Jeff Todd, ‘Implementing GST – Information, Education, Co-ordination’ in David White and Richard Krever (eds), *GST in Retrospect and Prospect* (Thomson Brookers, 2007) 30.

⁶² Institute for Fiscal Studies, *Tax by Design*, above n 35, 390.

In considering the measurement difficulties that may arise, it was conceded that there would be compliance and administrative costs associated with any system of valuation that may be used to value imputed rent. However, the availability of sophisticated technology and existing systems of valuing property suggests that these costs would be lower than they may have been in the past. The ability today to achieve an outcome closer to the economic objective of VAT may outweigh these costs.

In considering the potential financial disadvantage that may be experienced by low income earners and those who do not earn an income, it was suggested that some people who fall within this category may be able to take out loans to fund the potential VAT liability on imputed rent. It was also suggested that social assistance could be provided to those who may be genuinely disadvantaged. It was concluded that the potential problems that may arise from including imputed rent within the VAT base may not be insurmountable. Referring back to the research question that this article set out to answer, including imputed rent in the VAT base may be a viable way to tax the consumption of immovable property that may produce a result that is more consistent with the economic objective of VAT.

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