The problem with the current VAT treatment of immovable property

Christine Peacock, Graduate School of Business and Law, RMIT University

Abstract

There has been a fundamental shift from other forms of taxation, such as customs duties and wealth taxes to income taxes and broad-based consumption taxes. Schenk has described this as ‘the most dramatic change in tax systems around the world.’¹ Like all tax systems, the VAT is not perfect. This paper explains how and why there are problems with the VAT treatment of immovable property.

Background

In the course of the twentieth century, tax systems in developed countries underwent a fundamental shift from customs duties, wealth and property taxes, and wealth and transfer taxes to income taxes and broad-based consumption taxes.

As societies became richer the consumption of goods and services was increasingly used as a tax base. While in the past, taxing consumption was limited to imposing special excise duty types of taxes on a small range of luxury or demerit goods,² along with a general turnover tax (Europe), manufacturers’ sales tax (Canada) or wholesale sales tax (Australia and New Zealand), the trend in developed countries and, increasingly also developing and transitional countries, has been to replace cascading sales taxes with a broad Value Added Tax (VAT) system targeting the final consumption of almost all goods and services.³

³ Crawford et al have commented on the ‘remarkable shift in the balance of taxation... towards the Value Added Tax’. They have written that in contrast ‘[r]eliance on alcohol and tobacco excises... has fallen.’: Ian Crawford,
Schenk has described this shift as ‘the most dramatic change in tax systems around the world.’ He has also described the VAT as ‘the fastest-spreading tax system in history.’ In the 1960s fewer than 10 countries had adopted VAT systems. Now, over 150 countries have a VAT. The VAT has been implemented in all but one of the 34 member countries of the OECD, generating on average one-fifth of tax revenue.

Consumption tax theory

The VAT is often referred to as a broad-based tax. This is in keeping with the underlying theory of consumption tax, that similar goods and services should be treated in similar ways. Much literature suggests that the VAT should have a broad base. For example, Cnossen writes that ‘[a] large body of research analysing the properties and workings of the value-added tax... is now available. The best practice that can be distilled from the literature... strongly indicates that the consumption base of the VAT should be defined as broadly as possible’. Chisholm et al also recommend that the VAT should have ‘a broad a base as possible’. One of the intended outcomes of a broad-based VAT is that distortions to economic decisions are minimised, both from a consumer and supplier perspective. Consumers should not favour purchasing one good (or service) over another because of its VAT effect. Similarly, suppliers should not prefer supplying one good or service over another because of this effect. Ecker writes that:

‘[i]n order for a tax to be fully neutral, it should neither influence business decisions nor should it affect consumer decisions. In order not to influence business decisions, VAT should not be a

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4 Alan Schenk, above n 1.
10 Ibid., 145
cost for business, but should be shifted onto the final consumer. Furthermore, similar goods and services should “bear the same burden...”. In order not to influence consumer decisions, all supplies of goods and services should be taxed. Ideally, all current consumption expenditures should be taxed uniformly... similar goods or services should not be treated differently.’

**The disparity between theory and practice**

A broad-based VAT is more of an ideal than something which occurs in practice. The OECD reports that ‘there is a wide range of exemptions in OECD countries. Financial services, immovable property, and health care are the most widespread exemptions.’

This paper uses the VAT treatment of immovable property to illustrate this. Immovable property is a term generally used to describe land and buildings. Supplies of immovable property are common. Governments often encourage home ownership, and there are many consumer purchasers of property. Immovable property also represents one of the highest value items in a consumer’s goods basket.

It is the long-lived nature of immovable property, as well as the fact that it generally ‘appreciates in value over time’ which means that supplies of immovable property are difficult to deal with under a VAT. In this regard van Brederode observes that the consumption of immovable property is not immediate, but it is generally spread over many years. Similarly, Schenk and Oldman regard immovable property as ‘a long-lived asset, even more so than other consumer durables’. They consider the taxation of immovable property is ‘[o]ne of the most complicated problems in designing a VAT base’.

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13 This term will be used here to denote land and buildings.
15 Ibid.
17 Ibid. In this regard Cnossen realises that it is the appropriate treatment of housing and housing services, as part of the wider area of immovable property, which is the real difficulty: Sijbren Cnossen, ‘VAT Treatment of Immovable Property’, *Tax law design and drafting* (International Monetary Fund, 1996) vol 1, 6.
Conrad and Grozav see the significant timing difference between supply and consumption is not just a difficulty which is unique to immovable property. ‘The problem is apparent for all... consumer durables’. However while it may not be possible at the time other durable goods are purchased to know for how long these goods will be used, the tax on the initial purchase price will generally be approximately equal to the present value of all future consumption, as the consumption value of these goods is unlikely to rise in the future, even when the good is sold.

Immovable property is not the only consumer durable to appreciate over time. Other examples include artwork and jewellery. However immovable property is more commonly purchased than these other consumer durables. It is this combination of the fact that immovable property is frequently purchased, often has a longer life than other consumer durables, and has a particularly high value which makes its VAT treatment particularly worthy of examination.

Cnossen claims that all countries with a VAT currently use the prepaid method with respect to the VAT treatment of immovable property. Under this method the supply of new residential premises is generally subject to VAT, and the assumption is made that this is a prepayment of the tax relating to all future consumption. Later purchasers of used residential premises do not pay VAT.

Commentators have tended to rationalise that a different approach to the VAT treatment of consumer durables would be complicated and administratively difficult. For instance, Schenk and Oldman write that ‘[i]deally, the current use of consumer durables should be taxed each year. This approach raises significant administrative and practical problems. As a result, most

19 Van Brederode writes that ‘[t]heoretically, since the consumption or use of a capital asset takes place gradually during its life cycle, taxation should also occur over time. However, in most instances the same result can be achieved by collecting the tax upfront at the time when the asset is purchased because the initial tax represents the net present value of tax collected over time.’ Robert F van Brederode, above n 14, 183.
20 Cnossen, ‘VAT Treatment of Immovable Property’, above n 16.
21 Cnossen describes the use of the prepaid method with respect to the VAT treatment of immovable property: Ibid. In the US report Blueprints for Basic Tax Reform it is described that ‘[i]ncluding the value of durable goods in the tax base at the time of purchase produces, in effect, a prepayment of the tax on the value of future consumption services.’: David F Bradford, Blueprints for Basic Tax Reform (Tax Analysts, Second Edition, 1984).
22 This results in inequities between homeowners and renters, as renters pay tax on the housing services which they receive.
consumer durables are taxed at the time of purchase’.\textsuperscript{23} More specific to the question of how to appropriately treat supplies of immovable property for VAT purposes, Freebairn notes ‘[a]dministration and convenience costs, if not feasibility, means that in most countries the consumption taxation of consumer durables, including housing, is given a pre-paid consumption tax treatment’.\textsuperscript{24} Regarding the potential problems that would arise, for Cnossen ‘the registration of all owner-occupiers, as well as the computation of all rental values, would present formidable administrative problems’,\textsuperscript{25} and ‘[p]olitically, taxing rental values under the VAT would be even harder to accomplish.’\textsuperscript{26} Any proposal to tax immovable property would be met with concerns regarding housing affordability.

According to Cnossen, ‘as a second-best measure, it is assumed that the purchase price of a durable consumption good represents the discounted present value of its future services’,\textsuperscript{27} and that ‘[b]y extension the tax on the purchase price may be considered a close proxy of the discounted present value of the tax that should have been levied on the flow of services.’\textsuperscript{28} The system yields the appropriate result in the context of goods and services which provide immediate gratification. The appropriate result is also achieved if consumers sell their own goods partway through their useful life. The value of the used goods will include a portion of the tax paid by the first purchaser.

However, a person who retains appreciating property may pay less tax than would be paid if there was a mechanism to calculate tax based on the imputed rent which a home provides to its owner over time, taking into account the fact that the imputed rent would generally rise over time. This has been recognised in the United Kingdom in the Mirrlees Review:

‘... because houses are so long-lived their consumption value may change a great deal over time. Hence their upfront price may prove to be a bad approximation to the value of consumption services they eventually provide.’\textsuperscript{29}

\textsuperscript{23} Schenk and Oldman, above n 15, 408.
\textsuperscript{25} Cnossen, ‘VAT Treatment of Immovable Property’, above n 17.
\textsuperscript{26} Ibid, 236.
\textsuperscript{27} Ibid.
\textsuperscript{28} Ibid, 234.
Future purchasers of a used residence will have an effective tax burden equal to the initial tax at the time of first acquisition, which is likely to be lower than the tax which would be due on the hypothetical rent which they would pay to themselves as a landlord, which would increase as the value of the property increases. Governments using this approach are limited to receiving a consumption tax benefit from the sale of housing only when it is new. They receive no further VAT revenue relating to the consumption of the property.

It is the VAT treatment of owner-occupied residential property which is particularly problematic. The current VAT treatment of supplies of commercial residential premises and of residential leases generally yields the appropriate result. Business consumers are generally entitled to deduct VAT on the purchase or lease of commercial property. While the periodic rent which a residential consumer pays to a landlord is generally VAT inclusive, it rises over time as the market value of the property increases.

On the other hand the current VAT treatment of supplies of residential premises fails to capture the full tax that could be payable relating to the consumption of those premises. While a physical house or apartment may have a limited life and depreciate over time, for many owners of immovable property, particularly in urban areas, the value is quite likely to rise over time as property passes from one consumer to another. This general rise in the value of residential property is a phenomenon driven primarily by population growth and demand, particularly in countries with immigration.

The current VAT treatment of owner-occupied residential premises leads to administratively difficult borderlines, as well as confusion about which supplies are taxable and which are exempt. Also problematic is tax planning, as taxpayers attempt to receive the benefit of exempt treatment; thereby increasing the administrative costs of regulating tax avoidance. These problems lead to the question: Is there a better way to tax the consumption of owner-occupied residential property?

30 The taxation of owner-occupied residential property potentially includes the use, lease, and sale of land and buildings that are occupied or are intended to be occupied as a residence: Cnossen, VAT treatment of immovable property, (1995) Tax Notes International, 1037.

31 In Christine Peacock, ‘Taxing the consumption of owner-occupied residential property’ (2013) 5 International VAT Monitor 299, 301 I noted that instead of taxing owner-occupied housing at the time of the original purchase of the property there have been various authors who have proposed taxing owner-occupied residential property on an annual basis, and this is being done in many countries for income tax purposes.
There is an increasing body of literature questioning the rationale for standard exemptions from the VAT, particularly in light of experience with the problems caused by the use of exemptions, and also more recent intellectual advances. Ebril et al. observe, for instance, that ‘[t]he rationale for many standard exemptions is increasingly being questioned. A main item on the VAT reform agenda in many developed countries over the coming years is likely to be a movement from exemption to full taxation in a number of areas.’\(^{32}\) They note that generally in respect of exemptions in the VAT ‘the damage done by current widespread exemptions... is likely to become increasingly apparent: they take the VAT away from a broad-based tax on consumption... the battle against exemptions is likely to intensify.’\(^{33}\) De la Feria has also suggested that ‘questioning the existence of VAT exemptions appears to be both timely and fundamental.’\(^{34}\)

**Conclusion**

The political reality is that this exemption is most likely to remain in Australia for the foreseeable future. However, in a time where many countries are looking at reforming their existing VAT systems it is worth recognising that the current model for the VAT treatment of immovable property is not perfect. We can use this as a basis to question whether there might be a better alternative model.

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33 Ibid, 198.