

The rationale for considering including imputed rent in the VAT base

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Introduction

This paper discusses the debate in the literature as to whether value added tax (VAT)² is a tax on transactions or on the flow of consumption. A key finding of this paper is that whilst VAT systems generally currently have laws stipulating that VAT is to be accounted for at the time of transactions, it may be appropriate to consider whether VAT can operate in such a way that it is a tax on the flow of consumption. Section two discusses that VAT laws are 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. Use of the prepaid method generally produces the correct result. However, the VAT treatment of owner-occupied housing presents a particular challenge, as the general appreciation in the value of immovable property³ may result in the value of total consumption of owner-occupied housing being greater than the value which was taxed at the time of first purchase.

A possible alternative to the current VAT treatment of owner-occupied housing which has been suggested in the VAT literature is the possibility of subjecting the imputed rent of owner occupied housing to VAT.⁴ Imputed rent has been described as the net value of the services rendered by a house to its owner-occupier for which they would otherwise pay cash rent to a landlord. While imputed rent has been regarded as part of the tax base for income tax purposes in many countries, there is no country that taxes the consumption of owner-occupied housing in this way. This paper considers two famous examples of imputed rent being assessed for income tax purposes: The historical experiences of Australia and the United Kingdom. It then outlines some of the more practical considerations that would be involved in including imputed rent in the VAT base.

1. Is VAT a tax on transactions or on the flow of consumption?

Cnossen has compared the views of lawyers and economists regarding what he perceives to be their views as to the nature of the VAT. He has written that:

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² Whilst VAT was the traditional name for the broad-based VAT system which was implemented in the European Union, countries which have more recently introduced this system of consumption tax, such as Australia and New Zealand, have called it a GST (“Goods and Services Tax”). 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 which will be used throughout this paper, except when any GST system is referred to (for example, the GST system in New Zealand).

³ The term “immovable property” is generally understood to mean land, buildings and fixtures, both residential and commercial. In some countries, including Australia, immovable property is known as real property. However, owing to the international importance of this paper, immovable property will be referred to by its most common name. See Satya Poddar, “Taxation of Housing Under a VAT” (2009) 63 *Tax Law Review* 443, 445-446 for a detailed description of what is immovable property.

⁴ Several authors have suggested alternatives to the current use of the prepaid method which would involve consumers paying VAT on purchases of residential property, and receiving a refund when that property is sold. An examination of these alternatives is beyond the scope of this paper.

[L]awyers... maintain that the VAT is a tax on current consumption expenditures... they assert that the VAT is a tax on current consumption – on all goods and services... whether they are consumed immediately or embody a stock of services that are consumed over the lifetime of the asset.⁵

On the other hand, Cnossen has written that according to economists “the VAT is a tax on flows rather than stocks”.⁶ In contrast, Millar has provided a different perspective on the nature of the VAT. She has distinguished between the “economic objective” or the purpose of the VAT and its “legal form” or mechanism. In Millar’s view, the economic objective of the VAT “is to tax consumption but that objective is subordinated to the legal form of the tax: VAT operates as a... tax on transactions.”⁷ Millar has recognised that “[a]ny concepts of ‘consumption’ or ‘consumption expenditure’ embodied in a transaction-type VAT law are legal constructs, related to but independent from the economic concept of consumption.”⁸

Millar’s observation that the economic objective of the VAT is to tax consumption is supported by other literature that has focused on the nature of the VAT. For example, Van Brederode has written that “Value Added Taxes... are characterized by their economic purpose as taxes on private consumption”,⁹ Tait has written that “[t]he VAT is supposed to be a tax on flows”,¹⁰ and James has written that “a pure VAT” should apply in theory to “the consumption of all goods and services”.¹¹

The “legal form” or method described by Millar of “imposing VAT on transactions” is the way that VAT has generally been levied in countries with a VAT. James has written that it is considered best practice design that “VAT uses expenditure on consumption as a proxy for consumption.”¹² She observes that:

VAT is levied on transactions, giving rise to expenditure on consumption... Expenditure is the price paid, or in legal terms the ‘consideration’, for the good or service acquired... it is generally 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.¹³

Regarding the “legal form” of the VAT, Ecker has noted that “[f]rom the law one can deduce that VAT is a tax on consumption expenditure.”¹⁴ He has written that “[c]onsumption (benefit) is measured by reference to consumption expenditure at the time of supply. Consumption itself

⁵ Sijbren Cnossen, ‘A VAT Primer for Lawyers, Economists, and Accountants’ in *The VAT Reader: What a Federal Consumption Tax Would Mean for America* (Tax Analysts, 2011) vol 55, 23, 38-39. This is consistent with the following view expressed by the OECD: “[f]rom a legal and practical viewpoint, VAT is essentially a transaction tax.”: OECD Publishing, *Consumption Tax Trends 2016: VAT/GST and Excise Rates, Trends and Policy Issues* (OECD, 2016), 20.

⁶ Cnossen, ‘A VAT Primer for Lawyers, Economists, and Accountants’, above n 5, 39. Similarly Ebril et al have written that “[e]conomists generally favour designing the VAT so that it is a tax on consumption”: Liam Ebril et al, *The Modern VAT* (International Monetary Fund, 2001), 15.

⁷ Rebecca Millar, ‘VAT and Immovable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences’ in *VAT Exemptions: Consequences and Design Alternatives* (Wolters Kluwer, 2013) 253. Similarly Van Brederode has written that “[i]t is important to realize that there is a distinction between the economic purposes of a tax and the legal format chosen to realize these.”: Robert F van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’ in *Immovable Property under VAT: A Comparative Global Analysis* (Kluwer Law International, 2011) vol 37, 1, 1.

⁸ Millar, above n 7.

⁹ van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 7, 1-2.

¹⁰ Alan A Tait, *Value Added Tax: International Practice and Problems* (International Monetary Fund, 1988), 80.

¹¹ Kathryn James, *The Rise of the Value-Added Tax* (Cambridge University Press, 2015), 46.

¹² *Ibid.*, 41. Similarly, in the context of the New Zealand GST, Harley has written that “GST is fundamentally a tax levied on transactions with consumers, hence the expression “consumption tax””: G Harley, ‘Dilemmas for GST Tax Policy Designers - Land Transactions’ in *GST in Retrospect and Prospect* (Brookers Ltd.), 220.

¹³ James, above n 11, 41-42.

¹⁴ Thomas Ecker, *A VAT/GST Model Convention* (IBFD, 2013) vol 25, 96.

is not directly observable but what we can hope to observe is a spending and where it takes place.”¹⁵ Generally, there are time of supply rules imposed in countries that have a VAT which have the effect that it is generally accounted for at the time of the transaction. 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 Union (EU) Directive 2006/112 it is written that “on each transaction, value added tax... shall be chargeable”.¹⁷

Cnossen’s comparison of the views of lawyers and economists regarding the nature of the VAT is a theoretical discussion reflecting on the traditional roles of the disciplines of law and economics. On the other hand, Millar’s perspective that the economic objective of the VAT is to tax the flow of consumption, and the legal form in which this is done is as a tax on transactions offers a practical way to understand these two aspects of the nature and function of the VAT (its economic objective and legal form).

Millar’s statement that “[t]he economic objective... is subordinated to the legal form of the tax”¹⁸ is inconsistent, however, with the views expressed by Van Brederode and Conrad, as to whether the economic objective or the legal form of the VAT should be given priority in the way that VAT operates. When writing about the VAT in the European Union (“EU”), Van Brederode has written that “the economic principles of the VAT should take precedence over legal provisions”.¹⁹ Van Brederode has attributed the priority of economic principles over legal form to the manner in which the VAT was introduced in the EU, in the form of the First and Second Directives.²⁰ The First Directive defined the “purpose and principle workings of the system”, and the Second Directive provided the “legal format and modalities through which the envisioned system should be realized.”²¹ Van Brederode has observed that the Second Directive was “merely the legal vehicle to deliver the economic structure laid out in the First Directive.”²²

Similarly, Conrad has also placed emphasis on the purpose of the VAT being to tax consumption. He has written that “[t]he impact... of the VAT is designed to tax the “flows” of consumption in each time period. ... This fact would imply that the tax should be applied on “consumption” and not purchase.”²³ This is clearly contradictory to the way that VAT laws currently generally operate, where, as mentioned above, VAT is accounted for when transactions occur. An interesting question that flows from this discussion is whether VAT should be applied on the flow of consumption, rather than on transactions?

¹⁵ Ibid, 100.

¹⁶ Goods and Services Tax Act 1985 (New Zealand), s9.

¹⁷ European Union Directive 2006/112 Article 1.

¹⁸ Millar, above n 7.

¹⁹ Robert F van Brederode, ‘Judicial Cooperation and Legal Interpretation in European Union Tax Law’ 53(88) *Faulkner Law Review* 53, 86.

²⁰ Van Brederode explains that the First VAT Directive was repealed by Directive 2006/112 which was entered into force on January 1, 2007 “but the first three paragraphs of article 2, First Directive were reproduced in article 1(2) 2006/112: Ibid, 66. In article 1(2) of Directive 2006/112 the economic objective of the VAT appears: The VAT is described as a “general tax on consumption”: Article 1(2) of Directive 2006/112. The Second Directive, containing the “legal vehicle to deliver the economic structure” was replaced by Directive 2006/112: Ibid, 66.

²¹ van Brederode, above n 19, 67.

²² Ibid, 66.

²³ Robert F Conrad, ‘Value Added Taxation and Real Estate’ (Discussion Paper DRD224, Development Research Department Economics and Research Staff World Bank, February 1987), 1.

2. Should VAT be applied on the flow of consumption rather than on transactions?

VAT systems are 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 all future use and enjoyment (consumption) of the goods.²⁴ Legal rules are put in place so that VAT is imposed “on the original purchase price of the goods as a correct measurement of the present value of the extended period of consumption of those goods.”²⁵ 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.

This system yields the appropriate result where goods provide immediate gratification to the purchaser, for example, a cup of coffee. This has been recognised by Van Brederode who has written that:

using the expenditure as a trigger for taxation, leads, from an economic purpose perspective, to a correct result for non-durable goods. Because of their short life cycle, consumption of non-durables is either immediate or takes place in a very short time frame.²⁶

If the good is the present value of its future use and if it has a limited life, the tax on the initial purchase price will correspond to all future consumption. In this regard, Schenk, Thuronyi and Cui have written that for goods and services that are consumed shortly after their purchase “there is not much difference between the ideal “economic” tax base and the “legal” tax base”.²⁷

The system also automatically yields an appropriate result if goods owned by consumers are sold partway through their useful lives. The value of used goods will include a portion of the tax paid by the first purchaser. The owner of a used book, for instance, who sells it for, say, half the purchase price when it is halfway through its life recovers half the tax originally paid to the revenue authority and the second-hand book purchaser bears an effective tax burden equal to the present value of the tax on the remaining consumption yielded by the good. Krever has written that “in the case of ordinary long-life assets, everyone down the chain bears an appropriate amount of VAT on the use of the asset.”²⁸ Many consumer durables are wasting assets. They will not rise in value over time.²⁹ Expenditure is only recognised as goods decrease in value through usage or passage of time. Therefore the tax on the initial sale price of consumer durables will generally be approximately equal to the present value of all future consumption

²⁴ In explaining the operation of the prepaid method, Van Brederode has written that theoretically as the consumption of a durable asset takes place over a period of time, taxation should occur over that time. However, he suggests that “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, *Systems of General Sales Taxation: Theory, Policy and Practice* (Kluwer Law International, 2009), 183. See David F Bradford, *Blueprints for Basic Tax Reform* (Tax Analysts, Second Edition, 1984), 108 for a similar explanation.

²⁵ Christine Peacock, ‘Taxing the Consumption of Owner-Occupied Residential Property’ (2013) 5 *International VAT Monitor* 299, 299. Cnossen provides a similar explanation: Sijbren Cnossen, ‘VAT Treatment of Immovable Property’ in *Tax law design and drafting* (International Monetary Fund, 1996) vol 1, 233-234. See also Institute for Fiscal Studies, *Tax by Design: The Mirrlees Review* (Oxford University Press, 2011), 379; van Brederode, above n 24 and van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 9, 1-2.

²⁶ van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 9, 1. See also Rita de la Feria and Richard Krever, ‘Ending VAT Exemptions: Towards a Post-Modern VAT’ in *VAT exemptions: Consequences and design alternatives* (Wolters Kluwer, 2013), 27 and Poddar, above n 3, 453.

²⁷ Alan Schenk, Victor Thuronyi and Wei Cui, *Value Added Tax: A Comparative Approach* (Cambridge University Press, Second Edition, 2015), 408.

²⁸ Richard Krever, ‘Designing and Drafting VAT Laws for Africa’ in *VAT in Africa* (Pretoria University Law Press, 2008), 24.

²⁹ This has been recognised by Krever who has written that “[a]lmost all long-life assets decline in value”: *Ibid.*

as the consumption value of these goods is generally unlikely to rise in the future, even where the goods are sold from one consumer to another.³⁰ In this regard, Cui has written that “[t]he purchase price of a consumer durable generally reflects its consumption value during its useful life.”³¹

However, where a good is non-wasting, upfront taxation does not correspond with the present value of all future consumption. As the market value of the good increases over time, the value of total consumption by the owner will increase. The value of total consumption will therefore be larger than the value of the good that was taxed at the time of purchase. An owner who retains an appreciating good therefore bears less tax than the amount that corresponds with the increased consumption value of the good.

In this regard, it has been recognised in the VAT literature that immovable property presents a particular challenge, as the value of immovable property generally appreciates over time. For example, De la Feria and Krever have written that “the underlying real property in residential premises does not waste and most often rises in value over the longer term, even if the physical structure on it declines in value.”³² Similarly, Van Brederode has described immovable property as unique:

in that it, generally, appreciates in value over time, whereas most other capital assets depreciate. If tax is only imposed on the initial purchase, no tax would be collected from and be incurred by subsequent owners in respect of the increased value of the property.³³

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 will be used as an input into the purchaser’s production. Therefore, there is no VAT net effect for the revenue authority. In this respect, Van Brederode has written that “VAT is irrelevant, of course, for sales between fully taxable persons because the credit system will remove the actual tax burden.”³⁴ Supplies of residential property for lease are also not problematic, because the periodic rent that a residential consumer pays to a landlord is generally VAT inclusive; and rises over time as the market value of the consumption services relating to the property rises.

The VAT treatment of owner-occupied housing, on the other hand, presents a particular challenge. Applying the prepaid method may mean that the value of total consumption of owner-occupied housing may be greater than the value which was taxed at the time of first purchase.³⁵ This is problematic as it is inconsistent with the economic objective of the VAT of taxing the flow of consumption (discussed in section one).

³⁰ See van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 7, 1-2.

³¹ Wei Cui, ‘Objections to Taxing Resale of Residential Property under a VAT’ (2012) November *Tax Notes* 777, 779. See also Schenk, Thuronyi and Cui, above n 27, 409 and van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 7.

³² de la Feria and Krever, above n 26, 27.

³³ van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 7. 2. Cui has written that “[i]n some historical periods and some locations, housing values may witness unexpected appreciation or depreciation that had not been fully anticipated or capitalized into purchase prices. ...Urbanization, the building of new transportation pathways and amenities, unexpected rises in income in the local population, and so forth may all enhance the values of real property in ways that could not easily be predicted. Unexpected appreciation normally does not happen to other durable consumer goods, although it may happen to artwork, collectibles, and the like.”: Cui, above n 31, 779.

³⁴ van Brederode, above n 9, 2-3.

³⁵ de la Feria and Krever, above n 26, 27; Institute for Fiscal Studies, above n 25, 380; and Schenk, Thuronyi and Cui, above n 27, 408.

Over time, the value of a house or apartment generally rises above the consumer price index, driven primarily by population growth and demand, particularly in jurisdictions with immigration. The general rise in the value of immovable property is a phenomenon “driven primarily by population growth and demand, particularly in countries with immigration.”³⁶ It can also arise due to other circumstances relating to the property, such as a change of zoning, surrounding amenities or renovations.³⁷ Van Brederode has written that “[i]mmovable property is unique in that it generally appreciates in value over time, whereas most other capital assets depreciate.”³⁸

In the Mirrlees Review Report in 2011, it was written that “because houses are so long lived, their consumption value may change a great deal over time. Hence their up-front price may prove to be a bad approximation to the value of consumption services they eventually provide.”³⁹ Similarly, de la Feria and Krever have written that:

[i]f the initial sale price of residential premises does not fully capture the value of all consumption from the property, later owners of property will not bear VAT on the full value of their consumption... future increases – or decreases – in the value of residential property will be excluded from the VAT base.⁴⁰

Currently, under the prepaid method subsequent sales of residential premises are generally regarded as private out-of-scope supplies (this assumes that the vendor is not registered for VAT. If the vendor is registered for VAT, then the sale by the vendor of the residential premises is regarded as an exempt supply).⁴¹ Future purchasers of a used residence will have an effective tax burden equal to the present value of the tax at the time of acquisition, not the new value of future consumption. The government will receive no further tax relating to the consumption of the residential premises.

Conrad and Grozav have written that “the significant timing difference between supply and consumption... is not unique to real property. The problem is apparent for all capital items”.⁴² Similarly, Cui has recognised that unexpected appreciation may also arise in the case of “artwork, collectables and the like.”⁴³ To achieve consistency, the VAT treatment of other

³⁶ Peacock, above n 25, 300.

³⁷ Cui, above n 31, 779.

³⁸ van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 7. See also de la Feria and Krever, above n 26. Cui has also recognised that “housing values may witness unexpected appreciation... that had not been fully anticipated or capitalized into purchase prices.”: Cui, above n 31. In the course of discussing problem areas in designing and drafting VAT laws, Krever had earlier recognised that “[w]hile imposing VAT upfront on the purchase of long-lasting assets achieves the appropriate result for most consumer assets, it does not work well with immovable property.”: Krever, above n 28.

³⁹ Institute for Fiscal Studies, above n 25. Cui has also recognised that “the increased consumption value of housing attributable to unexpected appreciation falls outside the VAT’s reach.”: Cui, above n 31.

⁴⁰ de la Feria and Krever, above n 26.

⁴¹ van Brederode, ‘Theory and Practice of VAT Treatment of Real Estate’, above n 7. See also M Stewart, ‘Taxation Policy and Housing’ (2012) 7 *International Encyclopedia of housing and home* 152, 162. This treatment results in inequities between homeowners and renters, as renters pay VAT on the housing services which they receive. Similarly, Cnossen has written that “taxing rents but not rental values appears to favour owner-occupiers over lessees who would pay the VAT on rental charges.”: Cnossen, ‘VAT Treatment of Immovable Property’, above n 25. This has also been a concern where imputed rent is not included in the income tax base. See The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (George Allen & Unwin (Publishers) Ltd, 1978), 54.

⁴² Robert Conrad and Anca Grozav, ‘Real Property and VAT’ in *VAT in Africa* (Pretoria University Law Press, 2008), 87-88. Conrad had earlier written that “[f]or many consumption expenditures... the date of purchase does not correspond to the period of consumption; examples are consumer durables such as stoves and cars, occupied housing, and the purchase of land for housing or for investment. Real estate thus falls into a large group of long-lived stock. In theory, there is no reason to treat housing differently from other long-term consumer durables.”: Robert F Conrad, ‘The VAT and Real Estate’ in *Value added taxation in developing countries*, 95.

⁴³ Cui, above n 31.

lasting capital items that may also experience a change in real values over time should also be considered. However, this is beyond the scope of this paper, which will focus on owner-occupied housing, as it is more common for people to purchase immovable property than these other items. Residential premises are considered more of a necessity than these other items, and immovable property is the most frequently consumed asset to appreciate. 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 significant acquisition a person will make in his/her lifetime.”⁴⁴

3. Imputed rent: A possible alternative?

An alternative approach of taxing the value of housing on an annual basis has been mentioned in the tax literature. For example, in 2011 in the Mirrlees Review Report it was suggested that instead of subjecting the consumption of owner-occupied housing to the prepaid method, the flow of housing services could be included in the VAT base instead. It was written that “the purpose of a VAT is to tax final consumption. This is generally accomplished by levying the tax when goods are initially purchased, but in the case of housing it is better achieved by taxing the flow of housing services on an annual basis.”⁴⁵

“The flow of housing services” has been accepted as a recognised concept in the (theoretical) VAT literature. For example, in discussing the prepaid method, Cnossen has written that:

[s]ince the purchase price of a house may be taken to present the capitalized value of its future services, the tax on the purchase price may be considered a proxy for the capitalized value of the tax that should have been levied on the flow of housing services.⁴⁶

In writing about the prepaid method, Cnossen has also written that “in theory, the tax on a new building equals the present value of the tax on all future services of the building, as reflected in residential rents and rental values.”⁴⁷ The flow of housing services has therefore been equated to the rental value of a building.

According to De la Feria and Krever, “[t]he theoretically correct tax could be imposed by treating all sales of residential premises as taxable sales, registering every homeowner, allowing input tax credits on purchase and collecting monthly VAT on the imputed rental consumption by owner occupiers.”⁴⁸ 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.”⁴⁹ Stewart has written that “VAT could tax imputed rent in the same way as

⁴⁴ Millar, above n 7. Similarly, in the Meade Report it was written that “dwelling houses are... capital assets of great importance which have long lives over which they provide dwelling space, shelter, warmth, etc., which constitute a large fraction of a normal family’s total consumption.”: The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (George Allen & Unwin (Publishers) Ltd, 1978), 54. According to Poddar, “expenditures on housing are perhaps the single largest component of the consumer basket”: Poddar, above n 3, 443.

⁴⁵ Institute for Fiscal Studies, above n 25.

⁴⁶ Sijbren Cnossen, ‘Global Trends and Issues in Value Added Taxation’ (1998) 5(3) *International Tax and Public Finance* 399, 405.

⁴⁷ Sijbren Cnossen, ‘Is the VAT’s Sixth Directive Becoming an Anachronism?’ (2003) 43(12) *European Taxation* 434, 435.

⁴⁸ de la Feria and Krever, above n 26.

⁴⁹ Donald B Marsh, ‘The Taxation of Imputed Income’ (1943) 58(4) *Political science quarterly* 514, 514. Imputed rent falls within the broader concept of imputed income which Marsh defines 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.”: Ibid, 514. See also Victor Thuronyi, ‘The Concept of Income’ (1990) 46 *Tax Law Review* 45, 79 for a similar definition of imputed income.

it taxes other supplies by treating the homeowner as simultaneously both ‘landlord’ and ‘tenant’ in the home.”⁵⁰

While imputed rent has been regarded as part of the tax base for income tax purposes in many countries,⁵¹ there is no country that includes imputed rent in the VAT base. In fact, Cnossen has written that “no legislator has ever thought of, let alone proposed, taxing nonmarket consumption activities or durable goods on the flow of services they provide.”⁵² This has generally been regarded as conceptually too difficult, as potentially creating administrative problems, and as being inconsistent with political policies encouraging home ownership. In the next section, some examples of how imputed rent has been assessed for income tax purposes will be discussed.

4. Historical examples of the flow of housing services being subject to income tax

The historical experiences of Australia and the United Kingdom in assessing imputed rent for income tax purposes have been the most frequently cited examples of assessing imputed rent that have been provided in the income tax literature. In 1938, Simons wrote in particularly positive terms about the Australian system of assessing imputed rent, which existed at a national level for eight years from 1915 until 1923.⁵³ According to section 14(e) of the Commonwealth Income Tax Act 1915, the income of any person was to include “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.”⁵⁴ The reason for Simons’ positive review, however, appears to be 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.⁵⁵ Simons 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” (the operation of Schedule A in the United Kingdom is discussed below).⁵⁶ Albon has explained that the Australian system was, however, more administratively complex than this. He has written that, “[f]rom the ‘five per centum of

⁵⁰ Stewart, above n 41.

⁵¹ These countries include Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Israel, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. See Steven C Bourassa and William G Grigsby, ‘Income Tax Concessions for Owner-Occupied Housing’ (2000) 11(3) *Housing policy debate* 521, 525; 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, 437 and Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International, 2003), 258. Holmes has noted that New Zealand “has never included any form of imputed income in its legal concept of income. Indeed, there has been very little debate at all in New Zealand about broadening the income tax base to encompass imputed income,”: Kevin Holmes, *The Concept of Income: A Multi-Disciplinary Analysis* (IBFD Publications, 2001), 555. However, in New Zealand in 2011 a Risk Free Return Method (RFRM) was proposed. The following example from the Tax Review 2011 illustrates how this would work: “David and Ruth own a house that is valued at \$200,000 and have a \$100,000 mortgage. David’s marginal tax rate is 39 percent; Ruth’s is 21 percent. The risk-free return... is four percent. Taxable income in respect of the house is calculated as: $(\$200,000 - \$100,000) \times 0.04 = \$4,000$ ”: New Zealand Treasury, ‘Issues Paper - Tax Review 2001’ (2001), 39. This proposal was quickly dropped after public backlash.

⁵² Cnossen, ‘VAT Treatment of Immovable Property’, above n 25.

⁵³ Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (The University of Chicago Press, 1938), 116-117. South Australia had such a system from 1885 until 1930, Victoria from 1895 until 1936, and Queensland from 1920 until 1923: BF Reece, ‘Taxing Imputed Rent: Australian Precedents’ [1975] *Community*, 6.

⁵⁴ Section 14(e) of the Commonwealth Income Tax Act 1915.

⁵⁵ Barry Reece, ‘Simons’ Account of Australian Taxation of Imputed Rental Income’ 2(2) *Australian Tax Forum* 239.

⁵⁶ Simons, above n 53, 117.

the capital value', owner-occupiers could deduct for repairs, rates, land taxes and mortgage interest."⁵⁷

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 the early nineteenth century until 1963, has been cited in the literature as an example of the administrative difficulties that can arise in assessing imputed rent for income tax purposes.⁵⁸ Tax was levied on an annual value of the property remaining in the owner's occupation.⁵⁹ The annual value of owner-occupied property was the amount that it was "worth to be let by the year".⁶⁰ Revaluation of property occurred once every five years. However, no revaluations took place in the United Kingdom since 1936 due to war conditions and post-war difficulties.⁶¹ Merz has written that reassessment of the 1936 values "did not take place until 1963..."⁶² and "[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".⁶³ In writing about whether VAT should be introduced in the United States, Smith, Webber and Cerf have written that "[t]he British found that calculating imputed rents was a mare's nest, and, after one hundred years of anguish over including imputed rents as part of taxable income, the British abandoned this inclusion."⁶⁴

5. Including imputed rent within the VAT base

It is interesting to note that as with the historical experiences of Australia and the United Kingdom in including imputed rent in the income tax base, administrative concerns have arisen in the more recent theoretical VAT literature that has discussed whether imputed rent could be included in the VAT base. One example can be found in the writings of Cnossen who wrote in 1996 that "the computation of all rental values, would present formidable administrative problems that a VAT should not take on".⁶⁵ However, while valuing assets in general may have been problematic historically (for example, in the United Kingdom, as discussed above), this does not appear to be the case today. For example, in 2011 Homes wrote (that from an income tax perspective) "[t]here seems to be little justification for omitting imputed income from owner occupied housing on the basis of measurement difficulties in a climate of increasingly sophisticated valuation methodology for local rating (and other purposes)".⁶⁶ Despite the introduction of more taxes and also increasingly complex tax laws, tax administrations have become more capable in recent decades of administering increasingly more complex tax laws. These administrations have more sophisticated technology than they did in the past. Further, real values of residential property are currently utilised for tax purposes (including local council rating) in many jurisdictions, and these systems of valuation could potentially be looked at in determining how to include imputed rent in the VAT base. For example, the 2011 Mirrlees Review Report proposed that the council tax in the United Kingdom (which is charged to all

⁵⁷ Robert Albon, 'Housing and Taxation - Commonwealth Issues' (1990) 7(3) *Australian Tax Forum* 337, 340.

⁵⁸ See Richard Goode, *The Individual Income Tax* (The Brookings Institution, Revised Edition, 1976), 118; Merz, above n 51, 437; Canada, 'Report of the Royal Commission on Taxation' (Volume 3, 1966), 48.

⁵⁹ Royal Commission on the Taxation of Profits and Income: Final Report' (Her Majesty's Stationery Office, 1955), 246.

⁶⁰ Ibid, para 8.11.

⁶¹ Ibid 246 and Merz, above n 51, 438.

⁶² Merz, above n 51.

⁶³ Ibid, 437 and 'Royal Commission on the Taxation of Profits and Income: Final Report', above n 59.

⁶⁴ Dan Throop Smith, James B Webber and Carol M Cerf, *What You Should Know about the Value Added Tax* (Dow Jones-Irwin, Inc., 1973), 59.

⁶⁵ Cnossen, 'VAT Treatment of Immovable Property', above n 25.

⁶⁶ Holmes, above n 51, 535.

occupiers of domestic property) be replaced by a new housing services tax on rents and rental values at the VAT rate, using 'rating lists' maintained by the Valuations Office.⁶⁷

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 may be at a disadvantage.⁶⁸ For example, in considering an annual tax 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."⁶⁹ Likewise, when discussing the possibility of including imputed rent in 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."⁷⁰ 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).⁷¹ The authors of the Mirrlees Review Report also 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."⁷²

Conclusion

VAT systems are generally based on an assumption known as the "prepaid method". Only the first sale of goods is taxed (at the time of the first transaction), and later sales of goods from consumer to consumer are not subject to VAT. In most cases this produces the correct result. However, it has been recognised in the VAT literature that immovable property presents a particular challenge, as it generally appreciates over time. Applying the prepaid method may mean that the value of total consumption (over time) of owner-occupied housing may be greater than the value which was taxed at the time of first purchase. This is inconsistent with the economic objective of the VAT, which is to tax the flow of consumption.

While imputed rent has been regarded as part of the tax base for income tax purposes in many countries, there is no country that includes imputed rent in its VAT base. The theoretical VAT literature has identified administrative concerns with such an approach, some of which may have been informed by the administrative problems experienced by countries that have included imputed rent in their income tax base in the past. For example, concerns have been expressed as to how immovable property would be valued. Previously there were problems in this regard in the United Kingdom when imputed rent was included in the income tax base, but perhaps these problems are not insurmountable today. There has also been concern expressed

⁶⁷ Institute for Fiscal Studies, above n 25, 228. However, in the Mirrlees Review Report it was mentioned that a criticism of the council tax is that "valuations have passed the milestone of being 20 years out of date": Ibid, 383.

⁶⁸ The idea of including imputed rent within the VAT base would clearly be contrary to political support for excluding used housing from the tax base, such as arguments about housing affordability and encouraging people to own their own homes. Albon cites the strength of the home ownership interest group as a possible reason for the demise of the Australian imputed rent taxation in 1923: Albon, 'Housing and Taxation - Commonwealth Issues', above n 57. Poddar acknowledges that "home ownership is viewed in many jurisdictions as an important policy objective and is encouraged through fiscal instruments": Poddar, above n 3, 445-446.

⁶⁹ Institute for Fiscal Studies, above n 25.

⁷⁰ Bourassa and Grigsby, above n 51.

⁷¹ Todd writes that "GST was just one part of a wider programme of tax reform, which included income tax cuts and the abolition of an antiquated wholesale sales tax, and benefit increases, whereby welfare payments would be increased to offset the impact of GST on pensioners and others on low incomes": Jeff Todd, 'Implementing GST - Information, Education, Co-Ordination' in *GST in Retrospect and Prospect* (Thomson Brookers, 2007), 30.

⁷² Institute for Fiscal Studies, above n 25.

regarding whether such a proposal would be supported politically; but proposals have also been offered as to how this concern might be addressed. This discussion therefore suggests that the idea of including imputed rent in the VAT base is worthy of further consideration.