

Treatment of Housing under VAT for the US

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Treatment of Housing under VAT

Satya Poddar¹

1. Introduction

The treatment of housing and other real property supplies under a value added tax (VAT) has evolved significantly over the past two decades. Historically, real property transactions have been exempted from VAT (e.g., as under the VAT in the European Union), partly on the grounds that they are already subject to stamp duties and/or registration charges and the levy of VAT would lead to excessive burden. The exemption also reflected the view that land (the main distinguishing component of real property) did not constitute value added and should thus not be subject to VAT. This treatment has resulted in significant complexities and distortions. Primary among them is the complexity in defining supplies of real property. This is especially so where supplies of real property get bundled with those of goods and services, and where real property supplies are in the form of rights and interests related to real property (e.g., time-share interests). The exemption system leads to tax cascading and other economic distortions through blockage of VAT on inputs going into the construction of commercial/industrial real properties, which are in turn used to make taxable supplies.

To ensure a more neutral application of tax, under modern VATs², such as those in New Zealand, Canada, and Australia, exemptions for real property supplies are minimized. Most supplies attract tax, with the exception of sales of used residential dwellings and long-term residential rentals.

There are a variety of other conflicting social and political considerations that influence the application of tax to housing. On the one hand, expenditures on housing are perhaps the single largest component of the consumer basket and are distributed progressively with respect to income. This would call for full inclusion of housing within the scope of VAT.³ On the other hand, home ownership is viewed in many jurisdictions as an important policy objective and is encouraged through fiscal instruments⁴, notwithstanding the equity and neutrality considerations.

This paper provides a discussion of the issues that arise in the application of VAT to real property supplies. The paper focuses exclusively on neutrality considerations. This is not to suggest that social and political considerations are not important or secondary. They are omitted mainly because they cannot be dealt with satisfactorily within the time and space constraints of this paper. Also, they should not – and cannot adequately – be addressed in

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¹ Partner, Ernst & Young (India). The author gratefully acknowledges research/professional support of Jayanta Kalita, Rahul Acharya and Gunjan Mishra in drafting the paper. Valuable comments and suggestions were also provided by Rebecca Millar (Associate Professor, Sydney Law School) and Arbind Modi (Joint Secretary, Department of Revenue, Government of India) at various stages in drafting of the paper. The paper was presented at a conference organized by the American Tax Policy Institute, where many valuable comments were provided by Charles McLure, Tom Neubig, Robert Conrad, and other participants.

² The label ‘modern VAT’ was first used by Ebrill, Keen, Bodin, and Summers (2001).

³ The need for taxation of housing is also emphasized by McLure (1987), who states “a VAT that is intended to tax all consumption should apply to the value or imputed rent of existing owner-occupied houses. Otherwise, substantial inequities would be created between those who own houses at the time the tax is imposed or announced and those who do not.”

⁴ For example, encouragement is provided through the mode of mortgage interest deduction and home purchase grants.

the context of a VAT.. The housing sector in the United States (and other parts of the globe) is undergoing an unprecedented turmoil. Application of any tax to housing at this juncture would be controversial and compound the anxiety and uncertainty that currently prevails. But if and when the United States decides to impose a federal VAT, it should follow the “best practice” for the treatment of housing and real estate. This is another reason for the paper to focus exclusively on the technical design aspects of the tax.

The paper first provides a brief discussion of the concept of real property in general and residential property in particular. It then provides a description of the options that could be considered for taxation of real property, followed by a discussion of selected special transactions in real property.

2. Concept of Real Property

This section describes the concept of real property, and different types of real property. Understanding of the concept of real property is a pre-requisite for the design of a structure for applying the tax.

2.1. What is Real Property?

Property is broadly defined to include “real property” (including an interest in real property), “tangible personal property” (including all kinds of goods and chattels), and “intangible personal property” (property that is imperceptible to the senses, such as rights of all kinds, information / data and intellectual property). Classification of property as real or personal may vary across jurisdictions or, even within a jurisdiction, according to purpose, as in determining whether and how the property may be taxed.

Generally, the term real property refers to land, which, in its general usage, includes not only the face of the earth but everything of a permanent nature over or under it. All lands, buildings, fixtures, and improvements, are real property. Real property also includes mines, minerals, quarries, mineral springs and wells, oil and gas wells, trees and crops and all privileges pertaining to the real property.

Black’s Law Dictionary defines “real property” as land and generally whatever is erected or growing upon or affixed to land and that which is incidental or appurtenant to land.

Under English common law, real property includes land (which, in turn, includes buildings and appurtenants) as well as many legal relationships between individuals or owners of land that are purely conceptual or intangible.

The civil law definition of real property is similar to that of common law, but could include movable property that is placed on an immovable property permanently or for an indefinite period. For example, in the Province of Quebec (Civil law jurisdiction), real property includes immovable property and every lease thereof. As per the Civil Code of Quebec, property could be immovable by nature, by destination, by reason of the object to which it is attached, or by determination of the law. The main characteristic of an immovable by nature is its incorporation or physical attachment to the land itself.

Under the Australian GST Act 'real property' is defined to include any interest in or right over land, a personal right to call or be granted an interest in or right over land, or a licence to occupy land or any other contractual right exercisable over or in relation to land.⁵ By contrast, under the Canadian GST law, real property includes land, buildings, interests in such property and mobile and floating homes⁶. Although certain security interests in real property (e.g., mortgages and liens) may also be real property by definition, they are treated for GST purposes as financial interests and are therefore tax-exempt.

The term real property can also include space rights, occupation rights (lease/ license) and other interests in real property. This significantly broadens the concept of real property, which can include supplies which would normally be viewed as services. Take, for example, admissions to a theatre or sports arena. Technically, the admission ticket entitles the holder to the right of admission to the theater or the complex and to occupy a particular seat. As such it could be viewed as a supply of real property, and not that of entertainment services. The same can be said for membership to a golf course or a health club. In India, a petition has been filed at the Supreme Court to seek clarification whether leasing of real property is a service. These examples illustrate the blurring of distinctions between supplies of real property and those of services.⁷ Any differentiation in the taxation of the two would lead to classification disputes.

In the United States, transactions related to real estate (another term for real property) are governed by the federal statutes as well as the state statutes. All of the States (except Louisiana) have their own laws governing real property, grounded in the common law. Although the basic concepts are the same throughout the country, there are numerous variations in the application of these concepts among the states as well as among counties and cities within a state.

2.2. Residential Supplies

In most VAT jurisdictions, a distinction is drawn between residential and non-residential real property. Generally, supplies of residential supplies are exempt, while other real property supplies may be taxable. Therefore, it becomes imperative to determine what would qualify as an exempt supply of residential property. This determination is especially required in the case of mixed properties, i.e., where a property is used both for residential and commercial purposes. or where the usage changes from one to the other.

Residential real property could include the following:

- Individual houses;

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⁵ The definition under Section 195-1 of the *A New Tax System (Goods and Service Tax) Act, 1999* (Australian GST Act) goes well beyond the common law concept of real property.

⁶ Floating and mobile homes are not real property under common law, but are included in the definition of residential property to ensure uniform treatment of all property used as a place of residence. Under the Australian law, although these are not defined as real property, they are covered under the exemption or lower rate provisions (see sections 40-35, 40-65 and Division 87 of Australian GST Act).

⁷ For an Australian case, see *Saga Holidays Limited v Commissioner of Taxation* [2006] FCAFC 191 – a scheme to effectively avoid Australian GST on holiday accommodation by arguing that real property could be a GST-free export when the subject matter of the transaction was a 'right' to future occupation.

- Apartments⁸, flats, duplexes, townhouses, and condominiums (including common areas and appurtenances, structures and areas such as garages, garden sheds and swimming pools);
- Mobile and floating homes and campers;
- Vacation properties;
- Student residences, homes for senior citizens, and hospitals;
- Camping parks;
- Parking space for residents of a building.

The following are examples of commercial/ non-residential property:

- Factories and stores;
- Office buildings;
- Warehouses;
- General purpose parking spaces;
- Sports arenas, churches, and theatres.

Special rules are required for taxation of mixed use properties and allocation of input tax credits. Some of the examples of mixed use properties are:

- Farming properties with farm house;
- Personal residence with business office;
- Buildings with residential and office flats;
- Hotels, motels, and such other rental properties.
- Short term accommodation in trains, and ships (which can be considered real property under civil law).

Residential property can also include interests in real property, which require special consideration. The following are some noteworthy examples of such interests:

- Purchase of time-share interests in vacation properties; and
- Purchase of shares (financial security) in a housing co-operative or units of a unit trust, which entitle the purchaser to possession and use of a dwelling unit in the housing complex owned by the co-operative or the trust.

2.3. Housing Expenditures in the United States

For an assessment of various options discussed in the later sections of this paper, it is useful to look at the quantum of various components of housing expenditures.

Under the system of national income and product accounts for the United States, housing services are a component of personal consumption expenditures. Housing services are defined to include the rental value of tenant-occupied housing, the imputed rental value of owner-occupied housing and the rental value of farm-housing. While the rental value of tenant-occupied housing accounts for the money spent by tenants on housing, the imputed

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⁸Apartments could include individually owned rooms or serviced apartments rented out on a short or long-term basis.

rental value of owner-occupied housing reflects the opportunity cost of owner-occupied homes had they been rented.

It is useful to note that housing expenditures do not include purchase of houses, which are treated as an investment in fixed assets. Moreover, under the system of national income and product accounts, investment does not include that portion of purchase price of houses that is attributable to land. Under the national accounts, land is treated as a fixed resource that is not produced using factors of production.⁹

The table below provides data on housing expenditures in the United States for selected years. Expenditures reported in the table are only those attributable to the use of space. There are additional expenditures that are linked to the use of space, and which are also commonly described as housing expenditures. They include electricity and water, housing supplies, and furniture and fixtures. Expenditures on housing services constitute approximately 15% of total personal consumption expenditures. Other housing expenditures related to housing operations (not reported in the table) are an additional 10% of total consumer expenditures. For VAT purposes, such expenditures are treated as non-housing goods and services, and are generally included in the tax base.¹⁰

Gross domestic investment in residential housing was only \$0.5 trillion in 2008. It represents sales of new residential dwellings, excluding the value of land. Unlike expenditure on housing services, the value of investment in residential dwelling has been decline in the recent years.

Table 1
Housing Expenditures in the United States (\$ trillions)

Category	2005	2006	2007	2008
Personal Consumption Expenditure	8.7	9.2	9.7	10.1
Expenditure on Housing Services	1.30	1.39	1.46	1.51
Space Rent - Owned Housing	0.95	1.02	1.06	na
Space Rent - Rental Housing	0.26	0.28	0.30	na
Space Rent - Farm Housing	0.01	0.01	0.01	na
Space Rent - Other	0.07	0.08	0.08	na
Housing Gross Output	1.23	1.31	1.38	na
Housing Gross Value Added	0.96	1.04	1.11	na
Gross Dom. Investment in Housing	0.8	0.8	0.6	0.5

Source: US Department of Commerce, Bureau of Economic Analysis, National Income Accounts, January 2009.

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⁹ Further details on the definition of housing expenditures in the national income and product accounts can be found in Nicole Mayerhauser and Marshall Reinsdorf, "Housing Services in the National Economic Accounts" an internal explanatory memorandum of the Bureau of Economic Analysis.

¹⁰ Further details on the composition of housing expenditures can be found in Vendemia(2008).

3. Application of VAT to Housing

3.1. Basic Concepts

VAT is a tax levied on the consumption of goods and services. In the case of a consumer durable, consumption is the flow of services from the durable in a given period. Where the durable is leased, the rent actually paid would be the consideration for the consumption of the durable. The rent would be the proper base for VAT.

However, where the product is purchased by the consumer, generally VAT is applied to the full purchase price of the product upfront. The tax is applied on the sale price of the product, in lieu of the taxation of the imputed rental value of the product. Assuming that the price of product is equal to the present discounted value of the flow of imputed rental services over the life of the product, the tax under the two methods would be equivalent. The tax on the sale of the product is equivalent to pre-collection of tax on the future imputed rental value of the product.

Conceptually, the consumption of housing is no different from that of other consumer durables. Where the house is leased, the consideration for consumption would be the rent for the house. In the case of an owner-occupied house, the owner either purchases the fully constructed house from the seller or, alternatively, gets it constructed through employment of labour and material. VAT should apply to the rent paid for the house, or to the full sale price of the house. Where the homeowner gets the house constructed, the tax should apply to all of the inputs that go in the construction of the house (labor, materials, as well as land).

The equivalence between taxation of rents and of the full sale price of a durable is based on two critical assumptions – first, that the selling price of the durable is equal to the present discounted value of future rents, and second, that all the durables purchased by consumers and in use attract the tax. Assuming that the VAT base is comprehensive, the second condition relates essentially to the stock of durables at the commencement of the tax. While all new durables acquired after the introduction of VAT would attract the tax, those acquired before would not have borne the VAT. For most depreciables with relatively short life, these conditions (i.e., selling price equal to the net present value of future rents, and all existing stocks tax-paid) are reasonably satisfied. The stock of durables in existence at the start of VAT would likely have borne either the VAT or the taxes that get replaced by the VAT. Regardless, such stocks would diminish over time, lessening the significance of any gaps in their taxation.¹¹

In the case of housing, both of these conditions are likely to fail. First, the rental value of real property may increase over time due to enhanced location premium, and on account of improvements in the facilities/ area surrounding the property. Given the much longer life of real properties, such increases may not be fully anticipated at the time of purchase of the property. If so, the selling price of the property would fall short of the future increases in rents.

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¹¹ Conrad (1990), Cnossen (1993), and Ebrill, Keen, Bodin, and Summers (2001) provide a very good description of these basic concepts and issues.

Second, there would be a large stock of owner-occupied housing units at the start of VAT, which might not have borne any VAT or other taxes which are being replaced by VAT. To apply VAT to future rents from leased properties, with no past or future tax on such existing owner-occupied units would be seen to be lacking in neutrality and fairness.¹² Given the relatively long life of such properties, this disparity would continue for an extended period, and possibly forever as it relates to the value of land underneath the units.

It is considerations such as these which have stood in the way of extension of the standard VAT rules for durables to housing. In virtually all jurisdictions, long-term residential rents are exempt from VAT. The treatment of sales of land and housing also varies.

An interesting issue in this context is the proper treatment of land itself. It has sometimes been argued that land does not constitute value-added, and should thus not attract any VAT. However, much of the value of land is attributable to the direct or indirect improvements in the form of development of townships, landscaping, and construction of infrastructure that make it usable for agricultural, industrial, or residential purposes. Raw land is similar to the minerals underneath, which are of little or no value unless they can be extracted for commercial/industrial use or consumption. VAT is applied to the full selling price of minerals. In the same manner, VAT should apply to the full value of land.

This is generally the approach followed under modern VAT. However, there is some variation in the treatment of land held by individuals and families for personal use. In Canada, tax applies to any sale of land, whether by an individual or a commercial enterprise. The only exception is for personal use land or the land attached to a place of residence of the individual, and that is reasonably necessary for the use and enjoyment of the residence. Any land acquired by an individual from a commercial enterprise after the commencement of GST attracts tax. Personal use land held by an individual at the inception of the tax remains exempt as resale of a used residential property. However, when personal use land enters the commercial supply chain (e.g., when the vacant land is sold by an individual to a commercial enterprise for development or construction), it would become taxable as part of the price of the property constructed on it. In New Zealand and Australia, a notional credit is allowed to the commercial enterprise in respect of land acquired from an unregistered person, which has the effect of permanently sheltering such land from taxation.¹³ This treatment is discussed in further detail in a later section.

3.2. Housing under Modern VAT

As discussed previously, there are difficulties in applying the standard VAT rules to housing. One significant issue relates to the treatment of existing stock of housing at the inception of tax. Technically, the tax could be applied to future rentals of such units. However, it would be technically complex and politically unpopular to apply the tax to the

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¹² The lack of fairness of this system is based on the assumption that the tax is shifted forward in higher prices for new properties and a matching increase for the existing properties. The existing homeowner would receive a windfall gain. However, if the tax is shifted backward in the form of reduced price of land, there would be no increase in house prices (for the new or existing homes), and the application of tax to new housing only would not be seen to be unfair..

¹³ Such tax sheltering is provided in New Zealand by giving a notional credit for the land (under the general provision for second-hand goods), which effectively removes the tax on such land. In Australia the same effect is achieved by taxing the reconstructed homes under the margin scheme, where the taxes apply on the value add by the builders. Canada does not extend the second-hand goods provisions to real property.

existing stock of owner-occupied units or their imputed rental value. Applying the tax to the rentals only would be seen to be unfair and failing the test of neutrality. Considering that consumption of rental accommodation would be disproportionately in the lower-income groups, the taxation of rentals without any tax on imputed rental value of owner-occupied housing would be regressive. As a result, long-term residential rents are exempted from tax in virtually all jurisdictions, including those with a modern VAT.¹⁴

Another reason for exemption for rental of residential property is the fact that there is a high incidence of rental of housing units by individual homeowners who are otherwise not engaged in any commerce or trade. The use of housing units changes from time to time from owner-occupation to leasing (and vice versa) as individuals relocate from one place of another for reasons of employment or family circumstances. Also many housing units are partly owner-occupied and partly leased to third parties. Taxation of housing rentals would thus result in a large increase in the number of VAT registrants and would lead consequent compliance and procedural complexities which may be difficult to administer for the authorities. Further, the high frequency of change in the use of housing units between self-use and rental would render the input tax credit rules complex to comply with and to enforce.

Under modern VAT, the exemption system for residential rents is accompanied by full taxation of all supplies of construction services and first sale of new residential property. A resale of used residential dwellings is exempt from tax, with no right of input tax credit. Under this model, all supplies of new residential dwellings become taxable under the 'pre-collection' model, i.e., the tax on all future consumption of the dwellings is pre-collected at the time of their first sale or use as a place of residence.

This treatment for owner-occupied dwellings is similar to that of other consumer durables. Both attract tax under the 'pre-collection' method. The key difference is in the treatment of rental dwellings. While rental/leasing of durables is generally subject to tax, it is exempt in the case of residential dwellings, the tax having been imposed on a pre-collection basis.

As noted before, this treatment, while conceptually simple and practical, is likely to result in under-taxation of housing consumption in two respects. First, the existing stock of housing at the inception of the new system does not attract any VAT. It may or may not have borne any tax in the past either. Second, the supplies of new housing units attract tax on the price at the time of their first sale. Tax on this value may not fully capture future increases in rental value (actual or imputed) of the property due to enhancement of its location premium.

Data on consumer expenditures provide an indication of under-taxation of housing under this approach. The housing tax base under the modern VAT can be approximated by the value of gross domestic investment in residential dwelling, plus the value of land attached to those dwelling. Gross domestic investment in residential dwellings was \$0.5 trillion in 2008. While we do not have data on the value of land, assuming this to be approximately 20% of the value of gross domestic investment in dwelling, the total housing base under the modern VAT would be \$0.6 trillion. This represents only about 40% of the total expenditure on housing services in that year.

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¹⁴ One notable exception is China where residential rentals do attract the Business Tax, which is a form of turnover tax. The tax also applies to profits earned from resale of real property, whether residential or commercial.

3.3. Other Options for Treatment of Housing

In this section, we describe certain other options for the application of VAT to housing. Some of the options discussed hereunder are currently being used in some countries, while others are simply theoretical constructs, which have not been adopted in any country.

3.3.1. Option A – Comprehensive Taxation

The main elements of this option would be as follows:

- Rents for leased houses would be taxable, with the landlord being entitled to input tax credit on the tax paid on construction/purchase of the building.¹⁵
- In case of owner-occupied houses, VAT would be applicable on land and construction (on the value of labour and material) or on purchase of the house. However, no VAT would be applicable on the imputed rental value of the house. The owner of the house would not be entitled to input tax credit.
- The resale of the owner-occupied houses would be made taxable with the right to input tax credit at the time of resale. The quantum of input tax credit would be equal to the lesser of the tax originally paid on the purchase of the house (and any improvements to the home that are capitalized, i.e., other than repairs and maintenance) and the tax that would be payable on the value of the home at the time of resale.

It is worth clarifying how this system of giving credit is appropriate for a neutral application of tax. It is based on two guiding principles:

- Under a neutral system, tax on consumption of durable goods must equal the present value tax on rental values. Rents in any given period are equal to the time value of money invested in durable goods plus depreciation.
- Any decrease in value of durable goods is on account of depreciation which in turn is assumed to be on account of consumption of the consumer goods.

Table 2 illustrates the above principles for the purchase of a home under alternative scenarios. For purposes of the illustration, it is assumed that the home has a finite life of two years, with no residual value after two years.

Under scenario A, the home is purchased with the tax paid, and there is no resale or rental of the home. Under the basic model, the tax would apply on the full purchase price, with no input tax credit. The present value of tax would be 5, which is the amount of tax paid at the time of purchase of the home.

Under scenario B, the house is rented, and rents are fully taxable, which would entitle the owner/lessor to claim full credit in Period 0 for the tax paid on the purchase of the home. With no additional inputs in the latter periods, the tax would apply on the full rental value of the property in Period 1 and 2. The present value of the tax collected over the two periods would again equal 5.

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¹⁵ If the property owners are not very tax compliant then it can also increase the risk of tax compliance.

Table 2
Application of VAT to Durables, Illustration

	Period 0	Period 1	Period 2
Pre-tax Transaction Values:			
Purchase Price of Home	100		
Depreciation		50	50
Financing Cost @10%		10	5
Total Rent (payable at the end of period)		60	55
Resale price at the end of period		50	0
VAT Rate	5%	5%	5%
A: Tax on Home, with Rents Exempt			
Tax	5	--	--
Input Tax Credit	--	--	--
Net Tax	5	--	--
Present Value of Tax at Period 0	5	--	--
B: Tax on Rents, with No Resale of Home			
Tax	5	3	2.75
Input Tax Credit	(5)	-	--
Net tax	0	3	2.75
Present Value of Tax at Period 0	--	2.727	2.273
C: Rents Exempt, with Home Resale Taxable			
Tax	5	--	--
Input Tax Credit	--	--	--
Net tax	5	--	--
Present Value of Tax on Rents at Period 0	--	--	--
Tax on Resale of Property	--	2.5	--
Input Tax Credit for Property Sold		(2.5)	--
Net Tax	5	0	--
Present Value of Tax at Period 0	5	0	--

Under scenario C, it is assumed that the property is sold after one year of rental. The resale is taxable, but rental of property is assumed to be exempt of tax. This would be the situation of an owner-occupied home, where imputed rents are exempt, but the resale is assumed to be taxable.

In this case, the tax collected at the time of purchase of the property is not creditable, as rents are assumed to be exempt. Home resale at the end of Period 1 is taxable, but the tax payable is fully offset by the input tax credit, which is allowed equal to the lesser of the tax originally paid and the tax on the resale of the home. Again, the total present value of tax on the property would be 5.

It is useful to consider two variation of this scenario. First, assume that the property was acquired prior to the introduction of VAT. In this case, the input tax credit at the time of resale would be zero. As a result, tax would be payable on the full resale price of the property. The resale price represents future rental value of the property. Consumption of such properties remains tax free until the point of resale, at which time the tax is collected on their future rental value.

Second, assume that the property was acquired after the introduction of VAT, but the resale price is 150, i.e., higher than the original purchase price. In this case, the resale would attract net tax on 2.5 (5% of 150 less credit of 5). This can be viewed as a catch-up tax on unanticipated future increases in rental values.

Thus, if the house goes down in value below its purchase price, e.g., because of its wear and tear over time, the net additional tax payable on the home at the time of its resale would be zero. This result is appropriate because any decrease in value is presumed to be attributable to its use or consumption. If the sale price is higher than the cost of procurement and improvements, VAT would only be payable on the margin earned on sale of the house, i.e., the difference between the sale price and the cost of procurement and improvements. Thus, VAT would apply to any enhancement in the value of the property.

This feature extends the tax to resale of homes built prior to the introduction of VAT. The tax would apply to the full resale value with no input tax deduction, as no VAT would have been paid at the time of its purchase.

Conceptually, this option is the most comprehensive. It addresses the two gaps in taxation of housing consumption under the modern VAT, as identified in the earlier section. It extends the scope of VAT to the consumption of existing stock of housing, as well as to any unanticipated future increases in the rental value of new housing units. It flows from the normal VAT principle of taxing all supplies with corresponding input tax credits for procurements. This option does effectively entail full taxation of imputed rental value of owner-occupied homes. New dwelling units attract tax on their full capital value (i.e., the purchase price) at the time of purchase, for which no deduction is allowed to the homeowner during the period of occupation of the home. The existing dwelling units attract tax on their full capital value at the time of resale.¹⁶

The comprehensive application of tax under this option simplifies legislation. There is no need for defining residential or commercial properties or rentals of properties.¹⁷ However, its impact on administration and compliance is mixed. It increases the number of registered taxpayers. Many individual owners of residential rental property would have to register for VAT, pay the tax and undertake all the VAT compliance requirements. This may not be so much of concern in the case of rental activities by commercial operators as in the case of occasional rental of owner-occupied dwellings by individuals who would otherwise have no compliance obligations under a VAT. However, it is probable that most of such occasional rentals would remain exempt for reasons of not exceeding the small-business exemption threshold.¹⁸

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¹⁶ To achieve neutrality, the tax should be collected on the value of dwellings at the commencement of the tax, which would be complex and politically unpopular. The deferral of tax, while simplifying compliance and administration, does create a lock-in effect, i.e., creates an incentive to defer the sale of the unit as much as possible.

¹⁷ Homeowners buying the home for personal use would not be entitled for credit because they would not be registered for VAT. While resale would be a taxable sale, special rules would be required to clarify that in such case credit would be deferred to the time of resale of property.

¹⁸ Even though rental revenues would likely be less than the registration threshold, eventual sale of property would likely exceed the threshold, in which case the sale would be taxable with a credit in respect of any tax which may have been paid on the purchase of the property. Alternatively, resale of a home could be made subject to tax without the benefit of the registration threshold.

Application of tax on resale of dwellings would require the owners to keep track of input taxes paid on the acquisition of the dwellings and on improvements undertaken over the period of their ownership. Further, in many cases, there are frequent changes in the use of the dwelling as owner-occupied residence or rental dwelling. Since input tax credits are allowed only for houses used for rental purposes, these changes in the usage of the dwelling would require special rules for apportionment of the input tax credits resulting in serious compliance problems for property-owners and increased administration burden for the tax office.

While recognizing the compliance burden of more extensive taxation of housing consumption under this option, it is worth noting that it has not been a significant deterrent in taxation of income from housing properties under the income tax legislation. Rental incomes as well as capital gains from residential properties do already attract income tax in many jurisdictions. Given that the compliance requirements for VAT would be similar to those for income tax, the compliance cost argument against this option does not appear to be very convincing.

Another potential difficulty in the adoption of this option would be the lack of political support for taxation of housing units at the time of their resale. VAT on resale of owner-occupied homes would be similar to the tax on capital gains. There is already significant political pressure in many countries for exempting owner-occupied homes from capital gains taxation. In such a scenario, application of VAT to such gains is unlikely to receive much political support. Also, in the case of the existing stock of housing units, the tax would apply on their full resale value. Conceptually, this is appropriate only where the existing units did not previously bear the taxes that were being replaced by the VAT. But, where the taxes did previously apply to some or all components of the existing units, subjecting them to full taxation again under VAT would amount to double taxation. It would thus be appropriate to apply VAT at a reduced rate on such units, or otherwise make an allowance for the taxes already applied.

Notwithstanding its conceptual appeal, this option has not been adopted in any jurisdiction, perhaps mainly for administrative and socio-political reasons noted above.¹⁹

3.3.2. Option B – Exemption for Residential Rents

This option is similar to Option A, except that long-term residential rents would be exempted.

- No tax is applied on long-term residential rentals;
- Sale, construction, repair, renovations of residential property is taxable, with no right of input tax credit;
- The resale of residential property, whether leased or owner-occupied, would be made taxable with the right to input tax credit at the time of sale. The quantum of input tax credit would be equal to the lesser of the tax originally paid on the purchase of the house (and any improvements to the home that are capitalized, i.e.,

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¹⁹ As noted earlier, one exception is China, where both leasing revenues and sale of residential dwellings attract the Business Tax.

other than repairs and maintenance) and the tax that would have been payable on the fair market value of the home at the time of resale.

- All other supplies of real property would be taxable, including first sale of residential property and short-term rentals.

Under this option, there is a greater uniformity in the treatment of owner-occupied and rental units. In both cases, tax is not applied on the actual rent for rental units or the imputed rent for owner-occupied units. However, the resale of both rental and owner-occupied units would be taxable with corresponding input tax credits on purchase and improvement of the unit being available to the owner.

From an economic neutrality perspective, this option is similar to Option A in respect of all new dwellings constructed after the inception of VAT. All such units become taxable under the pre-collection method, i.e., on the full capital value, with no tax on actual or imputed rentals. A tax on resale of the units, with a credit for the tax already paid, serves the purpose of capturing in the tax base any enhancement in the rental (actual or imputed) value of the property.

The treatment of housing under the Modern VAT outlined above creates a windfall gain for dwellings constructed prior to the inception of VAT, which is capitalized in higher resale value of these units. Taxation of existing units at the time of resale under Options A and B eliminates this windfall gain.

For existing units at the inception of VAT, the tax is deferred for rental and owner-occupied dwellings until the units are resold. At that time, they become taxable on the full resale value. There would be no credit for the purchase of the units as no VAT would have been paid on the purchase.

Administrative and compliance difficulties under this option would be similar to those faced under Option A. While exemption for residential rentals would reduce the number of registrants. The exemption for long-term residential rents would simplify compliance when use of homes changes between owner-occupation and rental to third parties. There would be some increase in administration complexity in the case of mixed-use buildings, i.e. where the building is partly used for residential and partly for commercial rentals. However, in most cases, there will be clear segregation of residential and commercial portions of a building and the apportionment of input tax credits should not be problematic.

In many cases, along with the renting of the unit, various related services such as utilities, furnishings, meals and maid services are also provided. Special rules would need to be framed to segregate residential rentals from the related supplies.

Where the rental property is self-constructed by the owner, the property would attract significantly less VAT since no tax would be applied on the employee labor and other non-taxable inputs. Therefore, self supply rules need to be framed whereby VAT is applied on the fair market value of such property at the time it is put to rental use, with credits of the VAT actually paid on construction inputs.

Other issues such as political resistance to taxation of resale of dwellings and credit for the existing stock at the commencement of VAT would also need to be addressed.

This option is also not adopted by any of the VAT jurisdictions. A variant of this option was considered in Canada at the time of introduction of the GST. It entailed taxation of resale of residential dwellings, but the tax on resale of owner-occupied dwellings was to be deferred if the homeowner bought another dwelling. Thus, the tax was to be charged and collected only when the homeowner exited from home-ownership. The option that was eventually adopted was the modern VAT option.

3.3.3. Option C – Exemption for Sale and Lease of Residences

The elements of this option would be as follows:

- Sale and lease of residential dwellings would be exempt, with no right of input tax credit; and
- Construction, repair, renovations of residential property would be taxable.

This option is adopted by Singapore, where all real property transactions are taxable except for sale or lease of residential property, which is exempted. Variants of this option are found in other jurisdictions. For example, Russia exempts sale or lease of real property, and also certain housing construction services.

Under the European VAT directive, sale or lease of real property, whether residential or commercial, is exempt from tax. However, member States can allow the seller or lessor of property to elect to treat the supply as taxable. For commercial properties the tax would be fully creditable to the recipient of the supply (except for exempt recipients such as financial institutions). Thus, it would be advantageous for the seller or lessor of property to exercise the option and pay the tax on the supply. As a result, the scope of the exemption would be effectively limited to residential properties only. In the UK, supplies of real property are exempt (with option to tax) as per the VAT Directive of the EU, except that the first sale of residential property is zero-rated.²⁰

The exemption for all real property supplies under the VAT Directive in the EU is based, in part, on the historic view that land does not constitute value added, and, in part, on the fact that real property transactions are subject to stamp duties and other property transfer taxes. It is now generally recognized that an exemption for commercial properties is economically inefficient as it can lead to tax cascading. The option to pay tax is provided precisely to mitigate the undesirable consequences of the exemption.

In the case of residential dwellings, the exemption for the sale of dwellings (including the first sale) can be highly distortionary, as its benefits would depend on the mix of taxable and non-taxable inputs in the dwellings. The exemption would create a self-supply bias for the inputs, in order to minimize the incidence of non-creditable VAT on inputs. There are various ways of minimizing the bias, e.g., in the UK through zero-rating of the first sale of residential dwellings, and in Russia by exempting the construction services for residential dwellings.

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²⁰ Zero rate is allowed under transitional derogation

Such a system has a mixed impact on administrative complexity. On the one hand, the exemption for real property transactions significantly reduces the number of VAT registrants and consequent compliance.

On the other hand, even though the ‘traditional’ real property transactions are exempt from taxation, special rules are needed to define taxation of certain real property rentals, such as parking spaces, conference halls, and sports facilities. This creates complexities in administration.

Also, complex rules need to be formulated for input tax credit allocation by commercial firms. The reason is that although such firms are not allowed any credit for real property purchases, they are allowed full credit for repair and maintenance costs.

3.3.4. Summary of the Options

Table 3 below provides a summary of the treatment of different housing supplies under the various options discussed above.

Table 3
Taxation of Housing under Alternative Options

<u>Type of Supply</u>	<u>Modern VAT</u>	<u>Option A</u>	<u>Option B</u>	<u>Option C</u>
First Sale of Property	T	T	T	E
Resale of Property				
Owner-occupied	E	T	T	E
Rental	E	T	T	E
Long-term Rentals	E	T	E	E
Imputed Rent for Homes	E	E	E	E
Future Increase in Rental Value				
Owned	E	T def	T def	E
Rental	E	T	T def	E

T: Taxable,

E: Exempt, and

T def: Taxable, but the tax is deferred until property is resold.

4. Special Considerations

Of the various options discussed above, it emerges that the Modern VAT is the most practical structure, providing exemption for long term residential rentals and resale of used residential property. As in the case of all exemption systems, this structure gives rise various definitional complexities and other issues. In this section, we discuss briefly the special considerations that need to be kept in mind while designing the application of VAT to housing on the lines of the Modern VAT.

4.1. Definition of Residential Property

The definition of residential property is paramount in defining the exemption to residential supplies. Without a precise definition of residential property, various interpretational issues would arise resulting in unnecessary litigation.

‘Residential property’ may be defined as follows:

- A place that is used or intended to be used as a place of residence or lodging. This may include single houses, multiple family housing such as apartments, duplexes, townhomes and condominiums, mobile homes, rooms in student residences or nursing homes.
- Residential property should not include hotels, motels or other such property that may provide accommodation for shorter periods (e.g., for less than 60 days), even though the occupants may be referred to as ‘residents’ instead of ‘guests’.
- In a building with a mixed use of residential and commercial areas, only the portion that is used for residential purposes may be treated as a residential complex. Thus, apartments used exclusively as an office cannot be considered as a residence.
- The residential complex may also include driveways, garages, gardens, swimming pools etc. that are part of the complex and meant for the use and enjoyment of the residents.
- Land adjacent to a residential unit that is reasonably necessary for use and enjoyment of the residents may also form part of the residence. However, legislation could include an explicit limit on the size of land or fix a ratio of constructed area to the total land area.

In Canada, the term ‘residential unit’ includes any structure intended for occupation as a place of residence or lodging by an individual.²¹ Exemptions are based on actual use of a property as a place of residence, i.e., to qualify as a residential unit, it should be last occupied or intended to be occupied as a place of residence or lodging.

The definition includes premises such as mobile or floating homes, a residential condominium unit, a room or suite in a hotel, motel, inn, etc. Thus, commercial properties such as hotels, motels and serviced apartments are also considered residential if they have specific sections that are occupied for longer durations. However, short-term occupation of such commercial properties does not qualify for the exemption.

Properties with a mixed use require segregation into residential and non-residential portions for the purpose of the exemption. Thus, where a portion of the house is used for commercial purposes, this portion would need to be segregated and would not qualify for the exemption.

In New Zealand, residential property is defined as any ‘Dwelling’ other than ‘Commercial Dwelling’.²² The term ‘Commercial Dwelling’ includes:

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²¹ For complete definition of “residential unit” refer to section 123 of Excise Tax Act (R.S., 1985, c. E-15).

²² See Smith (2007) for a description of the New Zealand provisions relating to real property transactions.

- any hotel, motel, inn, hostel or boardinghouse; or
- any camping ground; or
- any convalescent home, nursing home, rest home or hospice; or
- any other similar establishment.

What would qualify as a commercial or non-commercial dwelling is a matter of debate. Some of the common general characteristics of a ‘commercial dwelling’ as stated in the New Zealand IRD Exposure Draft IS0049 are²³:

- operated on a commercial basis, possessing the characteristics expected of a business supplying accommodation to the public;
- provides accommodation to a number of people simultaneously (i.e. multiple units, rooms or beds are available as in hotels and motels);
- accommodation is generally provided by way of a license to occupy and not by a tenancy;
- a degree of on-site control is exercised by the owner/operator, generally varying with the level of service provided and the cost of the accommodation;
- servicing of the units, rooms or common areas is usually provided as an aspect of the supply;
- the accommodation is furnished;
- there may be communal facilities for the use of all guests;
- the guests are not part of the owner’s or owner’s family’s household during the stay; and
- the guests receive professional, formal or commercial hospitality.

In Australia, ‘residential premises’ is defined to mean land or building that is:

- (i) occupied as a residence or for residential accommodation; or
- (ii) intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation (regardless of the term of the occupation or intended occupation) and includes a floating home.²⁴

Unlike Canada, in Australia, the primary emphasis is on physical characteristics of the structure and not its actual use.²⁵ Hence, the sale of premises that have been built and designed as a residence is exempt from GST even though the purchaser may intend to use the premises for non-residential purposes. In Australia, the case law on the status of such properties is still evolving.

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²³ Exposure Draft IS0049 “GST Exempt Supply: Supply of Accommodation in a Dwelling”, IRD New Zealand, 18 October 2006. For current discussion on problems of GST treatment of accommodation please refer to “Options for strengthening GST neutrality in business-to-business transactions”, an official issues paper prepared by the Policy Advice Division of Inland Revenue and by the New Zealand Treasury, June 2008.

²⁴ See the definition under Section 195-1 of the *A New Tax System (Goods and Service Tax) Act, 1999* (GST Act).

²⁵ Evans (2007) provides a very useful summary of the political considerations underlying the Australian approach and the issues surrounding the interpretation of certain basic definitions.

4.2. Long Term and Short Term Rentals

The second primary issue is the definition of the term ‘long term rental’ and ‘short term rental’. This is because only long term rentals are exempt from VAT and short term rentals are generally taxable.

The definition can be based on the following:

- by length of stay, e.g., 30 days or less;
- by type of accommodation, i.e., hotels, motels, boarding houses, etc; or
- by a combination of both.

There are significant differences in the scope of exemption in different countries. While Canada exempts residential rentals of more than 30 days in all types of residential units (including hotels and motels, subject to thresholds), New Zealand does not exempt such rentals in commercial dwellings. On the other hand, in Australia there are special provisions for long-term accommodation in such units.

4.3. Mixed-use Properties

In the case of mixed-use buildings, i.e., where the building is partly used for residential and partly for commercial rentals or where the use of the unit changes between commercial and residential, pro rata input tax credits are allowed at the time of purchase.

In Canada, however, there are two exceptions to this rule.

- No input tax credit is allowed for commercial use of units where it is primarily for the owner’s personal use
- A full input tax credit is allowed if the unit is acquired primarily for use in commercial activities by a charity, non-profit organization or selected public sector organization. No credits are denied for partial use of the property in exempt activities, as long as such use is less than 50%.

Tax on electricity, home telephones, and such other supplies is subject to general rules where credit is allowed to the extent of purchase used for taxable activity.

Where the use of commercial real property changes significantly (i.e., 10% or more of the usage), change-of-use rules apply. If the commercial usage increases, the registrant will be entitled to additional input tax credit in proportion to the increase in use based on the lesser of the tax paid on acquisition of the property (plus tax paid on any subsequent improvements) or the tax on the fair market value of the property at the time the use changed. Conversely, if the commercial use decreases, the input credits are recaptured based on the extent of the decrease.²⁶ Similar rules apply in New Zealand and Australia as well.

Resale of mixed-use units is taxable, where input credits have been claimed partially or fully. Input credits denied previously may be allowed at the time of resale, not exceeding the tax on the resale price.

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²⁶ Goods & Services Tax Technical Paper, August 1989, Department of Finance, Canada, p 116

4.4. Vacant Land

The treatment of raw land varies in different jurisdictions. New Zealand extends rules for second-hand goods to land: notional input credit is allowed (tax rate times the value of the land) for land acquired from non-registered persons. This input tax credit can be adjusted against the VAT payable by the entrepreneur at the time of sale of the property. On the other hand, Australia applies tax to only the margin²⁷, where land is acquired without any tax. Thus, the sale price of the property gets reduced by the price paid for the acquisition of the land.

The need for these adjustments arises because the sale of land held by individuals²⁸ (non-registered persons) would not be viewed as a business/commercial transaction giving rise to VAT. Such land held by individuals at the inception of VAT is sheltered from tax when it enters the commercial supply chain and is resold as part of a constructed dwelling.

By contrast, in Canada, in general, all sales of land are taxable. The only exception is the sale of land held for private personal use. If an individual holds land which is more than what is needed for private personal use, then any subdivision and sale of that surplus land would generally attract GST. The definition of business is broad and includes any adventure in the nature of trade. Since land is taxable, no notional credit or margin schemes for land is required when land held by individuals enters the commercial supply chain.

4.5. Substantial Renovation

Special rules are required for renovation of used houses. In the absence of special rules, the sale of a renovated house will qualify for VAT exemption as a used house. This would result in inequitable VAT treatment between renovated houses (which would continue to be exempt from tax) and newly constructed houses. Therefore, there is a need to equalize the taxation of new homes with substantially renovated homes by excluding (all or part of the value of) substantially renovated homes from the exemption for used homes.

Both Canada and Australia tax substantially renovated units as sale of a newly constructed home. In both countries, the term substantial renovation has been similarly defined as removal or replacement of all or substantially all of the building (other than foundation, external walls, internal supporting walls, floors, roof and staircases)²⁹.

4.6. Ancillary supplies

Ancillary supplies constitute services like parking, meals, maid services, electricity, and health facility.

Generally, such supplies are exempt only if they are included in the rental contract and there is no separate charge for them. However, supplies by a third party to the landlord or

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²⁷ *Tax reform, Not a New Tax, a New Tax System* (“Australian White Paper”), August 1998.

²⁸ In Canada some provisions are limited to individuals and not extended to all non-registered persons

²⁹ See section 195-1 of the *A New Tax System (Goods and Service Tax) Act*, 1999 (GST Act, Australia) & section 123 of Excise Tax Act, (R.S., 1985, c. E-15), Canada

the tenant is generally taxable. The landlord pays tax on such supplies with no right to input tax credit. Maintenance charges in a housing complex (e.g., in the form of condominium fees) are exempted in Canada on the grounds that they are in the nature of cost-sharing arrangements among the residents.³⁰ They do not represent supplies by a third party.

4.7. Taxable Self-supply of Real Property

There are various situations where self supply rules may need to be framed to overcome anomalies in the production-distribution system.

For instance, self-supply rules may be required where a developer/ landlord constructs residential complex, such as an apartment building, for subsequent lease to tenants. In the absence of a self supply rule, the property would attract no tax on the employee labor and other non-taxable inputs to property. The total VAT on the property would be significantly less than if the developer/ landlord had purchased the property from another person.

In such situations, tax can be applied on the fair market value of the building at the time of commencement of its use in the exempt activity. The owner of the property will be able to claim input tax credits in the normal manner on purchases related to the construction of the building.³¹

4.8. Vacant Land held by Individuals

There are various situations where land is acquired by an individual and subsequently resold. Land can be originally acquired by an individual:

- as an investment property for resale or development;
- for construction of residential property or other personal use; or
- for personal use but subsequently subdivided and a part resold.

In Canada, any sale of land by an individual, other than land acquired for personal use/residence, is treated as a taxable sale. The individual is able to claim a credit for any tax paid on the land at the time of its purchase. Under the rules, the individual can:

- register for tax and claim full credit for the tax paid on the purchase of land and other inputs; or
- defer the credit until the land is put to a taxable use and resold.

4.9. Person Liable to Pay Tax

As per the general VAT rules, the liability for paying tax is on the vendor or supplier of real property. However, given the size of real property transactions, differences between the timing of collection of tax from the vendor and payment of credit to a registered buyer could create serious cash flow difficulties.

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³⁰ Taupo Ika Nui case in New Zealand made the same conclusion; case law in Australia says the opposite and these are taxed.

³¹ See supra note at 14 p. 114

Such cash flow difficulties could be suitably addressed by shifting the liability of paying the tax from the vendor to the buyer in the case of sales to registered buyers. In such cases, the registered buyer would be entitled to claim full input tax credit of the tax paid by him. Further, such registered buyers would not remit the tax if the time for the liability and the credit is the same. This system would work in a manner similar to the reverse charge for imports.

4.10. Personal Use Recreational Properties

Sale/ lease of personal use recreational properties like cottages, farm houses and vacation properties could be exempt as residential units. Exemption could also be provided for non-residential vacation properties, sold by an individual, if the property is not used in any business prior to the sale.

4.11. Time-share Arrangements

Time sharing is an arrangement whereby each participant is allowed to use the property for a limited period of time during the pendency of the time sharing arrangement. Time shares could take the following forms:

- Sale of an ownership interest in the property, with the right of exclusive possession for a pre-determined period each year. In this case the initial sale of ownership could be taxable as a sale of new residential unit. Subsequent sales would be exempt as used residential units.
- Lease of the property to each participant for a pre-determined period each year for a pre-determined number of years. This arrangement could be taxable as a short-term rental if the lease period does not meet the definition of long-term rental.
- Sale of membership in a club that allows each member to use the property for a pre-determined period in each year of membership. This would be taxable as a club membership. Subsequent sale of membership by the individual could be exempt as a non-business sale.

5. Conclusion

Housing constitutes a significant portion of the consumption basket in the United States. House occupancy services (consisting of actual rents and imputed rental value of owner-occupied homes) account for 15% of total consumption expenditure, with house operating expenditures, utilities, and furniture and fixtures accounting for an additional 10%. Housing expenditures are also likely to be distributed progressively with respect to income.

The objectives of tax neutrality and simplicity require that the base for the US VAT be comprehensive and include housing services. While home ownership is viewed as a desirable policy objective, an exemption for housing services is not necessarily the most efficient incentive for home ownership. Exemptions under a VAT lead to distortions as their benefit can vary significantly depending upon how the construction and sale of homes is structured. They also create a bias for horizontal and vertical integration.

Historically, the scope of VAT was limited to goods and services, with real property transactions generally exempted from the tax. However, increasingly such transactions are being brought within the ambit of VAT. Under modern VAT, all sales and rentals of commercial real property attract tax. In the case of residential properties, the application of tax is limited to the first sale of new residential dwellings. Long-term rentals and resale of residential dwellings are exempted from tax. For dwellings constructed after the commencement of VAT, this system is tantamount to pre-collection of tax on future consumption of housing services from such dwellings, resulting in little or no erosion of the tax base. This is not the case for existing dwellings constructed before the introduction of VAT. Housing services flowing from such dwellings remain tax free, which constitutes an erosion of the tax base.

No country has gone beyond taxation of first sale of new residential dwellings. While this option could be viewed as a reasonable compromise, purely from a technical and tax design perspective, there are options available for extension of tax to the existing stock of housing. Under a comprehensive taxation option, all sales, resales, and rentals of real property (whether residential or commercial) would be subject to VAT, with the exception of imputed rental value of owner-occupied homes. Such an option warrants a serious consideration in advanced economies such as the USA where taxpayers (both individuals and corporations) are already used to reporting residential rental activities for income tax purposes.

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