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Objections to Taxing Resale of Residential Property Under a VAT

By Wei Cui



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The pre-collection of tax on imputed consumption generated by owner-occupied housing plays a crucial role in consumption tax theory and real-world tax regimes. But even under VAT systems with the widest tax bases, the taxation of imputed housing consumption is incomplete because preexisting housing stock is typically not taxed when the VAT is introduced, and because housing value may appreciate after the initial sale. Some have recommended taxing residential resale to capture previously untaxed consumption value. This article argues that because the incidence of any properly designed tax on resale will fall only on economic rent and existing assets, taxing housing resale in itself cannot produce efficiency gains. Moreover, to avoid distortions and be consistent with consumption tax theory, a tax on resale must be refined to ensure the nontaxation of investment returns other than economic rent. The refinements are alien to normal VAT mechanisms and can no longer be viewed as embodying the pre-collection method.

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Introduction

In discussions on VAT design conducted in many countries, improving the VAT treatment of housing continues to receive attention as an important policy topic. A recent survey of international practices shows that countries still adopt very different approaches to taxing real estate under their VAT

and goods and services tax regimes.¹ An earlier classification developed by the Dutch economist and lawyer Sijbren Cnossen² groups these diverse approaches roughly under the rubrics of the exemption method and the tax method. Under the exemption method, commonly applied in Europe, all sales and long-term leases of residential property are exempt from the VAT, but the VAT paid by home builders on input purchases is not creditable and therefore may be buried in sale or rental prices. Consumers of housing thus may indirectly bear some of the VAT burden, and to the extent that different inputs into housing production are taxed differently (for example, some are exempt and others are not), tax-induced distortions in production decisions may result.

By contrast, the tax method, which describes the “modern VAT” adopted under the Canadian, Australian, and New Zealand GSTs, subjects the first sales of residential property to the VAT. This is more likely to result in the full future consumption value of new housing being included in the consumption tax base³ and may also reduce distortions in housing production decisions. In a variation of the tax method (adopted in the United Kingdom), the sale of new residential property is zero rated, which allows all previous VAT paid on input purchases by producers of housing to be refunded. This removes distortions in housing production decisions, but at the cost of giving up taxing housing consumption.

It has increasingly been recognized, however, that even in countries with the widest consumption tax bases, the taxation of housing consumption under the VAT is incomplete.⁴ This is mainly due to two factors. First, the relatively young nature of the VAT for most countries means a significant portion

¹Sijbren Cnossen, “Improving the VAT Treatment of Exempt Immovable Property in the European Union,” in *VAT Exemptions: Consequences and Design Alternatives* (forthcoming). See also Robert Brederode, ed., *Immovable Property Under VAT: A Comparative Global Analysis* (2011).

²Cnossen, “VAT Treatment of Immovable Property,” *Tax Notes Int'l*, Mar. 20, 1995, p. 1037.

³See below for a further discussion of the method of taxing housing consumption under the pre-collection method.

⁴See Satya Poddar, “Taxation of Housing Under a VAT,” 63 *Tax L. Rev.* 443 (2010); Rebecca Millar, “VAT and Immoveable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences,” in *VAT Exemptions*, *supra* note 1.

of housing stock has not been subject to tax on initial sale. Second, no country subjects the resale of residential property to the VAT. This not only means that previously untaxed residences continue to be untaxed, but also that the increased consumption value of housing attributable to unexpected appreciation falls outside the VAT's reach. Many consumption tax theorists who have identified this issue view it as a flaw in existing VAT systems.⁵ Some therefore advocate taxing the resale of residential property in the context of either the reform of existing VATs or the implementation of new VATs.⁶ Others believe that political resistance would render more fulsome consumption taxation of housing unlikely in most countries.⁷

Subjecting the resale of housing to consumption taxation seems feasible from an administrative perspective. Many countries subject the resale of business or residential real estate to transfer taxes, which suggests that the detection of these transactions is not difficult. Although delineating the tax base that a consumption tax should target in a resale transaction requires precision,⁸ finding real-world approximations for it may be no more administratively or politically difficult than taxing capital gains from similar properties under an income tax, and capital gains taxation of real estate transactions is widespread. In many housing markets, property appreciation may be gradual (or fast but transient), so targeting previously untaxed value in residential property is not always promising from a revenue perspective. On the other hand, some large and active housing markets in the world — in Australia, China, and India, for example — have witnessed extraordinary and sustained appreciation in housing value in recent years. The revenue potential of taxing residential resale in these markets is great. In light of these strong housing markets, along with the feeling in some countries that the wealthy have been the primary beneficiaries of real estate booms, one should not underestimate the political feasibility of a new policy.⁹

⁵See Liam Ebrill et al., *The Modern VAT*, at 98-99 (2002); Cnossen, *supra* note 1; and Cnossen, *supra* note 2.

⁶Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* 429-431 (rev. ed. 2007).

⁷Poddar, *supra* note 4.

⁸See below for a discussion of possible needs to adjust for time value return, risk, and inflation.

⁹Taxing the resale of residential properties was reportedly discussed when Canada enacted its GST legislation. Poddar, *supra* note 4, at 459. This taxation is also embodied in the current Chinese consumption tax treatment of housing, and the question whether it should be continued during further VAT reform is being considered. See Wei Cui, "Learning to Keep the Consumption Tax Base Broad: Australian and Chinese VAT Design

(Footnote continued in next column.)

However, the question whether the resale of residential property should be subject to consumption taxation under the VAT/GST is not just a matter of evaluating the practical feasibility of something that is unquestionably desirable from a theoretical perspective. In this article, I suggest that there are significant conceptual challenges facing proposals of taxing residential resale. The most important of these is that the economic incidence of a tax on resale is likely to fall fully on the seller of property, while the actual consumers of housing, per consumer, do not bear the tax. This is because existing housing stock is by definition inelastically supplied and because any additional taxable value found in previously taxed property represents infra-marginal rent. As a result, a key objective of consumption tax policy — namely, ensuring that different consumption goods are taxed at similar rates and that consumption choices are not distorted by taxation — is not furthered by taxing the resale of residential property. Moreover, because the tax on resale may be avoided by deferring resale, it creates a special type of lock-in effect that results in tax-induced overconsumption by housing owners. Equally important, because existing housing has already been produced, taxing it cannot enhance production efficiency, which traditionally has been another VAT objective.¹⁰

This critique of proposals to subject housing resale to the VAT is made on efficiency terms, as opposed to fairness or legal doctrinal terms, and it treats housing entirely as a consumable asset. This article also attempts to further sharpen the debate between advocates and opponents of applying the VAT to housing resale by considering whether housing should be viewed in part as an investment asset, and what the implications would be.¹¹ Denying that housing has investment value beyond its consumption value is implausible. However, admitting the investment value of housing means that proponents of taxing resale must allow for adjustments for the risk-free rate of return, as well as any nominal appreciation due to inflation. To avoid taxing risk taking, as a consumption tax ought to, the proposal to tax resale must also allow the possibility for refund in cases of housing devaluation. Not only are these adjustment and refund mechanisms alien to the VAT regime, but they also

for the Housing Sector," in *The Australian GST: Looking Forward From the First Decade*, at 367-377 (2011).

¹⁰Ebrill et al., *supra* note 5, at 15-7.

¹¹Millar, *supra* note 4, argues that housing represents a mixture of consumption and investment assets. Poddar, *supra* note 4, assumes that housing is completely a consumption asset.

deviate from the traditional conception of the use of the pre-collection method for consumption tax purposes.

Overall, this article suggests that despite improvements in VAT design, any transaction-based tax still cannot succeed in fully taxing imputed housing consumption. Current taxation of housing consumption — under an income, consumption, or a property tax — is required for full taxation.

Pre-Collecting Tax on Imputed Consumption

Buying a house or a condominium is, in some fundamental ways, just like buying durable consumer goods like refrigerators, cars, and furniture. The act of the purchase is not itself an act of consumption. Instead, consumption happens when the durable good is used. A uniform tax on consumption should tax the value of imputed consumption just as it taxes other forms of consumption of goods and services. However, for durable goods, this is usually achieved by collecting the tax when the durable good is purchased, rather than as it is used. The purchase price of a consumer durable good generally reflects its consumption value during its useful life. Assuming that the (tax-exclusive) purchase price equals the sum of the present values of the use of the good during each future period, a tax imposed on the purchase price equals the sum of the present values of tax payments that could be collected from the imputed consumption of the good during future periods. Algebraically:

$$(1) V * T = \sum_t [T * c_t / (1+r)^t]$$

where t = time period; c_t = the value of the consumption use of the good in period t ; r = rate of discount; T = tax rate applicable to all periods; and V = tax-exclusive purchase price of the durable good.

Where this equivalence holds, taxing purchases has the effect of pre-collecting the tax on the imputed consumption of the purchased goods. This is how countries with VATs generally tax the consumption of durable goods other than housing,¹² and its superiority from an administrative perspective is easily appreciated. Extending the pre-collection method to imputed housing consumption implies taxing initial purchases of housing, which is what Canada, Australia, New Zealand, and a number of other countries currently do under the modern VAT.¹³ By contrast, under the traditional European VAT, sales of residential property are

often exempt from the VAT¹⁴ and subject only to turnover taxes that are not part of a comprehensive consumption tax.¹⁵ In standard discussions of VAT design, the modern VAT is considered superior, because exempting the sales of residential properties means that the material and labor inputs to housing construction are still subject to the VAT, which encourages builders to self-supply to avoid the VAT in the production process and results in other distortions in production choice. Moreover, taxing only the input to housing production undertaxes the consumption value of housing to the extent that the sales price of housing exceeds taxable factor costs.¹⁶

However, this latter flaw — of undertaxing housing consumption value — may also afflict VAT systems that tax only sales of new residential property, to the extent that equation (1) above does not hold. For housing, the most important assumption underlying the equivalence expressed in equation (1) that may be violated is that the purchase price fully reflects future consumption value. In some historical periods and in some locations, housing values may witness unexpected appreciation or depreciation that had not been fully anticipated or capitalized into purchase prices. Although these changes may occur for various reasons, an important reason is enhanced locational premium. Urbanization, the building of new transportation pathways and amenities, unexpected rises in income in the local population, and so forth may all enhance the value 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. When it does happen, the pre-collection method undertaxes imputed consumption.

Also, even when equation (1) does hold, taxing imputed housing consumption *only* through the sale of new housing may result in undertaxation — that is, if residential properties are subject to the VAT only on their initial sale, the housing stock existing when the VAT is introduced will never bear the VAT. Although this is true of other consumer durables as well, it may be neglected for goods that have limited useful lives and tend not to be resold

¹²Ebrill et al., *supra* note 5, at 98.

¹³*Id.*; Poddar, *supra* note 4; Cnossen, *supra* note 2.

¹⁴Under the European VAT directive, member countries may allow the seller the option to treat a sale as taxable. But this is relevant mostly only when the buyer is a VAT-paying business that can use the input credit. Cnossen, *supra* note 1.

¹⁵To equalize the treatment of owner-occupied and rental housing, long-term rental of residential property is also typically exempt from the VAT (sometimes with the option to elect taxable treatment). Cnossen, *supra* note 2.

¹⁶Poddar, *supra* note 4.

for substantial values. Because residential properties have long useful lives and their resale represents a substantial part of the housing market, these properties are different.

Perpetual nontaxation (under the VAT) of housing that existed before the introduction of the VAT may be viewed as troublesome for two distinct reasons. First, if the owners of these properties continue to occupy them, their housing consumption may be undertaxed relative to other consumption options. At least in some circumstances, the effectively nonuniform taxation that results may distort the consumption choices of the owner occupiers.¹⁷ As we will discuss in the next section, the problem is that taxing resale may actually worsen, not alleviate, these distortions. A second and quite different concern is illustrated by the case in which the owner sells the housing property after the introduction of the VAT. Someone might suggest that if (i) preexisting housing is resold in the same market as newly produced housing; (ii) property prices are determined by newly produced housing; and (iii) the latter is subject to the VAT while the former is not, then the seller of existing housing reaps a windfall gain.¹⁸

Consider a concrete example in which an apartment owned and occupied by person A had a market price of \$100,000 before the introduction of the VAT. The introduction of the VAT would cause prices to rise. If the VAT is imposed at 15 percent, comparable new apartments would sell at \$115,000 after the VAT's introduction, with \$15,000 being paid to the government, leaving \$100,000 after-tax net proceeds to the sellers. If A's apartment is sold at \$115,000, but no tax is paid to the government because resale is not subject to the VAT, then A pockets \$115,000 in net proceeds. This raises a concern about the unintended distributional consequences of introducing the VAT. Note that the concern is not with distorted relative prices for consumption goods, because new and existing housing is assumed to be priced the same for buyers as consumers.

¹⁷More specifically, if the owner of this housing can sell it at the same price as the VAT-inclusive price of comparable new housing, but the resale of the used property is not subject to the VAT, the owner of used housing should be able to sell the used housing property and use the proceeds on consumption choices of equal consumption value as the property sold, even if those new consumption choices are subject to the VAT. In this situation, the nontaxation of used housing is not distortionary. However, if the used housing cannot be sold at the VAT-inclusive price of new housing, the nontaxation of used housing may be distortive. See *infra* text accompanying footnote 41.

¹⁸Poddar, *supra* note 4, at 458.

The validity of this second concern is open to dispute.¹⁹ It may be argued that if, after the introduction of the VAT, the prices of all goods rise by 15 percent, just as the example assumes the prices of apartments do,²⁰ A's purchasing power from the sale of the apartment is the same as it would have been without the introduction of the VAT. Even with \$115,000 of proceeds, A is able to purchase no more than the amount of other goods that he would have been able to purchase with \$100,000 before the introduction of the VAT. The same argument could be made if the prices of goods rise by less than the full rate of the VAT: Whatever the extent of the general price adjustment, A's windfall from not being taxed on his resale of the existing apartment is offset by the reduction in his purchasing power due to the general price increase. Although with a VAT in place, A might be better off than sellers of newly produced housing, A is not better off than if the VAT hadn't been imposed.

To better understand these opposing views, the distributional consequences of leaving existing owner-occupied housing out of the VAT base when the VAT is introduced must be assessed in light of a more general framework for analyzing transitional issues. This type of framework has been developed and refined by various economists.²¹ In summary: An important type of transition effect associated with the introduction of the VAT (and VAT rate adjustments generally)²² is the so-called capital levy

¹⁹I am grateful to Peter Merrill for raising this point. See also Ebrill et al., *supra* note 5, at 99.

²⁰Reasons for expecting a general price increase include the fact that it would be difficult for nominal wages to go down and that non-adjustment would drive many businesses into bankruptcy. See David Bradford, "Consumption Taxes: Some Fundamental Transition Issues," in *Frontiers of Tax Reform*, at 135-136 (1996). Price increases have indeed been observed in connection with the introduction of new VATs in countries like Australia and New Zealand.

²¹See especially Bradford, *id.*; Shounak Sarkar and George R. Zodrow, "Transitional Issues in Moving to a Direct Consumption Tax," 46 *Nat'l Tax J.* 359 (1993); Louis Kaplow, "Recovery of Pre-Enactment Basis Under a Consumption Tax: The USA Tax System," *Tax Notes*, Aug. 28, 1995, p. 1109; Louis Kaplow, "Capital Levies and Transition to a Consumption Tax," in *Institutional Foundations of Public Finance: Economic and Legal Perspectives* (2009).

²²Because in the United States the introduction of a VAT has often been discussed in connection with the repeal of the income tax, transitional effects of the introduction of a VAT should be separated into two sets of effects — those due to the VAT's introduction and those due to an income tax's repeal. The first set of effects also arise whenever the tax rate of an existing VAT goes up (and down), because the introduction of a VAT is equivalent to increasing the general VAT rate from zero to some positive rate. For the same reason, the second set of effects also arises whenever the tax rate of an existing income tax goes down (and up). When the enactment of a VAT or change in VAT

(Footnote continued on next page.)

on existing business assets.²³ The idea of the capital levy is that if a business asset is consumed (or converted into cash or assets that are then consumed) before the enactment of the VAT (rate increase), it would benefit its owner more than if the asset is used (or sold) for consumption after enactment. Compared with pre-enactment consumption, an asset kept for consumption until post-enactment loses consumption value because of government's extraction of tax through the VAT.²⁴

Unlike preexisting business assets, housing and other durable consumer goods held by owner-users are not subject to the capital levy, precisely because their consumption is generally not currently taxed under the VAT.²⁵ Indeed, as Louis Kaplow puts it: "If consumer durables were treated using a prepayment approach, under which purchases would not be deductible as investment and sales proceeds would be exempt, there may be a substantial incentive for individuals to purchase consumer durables before enactment" of the VAT.²⁶ Preexisting owner-occupied housing sold tax free after the enactment of a VAT enjoys the same treatment. The nontaxation of these sales exempts the existing housing assets from the capital levy. That, however, does not

mean the assets enjoy a windfall, relative to the state where there is no VAT.²⁷

Nonetheless, taxing the resale of existing housing might be unfair if we think about existing residences that have been taxed but have experienced unexpected appreciation. Although the concern about a windfall is raised in connection with housing acquired before the enactment of the VAT, that concern should also apply to the resale of previously taxed housing. Such residences may also sell in the same market as newly constructed properties, and thus may benefit from an increase in prices attributable to the VAT, without actually paying the tax. It should be clear that such sellers receive an unjustified benefit.

Regardless of how compelling one finds the distributional concern about not taxing re-sales of residences, clearly the nontaxation of unexpected appreciation and pre-VAT housing stock leaves consumed value outside the consumption tax base. Recent proposals to tax the resale of residential properties under the VAT/GST all seem motivated by this simple recognition.²⁸ Currently, the most explicit proposal of taxing resale, advanced by Satya Poddar,²⁹ is that although the standard VAT rate is applied to the value of the resale, the seller

rates is considered independently of any change to the income tax, it is obviously only the first set of effects that are relevant.

²³Kaplow, "Capital Levies and Transition to a Consumption Tax," *supra* note 21. When VAT rates go down, the capital levy is negative — there is a windfall to owners of existing business assets.

²⁴In efficiency terms, if the VAT (rate increase) is unanticipated, such value extraction from the private sector by the government is efficient because tax revenue is collected from assets that have already been produced. The tax does not distort saving and production decisions. Conversely, if a VAT rate increase is anticipated, people may be motivated to accelerate consumption (to the extent they can) to avoid the capital levy. The distributional effects of the capital levy resulting from the introduction of the VAT depend on several general economic factors, including whether a monetary policy is adopted to allow a general price level adjustment and investors' holding of equity and nominally priced debt assets. Generally, one would expect the price level to rise, which would help spread the burden of the capital levy from equity holders to holders of debt claims. See Bradford, *supra* note 20; and Kaplow, "Capital Levies and Transition to a Consumption Tax," *supra* note 21.

²⁵Bradford, *supra* note 20, at 140; Kaplow, "Capital Levies and Transition to a Consumption Tax," *supra* note 21, n.29.

²⁶*Id.* at 11.

²⁷Interestingly, when Australia introduced its GST in 2000, it allowed builders to elect the application of a "margin scheme" under which the value on July 1, 2000, the day of the GST's implementation, of properties forming the pre-GST inventory to be deducted from subsequent sales price of such inventory properties in determining the amount of GST due. Christine Peacock, "Changes to the Australian GST Immovable Property 'Margin Scheme,'" 17 *Int'l VAT Monitor* 328 (2006). However, it would seem that this policy was not aimed at avoiding a capital levy on existing asset. It is believed that because the buyer in a transaction to which the margin scheme applies would not be able to claim input credit, the margin scheme would be used only for residential property. However, the capital levy resulting from a transition to a consumption tax would afflict all business assets. Rather, the Australian policy seems more likely aimed at mitigating the pressure of price increase in the housing sector.

²⁸Taxing resale may also be supported on the ground that it would reduce distortions in choices of inputs (between those subject to the VAT and those, like self-supplied services, that are not) for any renovation of the property. Various countries, including Australia, that do not generally tax the resale of residential property have rules that treat sales after "substantial renovations" as first sales, thus mitigating the distortions dealing in those cases. However, these rules tend to apply only if the seller is carrying on an enterprise, and not to substantial renovations by owner-occupiers. I am grateful to Rebecca Millar for this point.

²⁹Poddar, *supra* note 4. Other versions of the proposal can be found in Robert Conrad and Anca Grozav, "Real Property and VAT," in *VAT in Africa*, at 81-112 (2008); and Crossen, *supra* note 1.

can take a credit for any VAT paid on his earlier purchase of the residence. Credit can also be taken for any VAT paid when making improvements to the property. However, the total credit cannot exceed the amount of VAT chargeable on the resale price.³⁰ For properties not subject to the VAT on their initial sales,³¹ imposing the VAT on the values of their secondary sales can be interpreted as pre-collecting tax (for the first time) on their future consumption value for the rest of their useful lives. Alternatively (or additionally — it is unclear which is intended),³² this measure may eliminate the windfall that the seller of the previously untaxed property is believed to enjoy.

For properties that have been subject to the VAT, taxing resale (assuming the VAT rate has remained constant) is equivalent to imposing the VAT rate on any difference between the selling price and the sum of the original purchase price and any cost of improvement already subject to the VAT. The idea is that this difference approximates the unanticipated appreciation in consumption value of the residence, and that failing to apply the VAT to it would result in undertaxation. Correcting for undertaxation seems to be desirable on both efficiency and distributional grounds.

To the author's knowledge, proposals for taxing residential resale have been discussed largely among VAT specialists. As a result, many of the criticisms of those proposals are doctrinal. Some VAT specialists have asserted that for a VAT to apply, a person must be engaged in economic or business activities, and sales of used residences by their owner-occupiers do not constitute these activities.³³ Although doctrinal VAT issues are important to discuss, it is perhaps more crucial to ask whether the policy justifications for proposals of taxing residential resale are adequate. As already discussed, whether there are genuinely problematic distributional consequences for not taxing resale is

³⁰This "no refund" position is an aspect of Poddar's proposal that is not followed in Cnossen, *supra* note 1, or Conrad and Grozav, *supra* note 29. The need to refund in the case of devaluation is discussed below.

³¹In this article, initial sales may be understood to include the initial use of self-constructed residences. Ideally, a VAT system should have self-supply rules that ensure self-constructed property is treated in the same way as property constructed and sold to third parties.

³²As discussed below, the same tax burden on resale cannot both bear on infra-marginal rent and affect marginal price.

³³Engagement in economic, business, or commercial activity has been a legal requirement for the existence of a taxable transaction or taxable person under the VAT/GST laws of many countries. Michael Evans, "The Value Added Tax Treatment of Real Property — An Antipodean Context," in *GST in Retrospect and Prospect*, at 255-257 (2007).

open to debate. The next section of this article argues that there is no justification in efficiency terms for proposals to tax resale.

Taxing Resale: Creating vs. Removing Distortions

Consider the economic incidence of a pre-collected consumption tax on housing. First, under standard economic theory, the tax on the portion of the property's purchase price attributable to land (and implicitly the location) is borne by the owner of the land.³⁴ It is only the remainder of the tax that is (potentially) borne by capital, labor, and consumers. In other words, a portion of the tax on the consumer good — a residence — is entirely shifted to the seller as the landowner. This suggests that even under a uniform consumption tax, the purchaser of housing bears less of the burden of the tax than on many other goods and services.

This is arguably unremarkable in the context of newly constructed housing, because the factors that go into the production of consumer goods and services may all have different price elasticities: There may be other factors that are relatively inelastic in supply, and land may be just an extreme example. It may be held that a VAT applied at a uniform rate to all consumption does not attempt to be an optimal tax by taking factor elasticities into account. Instead, it aims at achieving production efficiency — that is, causing minimal distortions in the choice of factor inputs.³⁵ However, reflections on incidence take on an unusual significance in the context of a VAT imposed on housing resale. Consider a resale in which the property had already been subject to a VAT — that is, when the consumption tax had already been collected on the anticipated consumption value of the property. The purpose in subjecting the property to a VAT again is mainly to capture any unexpected appreciation in the (expected) consumption value of the property. But that unexpected appreciation generally cannot be explained by the properties viewed as physical structures; the value of the physical structure should generally go down. Any actual improvements made to the physical structures should also have been subject to the VAT and therefore would not create a net tax liability on resale.³⁶ Instead, the most important reason for increases in housing value is locational premium. But this premium is

³⁴This is because land is inelastically supplied. For a basic discussion of tax incidence in a partial equilibrium context, see for example, Harvey Rosen, *Public Finance*, ch. 12 (2005).

³⁵Ebrill et al., *supra* note 5, at 15-7.

³⁶As discussed in the introduction, exempting sales of residential property (whether new or used) still means that the cost of producing, maintaining, or renovating this property has been subject to the VAT; there is "input taxation."

inherent in the land and is by definition a form of infra-marginal return.³⁷ Under standard economic theory, a tax on such premium should be borne by the person that benefits from it — the seller of existing residential property — and is unlikely to be shifted forward to the buyer.

A similar conclusion holds if one considers taxing the resale of owner-occupied housing that pre-existed introduction of the VAT. Existing housing stock is inelastic in supply — except to the extent it actually deteriorates and dwindles. One may renovate existing property, and the degree of renovation is elastic. However, renovation is not likely to generate substantial net VAT liability when resale is taxed (in the absence of increase in location-based rent).³⁸ If the inelastic supply of pre-VAT housing formed its own market, the tax-inclusive price of the property should be determined entirely by consumer demand, and the burden of any net VAT on the resale of the property should fall entirely on the seller. Alternatively, when existing residences sell in the same market as new housing, it is reasonable to assume that the VAT-inclusive cost of new housing is what sets the market price. As a result, proponents of taxing resale suspect that owners of previously untaxed housing could reap windfall gains. If there are windfall gains, however, instituting the tax on resale would not change that tax-inclusive market price of housing but would only eliminate the rent.

Another way of thinking about the effect of taxing the resale of housing that existed before the VAT is to consider deeming the housing to be subject to a taxable sale, at market value, at the time the VAT is introduced. Proponents of taxing resale would be sympathetic to this option if it were politically acceptable. The future consumption benefits of existing housing would immediately be subject to tax through pre-collection; no consumption could escape taxation through the deferral of resale. The only remaining justification for taxing resale would be any unexpected appreciation that might occur in the future. However, the efficiency of a tax on a deemed sale of existing housing actually would not depend on applying the same tax rate here as is applied to other consumption activities. Instead, the efficiency arises because the tax would be a capital levy: It would be a lump sum tax on production, investment, and consumption decisions that have been made already. Except to the extent that a capital levy may be anticipated and may

create expectations of repeated capital levies,³⁹ the tax would not create any behavioral distortions. Therefore, it would be unnecessary, purely from an efficiency perspective, to stick to the rule of uniform consumption taxation here. One may determine the rate at which the capital levy is imposed regardless of the tax rate applicable to future consumption activities.

It should be clear by this point that the tax on resale, as it is applied to consumption value attributable to location-based premium and past production decisions, cannot have any effect in enhancing production efficiency in an economy. Extending the pre-collection method to resale thus seems only tenuously connected to the basic aims of consumption taxation — namely, minimizing distortions in production and in consumption (in the latter case, both across different goods and services and across time). In substance and not just in appearance, the tax on resale has more affinity to a capital gains tax (or, if it is designed to exempt the normal return on investment, to a pure profit tax), despite protests to the contrary by some proponents of taxing resale.⁴⁰ As a result, it may be imposed at very different rates from the regular consumption tax.

In addition to not being able to correct any distortions in consumption choice, taxing resale may create distortions. If the owner-occupier does not sell a property that has appreciated unexpectedly, he could enjoy the increased consumption value without taxation under the pre-collection approach. This could be viewed as a consumption tax subsidy, relative to the option of currently taxing the property's consumed value.⁴¹ The owner would lose the subsidy by selling. As a result, a lock-in effect can be expected if resale is taxed.⁴² The effect of this is distinct from the lock-in effect associated with the realization principle under the income tax

³⁹See generally Kaplow, "Capital Levies and Transition to a Consumption Tax," *supra* note 21.

⁴⁰Compare Cnossen's claim that the answer to the question whether the VAT-like tax on resale "resembles a capital gains tax . . . is an unqualified 'no.'" Although the two taxes are imposed on the same base . . . the [VAT] is a tax on consumption, whereas the capital gains tax is a tax on income." Cnossen, *supra* note 1, at 16. However, no argument is given for this assertion.

⁴¹However, it may not be a distortionary subsidy in the sense of creating a tax inducement or bias toward the continued use of the property as opposed to substituting for other, taxable goods and services. If resale is not taxed, the property may be sold for a price reflecting the VAT-inclusive price of comparable new property. This allows the seller to use the proceeds to purchase other taxable consumer goods and services equal in value to the housing property sold.

⁴²The lock-in effect of taxing resale is briefly noted in both Cnossen, *supra* note 1, at 15, and Poddar, *supra* note 4 at 456, n.38.

³⁷The value of the premium cannot simply be produced, and thus has no production cost.

³⁸Further, many VAT systems already have rules for treating "substantial renovation" as though it is an initial sale.

— that is, instead of creating distortions in investment choices, the lock-in effect of taxing residential resale maintains a price distortion between the consumption value of a house and other consumption alternatives. Moreover, none of the recent theoretical proposals for undoing the lock-in effect without abandoning the realization principle under the income tax seems to work for locked-in consumption.⁴³

This section has attempted to review the proposal to tax residential resale in light of the characterization of housing as purely a consumption asset. There is obviously undertaxed consumption value in preexisting housing that has been untouched by the introduction of the VAT, and in housing that experienced unexpected appreciation since its taxable first sale. The question is whether taxing resale can reach this consumption value. It clearly cannot do so before resale takes place. Our reflection has shown further that on resale, taxation may be either unnecessary or insufficient. It would be unnecessary when the sales price is already determined by the tax-inclusive price of newly constructed housing: Here the buyers' housing consumption choices are not tax favored compared with other consumption choices. And it would be insufficient if consumers only had existing housing to choose from. The incidence of the tax on resale is on the seller. In addition, taxing resale may do harm from a consumption tax theory perspective by creating a lock-in effect for undertaxed housing. The only justification for taxing resale, it seems, is eliminating the differential treatment between new and

⁴³Traditionally, concerns with the distortions (as well as the unfair advantages of deferral) caused by the realization principle have led to proposals for its abandonment and the adoption of mark-to-market or other similar methods of income taxation. More recently, it has been suggested that adopting retroactive taxation can alleviate problems associated with taxing income only when realized. See Noel B. Cunningham, "Observations on Retrospective Taxation," 53 *Tax L. Rev.* 489 (2000). Under retrospective taxation, investments are taxed on their assumed gains on disposition and interest is charged on any deferred tax payments. Proposals of retrospective taxation, however, are largely framed in terms of the need of the income tax only to reach the risk-free rate of return on investment assets. (There is no need to deal with risk premiums because, at least in the idealized settings dealt with in these proposals, taxpayers can adjust their portfolios to neutralize the effect on any taxation on risk taking. And economic profit is generally not considered.) They do not deal with the need to tax consumption and therefore not with the difference between taxing consumption currently or on a pre-collection basis. It thus appears that only a tax that accurately measures and taxes imputed consumption currently (corresponding to the mark-to-market method of income taxation for investment assets) may avoid the lock-in effect created by the pre-collection method of taxing imputed consumption. This, of course, amounts to abandoning the pre-collection method.

existing residences when they sell in the same market for the same market prices. Even if that is a reasonable goal, it cannot be understood as a matter of preserving the integrity of consumption taxation.

In the next section, we examine whether taxing resale may have other defects, particularly in cases when housing is an investment.

Indexing for Risk-Free Returns to Investment

The last section argued that taxing resale is in itself insufficient for bringing into the consumption tax base the consumption value associated with unexpected appreciation in housing value and with pre-VAT housing stock. This is because of the special nature of appreciation (that is, all of it is economic rent) and the special character of existing housing (that is, it is inelastic in supply). Even without these objections, current proposals for taxing housing resale may be criticized for not accurately tracking the value of untaxed imputed consumption. For example, under these proposals, a rise in the consumed value of the property (for example, because of better transportation and other amenities nearby) will not create an additional tax liability, as long as there is no sale of the property. When the property is sold, it is only the rise in its future expected consumption value, not the increased consumption value that has already transpired, that would give rise to any tax liability. Moreover, the difference between the resale value and the original purchase price underestimates the increase in value in future imputed consumption.⁴⁴ Similar observations can be made about situations in which the actual consumption value of a property turns out to be lower than expected (for example, because an expected amenity was not built). These inaccuracies may be tolerated as doing rough justice, if taxing resale served to preserve the integrity of the consumption tax. But the last section of this article suggests that taxing resale may be missing the mark in a more fundamental sense.

This section examines a different type of measurement problem, arising because many home buyers treat their residences as both consumption and investment assets because of the enduring nature of real property and its (perceived) propensity for

⁴⁴For example, if the value of a property at its initial sale is:

$$V_0 = \sum_{t=(0,b)} c_t / (1+r)^t,$$
 (where b denotes the last period of the property's useful life), and if its sales price at time a ($< b$) is:

$$V_a = \sum_{t=(a,b)} c'_t / (1+r)^{(t-a)},$$
 (where c'_t denotes the new expected consumption value for each period after a), then:

$$\Delta V = V_a - V_0 = \sum_{t=(a,b)} (c'_t - c_t) / (1+r)^{(t-a)} - \left\{ \sum_{t=(a,b)} c_t [(1+r)^{-a} - 1] / (1+r)^{(t-a)} + \sum_{t=(0,a)} [c_t / (1+r)^t] \right\}$$

The second term on the right side of the last equation shows the amount of undervaluation.

appreciation. Colloquially, when one purchases a house or apartment, one may consider both its rental value and its resale value. Although a consumption tax should subject to tax the consumption value of the asset — in the form of either actual or imputed rent — the treatment of any pure investment return generated by the asset has to be more carefully considered.

If the arguments against taxing resale contained in the last section of this article are persuasive, these measurement problems are of only secondary interest in evaluating proposals for taxing resale. Nonetheless, examining them closely can help in two ways. First, it clarifies certain debates among VAT specialists, especially regarding whether the same asset can simultaneously have investment and consumption value. Second, it situates, within a larger framework regarding the consumption tax treatment of investments, the concern that housing consumption is undertaxed if resale is not taxed.

Some deny that a residential property can have an investment aspect beyond its consumable aspect. It may be argued that assets are either purely consumption assets or purely investment assets. According to this view, if someone purchases an apartment with the expectation that it will appreciate in value, and the apartment does appreciate in value, the person, whether she lives in the apartment or leaves the apartment empty, should not claim that she holds the apartment only as an investment. She may not derive utility use from the increased value of the apartment before she sells, but that does not mean that the apartment, even before the sale, is not already providing her with increased consumption value. In other words, consumption value does not equal subjective utility. It seems to follow from this view that there is no change in the price of a residence that should not be reflected in the consumption tax base. Conversely, it may be held that other assets are pure investment assets. For example, if one purchases as an investment a barren and undeveloped piece of land that could not be put to personal use, a consumption tax should not burden the purchase of the land at all. Instead, the owner should be allowed to immediately expense the purchase.⁴⁵

Against this view, consider the following example. An apartment is for sale, and for each of the next five years, it is expected to generate zero net income flow — the rental value it generates each year is offset by expenses in the same amount. But a potential buyer, A, believes that the asset may be sold at the end of year 5 for \$100x. Suppose A's

discount rate is 5 percent (we will come back to how to interpret this discount rate). She should be willing to pay up to \$78.35x for the apartment. Suppose that is what A does and that she sells the apartment for the correctly anticipated price of \$100x at the end of year 5.

To make our example more specific, suppose that during the five years of ownership, expenses are incurred for services like repair and maintenance that are taxable under the VAT. Thus, if the property were rented at market value and the landlord was subjected to the VAT for rental receipts, she would not experience any net VAT liability — the input tax credit for repair and maintenance services entirely offsets the output tax. If the property is owner occupied, the landlord effectively would have borne the VAT on her housing consumption for the current period by paying tax on the input service (and not being able to take a credit for the tax).

In this example, the question for the proposal to tax resale is this: If the VAT is imposed not only on the initial purchase price of \$78.35 but also to the resale, how much of the asset's appreciation should be subject to the VAT? If a goal of the consumption tax is not to tax the return to investment, the intuitive answer is none, because the appreciation merely reflects the accrual of investment returns. If the resale were to be subject to tax, appreciation should be excluded from the tax base. One way of doing this is to adjust the initial purchase price of the apartment upward by the appropriate rate of return, say 5 percent. The purchase price so adjusted would be \$100x, and the imposition of the VAT on the resale for \$100x would generate zero tax liability. There would be an amount subject to the VAT on resale only if the resale price exceeded \$100x, the adjusted purchase price.

This example illustrates what should already be clear to many, namely, that an asset can be held for investment and for consumption. One can view homeownership as an investment without denying that the owner may derive consumption value from it. In this respect, housing and other consumer durables are unlike stock and bonds and other financial claims. That is, even though consumer durables are investments in the sense that they are purchases made in expectation of future return, their return consists (whether primarily or partially) in consumption. Further, the example shows that proposals to tax resale must be refined to address the character of housing as investment. The adjustment of the initial purchase price, for example, would not be straightforward if the expected net consumption value of the apartment between the initial sale and the resale is not zero, which is generally the case. If the present value of the first five years' net consumption benefits generated by

⁴⁵Canada allows that treatment of individual ownership of land, at the taxpayer's election. Poddar, *supra* note 4, at 466.

the apartment contributes a positive amount to the initial purchase price, it would not make sense to adjust that portion of the purchase price by a rate of return when computing tax liability upon resale. If one knew what that portion was, one would want to subtract it from the initial taxable purchase price of the asset when taxing resale in year 5, because only then could the appreciation in the apartment's expected consumption value after year 5 be measured. That is, one would have to adjust the initial purchase price both (i) downward for actual consumption transpired and (ii) upward to exclude investment returns from the consumption tax base.

To be consistent with consumption tax theory, proposals of taxing residential resale should exclude the time value return of investment from the tax base. It should also avoid taxing risk taking and nominal increases in asset value resulting from inflation. It may, however, tax the part of investment return represented by economic rent, because there is no objection to that from the perspective of consumption tax theory. Nonetheless, it is not clear that proponents of taxing resale are ready to make the more plausible refinements. For example, Conrad and Grozav⁴⁶ propose taxing resale with inflation adjustments, but Poddar⁴⁷ and Cnossen⁴⁸ make no mention of these adjustments. Just as significantly, Cnossen⁴⁹ suggests that the taxation of resale should allow refunds of previously collected VAT if the housing property loses value, thus effectively requiring the government to share the risk of property price fluctuation with homeowners. By contrast, Poddar does not contemplate compensating homeowners for overcollected VAT due to devaluation after initial sales.⁵⁰

The relationship between proposals of taxing resale and risk taking is noteworthy. Recent scholarship has tended to agree that the consumption tax, just like an ideal income tax, generally does not impose a burden on risk taking.⁵¹ For instance, under a cash flow consumption tax, any amount that is invested rather than consumed would be excluded from the consumption tax base; the amount excluded and the yield it generates would be taxed only when withdrawn from investment for consumption. In effect, the public becomes a partner in the taxpayer's investment activities. Accordingly, the taxpayer may make appropriate portfolio

adjustments to achieve a risk exposure and expected returns similar to what he could obtain had there been no tax (just as he may do so in response to an ideal income tax).⁵² Similarly, under a VAT, at least for business taxpayers, any investment outlays are immediately deducted in the computation of VAT liability. As a result, "the general public shares in the investment and payoffs in proportion to the tax rate[; in] making the investment, the taxable firm considers its share."⁵³ However, the pre-collection method works differently. The investment is fully taxed upfront and there is generally no subsequent taxation. What this implies in terms of the tax burden on risk taking is less often discussed.⁵⁴

In fact, the pre-collection method also avoids taxing risky returns. If two assets, one safe and one risky, sell for the same price, the risky asset should generate higher expected returns. Conversely, if the two assets generate the same expected returns, the risky asset should be cheaper, because the greater risk should be compensated by greater yield. However, when the VAT is pre-collected on the purchase of a consumer durable — or, more generally, when the consumption tax is prepaid on an amount that is used for both investment and deferred consumption — no distinction is made regarding whether the investment is made in a safe or risky asset. The government collects the same amount of tax on the purchase of a safe asset as it would on the purchase of a risky asset sold at the same price. This means that the government is not really pre-collecting the tax that would be due on the periodic returns generated by the risky asset. Those returns, being risky, would have generated on average higher total tax payments, but the government undertakes no similar risk in making a pre-collection; instead, it collects a sum certain. Thus, the pre-collection method avoids burdening risk taking by requiring the taxpayer to remit only the certainty equivalent of amount of the tax that could be expected to be due on the consumer durable/investment asset.⁵⁵ In this case, no adjustment of investment portfolios is needed for investors to maintain their risk profiles.⁵⁶

⁵²Weisbach, *supra* note 51.

⁵³Bradford, *supra* note 20, at 132.

⁵⁴Bradford has pointed out that for imputed consumption taking place in the "tax-exempt household," "the general public does not share in the investment or the return. The investment decision is based on the full cost and the full return." *Id.* The next paragraph in the text further fleshes out this idea.

⁵⁵The conversion to the certainty equivalent amount is at the taxpayer's own rate for discounting risk.

⁵⁶I have not seen a full exposition of this difference of the pre-collection method from the rest of the consumption tax

(Footnote continued on next page.)

⁴⁶Conrad and Grozav, *supra* note 29; see also Conrad, "Commentary on Poddar," 63 *Tax L. Rev.* 471 (2010).

⁴⁷Poddar, *supra* note 4.

⁴⁸Cnossen, *supra* note 1.

⁴⁹*Id.*

⁵⁰Poddar, *supra* note 4.

⁵¹See, e.g., David A. Weisbach, "The (Non)Taxation of Risk," 58 *Tax L. Rev.* 1 (2004); Bradford, *supra* note 20.

Taxing resale, however, deviates from this logic of the pre-collection method. Under Poddar's proposal, the government would be taxing any actual return above the expected return of an asset but would not be compensating for any actual loss if the expected return is not achieved. This changes the payoffs of taxpayers' bets, and it affects choices involving risk in a way that cannot be neutralized through portfolio adjustments. One might be tempted to rationalize that asymmetrical treatment by claiming that for legislative and administrative simplicity, the case of devaluation can be ignored because it is unusual for residential real estate to lose value. The persuasiveness of this claim has been somewhat diminished in many housing markets since the global economic downturn in 2007. Moreover, even if one were willing to accept this claim, the adjustment of the original purchase price when computing the tax liability on resale by the risk-free rate of return and a risk premium is necessary. (In the example given earlier of person A selling an apartment after five years for a 5 percent per-annum gain, the 5 percent discount rate for A is more plausibly understood as a risk-adjusted discount rate and not the risk-free rate.) This is because the government previously had not paid this premium, and sharing risky rewards without paying a premium would clearly burden risk taking, which is inconsistent with the rest of the consumption tax regime and the theoretical goals of consumption taxation.

On the other hand, if, in accordance with Cnossen's proposal, the government were to recognize losses realized on resale, it would then be taking on some risks associated with the asset — a different result than when the government merely collects a sum certain on the initial sale. This does not mean that the normal consumption tax treatment of risk is restored (that is, taxpayers make portfolio adjustments that neutralize any tax burden on risk taking). Instead, some of the distortions of realization-based income taxation may also surface.⁵⁷ For instance, a homeowner may be able to hedge against price fluctuation of his residence and obtain a tax benefit from a VAT refund in the case of loss in value to the residence if either the realization of gain on the hedged position is deferred by the owner or if the gain on the hedged position is

exempt from taxation under a VAT.⁵⁸ Those arbitrage opportunities would create a bias in favor of risk taking, which also deviates from the consumption tax norm of neutrality with respect to risk taking.

Overall, the divergence of the economic structure of proposals of taxing residential resale from the normal structure of the consumption-type VAT may be summarized through the chart on the next page (italicized results in the chart indicate incorrect treatments in light of consumption tax norms). The cells in the top row denote the types of value that may be reflected in investment return: (i) risk-free rate of return, (ii) risky return, (iii) inflationary value, and (iv) economic rent. A consumption tax is generally expected to exempt the first three types of value but bear on the last. Under the normal consumption-type VAT, all acts of consumption can be classified as either (a) deriving from consumer durables or (b) not deriving from consumer durables. Consumption of type (b) is consumption occurring in the same period as the purchase of the consumed good or service, and the VAT, through full expensing for business purchases and full taxation of output, achieves the right mix of tax burden on the four types of investment return (row 2). Consumption of type (a) occurs after the period in which the related durable goods are purchased. The pre-collection method achieves the right mix of tax burden except that it leaves out rent arising after initial purchase (row 3). This is not a surprising result: It has long been recognized that prepayment of consumption tax liability will likely leave economic rent out of the tax base. Proponents of taxing residential resale under a VAT are simply motivated by a significant instance of this gap in the tax base. Their proposed solution, however, calls for a mechanism that would have to differ significantly from both normal VAT applicable to businesses and the pre-collection method on consumer durables. The mechanism is neither prepaid nor postpaid, but the combination of a prepaid approach (taxing initial sales) and a realization-based approach for making up for the defect of the prepaid approach. The realization-based approach, however, means that unrealized, imputed consumption may continue to be untaxed. In addition, it potentially brings types of investment returns other than economic rent into the consumption tax base, which it needs to avoid doing in order to be consistent with

apparatus (that is, in a cash flow consumption tax or under the typical VAT treatment of business taxpayers), despite the wide agreement on the importance of pre-collection for real-world consumption tax implementation.

⁵⁷See Robert H. Scarborough, "Risk, Diversification, and the Design of Loss Limitations Under a Realization-Based Income Tax," 48 *Tax L. Rev.* 677 (1993).

⁵⁸For tax arbitrage opportunities arising under a VAT due to the exemption of certain financial transactions, see Joseph Bankman and Michael Schler, "Tax Planning Under the Flat Tax/X-Tax," Brookings Institution Conference on Taxing Capital Income: Do We? Should We? Can We? (Can We Not?) 19 (Sept. 2005).

	Riskless Rate of Return	Risky Return	Inflationary Value	Economic Rent
Tax on purchases of current consumption	Not taxed (through immediate expensing of non-consumed purchases by businesses)	Not taxed (through expensing and investor portfolio adjustment)	Not taxed since only current consumption value is taxed	Taxed (e.g., compared to a wage tax)
Pre-collected VAT on consumer durables	Not taxed (since tax is equal to fully discounted value of future tax payment)	Not taxed (through collection of a certainty-equivalent of future expected returns)	Not taxed since future consumption is taxed upfront	<i>Not taxed if rent arises post-collection</i>
Taxing resale of consumer durables	<i>Taxed</i> unless adjustment is made to basis	<i>Taxed</i> unless refund is given for realized losses, but incomplete given realization-based taxation	<i>Taxed</i> unless adjustment is made to basis	Taxed

consumption tax norms. But refining the taxation of resale to exclude the risk-free return and inflationary increase in value, and to maintain neutrality with respect to risk taking, would involve complex adjustments that proponents of taxing resale are not committed to making. This is no doubt because, traditionally, the superiority of the consumption tax over the income tax has been understood as resting substantially on its ability to avoid complexities arising from inflation and from realization-based taxation. Typical VAT mechanisms do not need to deal with these issues or with the danger of taxing risk-free return.

It is therefore not surprising that taxing resale will appear alien to many VAT specialists, or that numerous VAT doctrinal objections can be raised against it.⁵⁹ But the fundamental, conceptual challenge to proposals to tax residential resale comes from an economic, as opposed to jurisprudential, perspective.

Fully Taxing Imputed Consumption: Why?

It is useful to reexamine the basic intuition that motivates proponents of taxing resale. Consumable value can arise from labor and investment decisions already made before the introduction of a VAT (or

of any consumption tax). This is illustrated by preexisting housing stock. It may also arise from economic rent, as illustrated by land premia. One might think that all consumable value should be included in the comprehensive consumption tax base, no matter how it arises. This normative thought is likely to be what motivates proposals for subjecting housing resale to the VAT, but it is important to reflect on its underlying justification.

The principle of applying a uniform tax rate to the entire consumption tax base may generally be a useful guide for avoiding tax-induced distortions in consumption choices. It is a good rule of thumb for choosing efficient tax policy. But in some cases — for example, consumable value corresponding to past work and investment decisions and to economic rent that has accrued to the consumer — the guide is not effective regarding the goal of efficiency. At least in theory, taxing that value at a rate of 0 percent, 100 percent, or anywhere in between, would not create behavioral distortions, because the realization of the value does not depend on the taxpayer’s new decisions. From an efficiency perspective, the non-distortive nature of the tax favors its maximal use. Revenue raised by the tax may allow lower rates to be used for distortive taxes; it follows that the theoretically optimal rate should be 100 percent. Certainly, from this theoretical perspective, simply taxing the initial sale of housing may seem too concessive and complacent (even if nearly always politically popular) in leaving out very large amounts of economic rent.

Consumption tax design in general and VAT design in particular are more typically viewed as aiming at neutrality.⁶⁰ They try to offer the least distortive (and practically implementable) versions of a tax that is nonetheless accepted to be distortive

⁵⁹To many VAT practitioners, the method of taxing resale — by giving a credit for VAT paid on the prior purchase — would not feel like the VAT at all, despite the label of a “credit” mechanism. True input tax credit in a VAT is generally designed to ensure that a producer does not bear any of the burden of the VAT charged on inputs. Any deferral of the refund of any excess input tax credit over VAT on output would defeat this purpose by making the producer bear (a part of) the burden of the tax, and an indefinite deferral of the refund of tax paid on the purchase of an asset until its resale would be utterly erroneous. Although the proposed method of taxing resale may also be analogized to the “margin scheme” of taxing used goods adopted in some countries, the analogy is incongruous because the margin scheme is typically used when the prior acquisition was not subject to the VAT (for example, because the acquisition was made from a nonregistered taxpayer).

⁶⁰Poddar, *supra* note 4, at 444, purports to discuss options for VAT treatment of housing by focusing “exclusively on neutrality considerations.”

in some basic fashion — that is, by affecting choices between work and leisure — and not taxes that are completely free of distortions. From this more familiar perspective, leaving out of the tax base consumption value derived from economic rent and past decisions is not objectionable in the sense of leading to behavioral distortions in itself. Specifically, it would not create a bias toward the enjoyment of that consumption value.

The normative case to include this value in the consumption tax base is more likely to be based on distributional concerns or the idea of the ability to pay.⁶¹ Taxing all consumed value, whatever the source, based on the ability to pay is a perfectly

coherent rationale in itself, but it must be noted that the traditional concern with the nontaxation of imputed income/consumption from housing is generally understood to be with inefficiency arising from behavioral distortions. Moreover, the question raised by the last section is whether the goal of comprehensive inclusion of consumable value is achievable under a VAT *without undermining the neutrality of the VAT*. Our analysis suggests that it would be difficult for a realization-based VAT to capture the economic rent accruing to housing without causing all kinds of distortions. It seems that only some type of *current* taxation of housing consumption can avoid those distortions. But current taxation of a durable good like housing would amount to abandoning the pre-collection method and indeed to abandoning the VAT in favor of some form of personal consumption tax.

⁶¹This is essentially the conclusion reached by Millar, *supra* note 4, although the arguments she gave are quite different from what are offered in this article.