How Could Sales of Residential Premises between Otherwise Unregistered Homeowners Be Brought into the VAT Base?

Christine Peacock*

Abstract

In jurisdictions with a value added tax ('VAT'), the normal practice is that sales of existing residential premises are regarded as exempt from VAT, or outside of its scope. Under what is known as the prepaid method, it is assumed that the value of new residential premises at the time of purchase is equal to the use and enjoyment (consumption) of the residential premises. However, a problem with this approach, which has been recognised in the VAT literature, is that the consumption value of residential premises generally appreciates over time (as the property increases in value). Therefore, the value of total consumption of the premises as represented by the general increase in its market value may be greater than its value at the time of first purchase. This is problematic from the perspective that VAT is a consumption tax, and the key economic objective of the VAT is to tax the flow of consumption.

A feature common to much of the literature on the optimal VAT treatment of immovable property is the call for sales of residential premises by unregistered homeowners to be brought into the VAT base, with deferred input tax credits for the initial acquisition. This article will provide further thought regarding this approach. It will suggest multiple ways that VAT could be collected on each sale of residential premises, and provide further discussion regarding the question of the appropriate quantum of input tax credits that should be available as deferred input tax credits. It then questions whether homeowners should be able to claim deferred input tax credits before coming to a conclusion.

* Christine Peacock is a Lecturer in Law at Federation University and a PhD candidate at the University of Canterbury. She has significant industry experience as a GST/VAT specialist, and has worked in the Asia Pacific region and Europe. Christine was previously a Director in Indirect Tax at KPMG Malaysia, and Senior VAT Specialist at the International Bureau of Fiscal Documentation, the world's foremost authority on cross-border taxation.

I INTRODUCTION

Under the theoretical model of VAT,[1] a purchaser of goods would be entitled to claim input tax credits in relation to VAT paid when acquiring those goods.[2] VAT would then be imposed on the annual value of goods as they depreciate and are used. However, to simplify matters, under what is known as the prepaid method, VAT is imposed just once, when goods are originally purchased. VAT on the original purchase is regarded as a measurement of the present value of VAT payable on all future consumption.[3] Second-hand sales of goods by unregistered vendors are not subject to VAT, although, theoretically, later consumers pay VAT, as future consumption is assumed to be built into the price at which second-hand goods are sold. Pomp and Oldman have provided the following example:

> Assume that … A bought a stereo for $1,000 cash, paying a 10 percent sales tax of $100. This year A sells the used stereo to B for $550. … The stereo's tax inclusive cost to A was $1,100 … A sold it for half of the tax inclusive cost ($550 = ½ x $1,100). The $550 that A received on the resale can be viewed as consisting of two parts: $500, half the $1,000 tax exclusive cost of the stereo ($500 = ½ x $1,000) and $50, half of the sales tax paid on its purchase ($50 = ½ x 100).[4]

Use of the prepaid method generally produces the correct result for most goods.[5] However, the problem with this approach when it comes to the VAT treatment of residential premises is that upfront taxation generally does not correspond with the present value of all future consumption. While the value of residential buildings depreciates over time as the buildings waste, the value of residential land underlying the buildings generally rises over the longer term.[6] Any appreciation in the value of residential land, an element in the value of an owner-occupier's consumption, is not captured within the VAT base.[7]

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[1] As VAT is the term most commonly used internationally for this type of consumption tax, it will be the term that will be used in this article.

[2] See Richard Krever, 'Designing and Drafting VAT Laws for Africa' in Richard Krever (ed), *VAT in Africa* (Pretoria University Law Press, 2008) 24.

[3] Christine Peacock, 'Is There a Viable Way to Tax the Consumption of Immovable Property That Is More Consistent with the Economic Objective of the VAT?' (2018) 13(1) *Journal of the Australasian Tax Teachers Association* 336, 338.

[4] Richard D Pomp and Oliver Oldman, 'A Normative Inquiry into the Base of a Retail Sales Tax: Casual Sales, Used Goods, and Trade Ins' (1990) 43(4) *National Tax Journal* 427, 427–8. This example relates to the application of retail sales tax in the US. Van Brederode has also explained that the resale price of a used good includes a fraction of the tax-inclusive price made by the first consumer. See Robert F van Brederode, *Systems of General Sales Taxation: Theory, Policy and Practice* (Kluwer Law International, 2009) 169.

[5] See Peacock (n 3) 338–9.

[6] This is recognised in Wei Cui, 'Learning to Keep the Consumption Tax Base Broad: Australian and Chinese VAT Design for the Housing Sector' in Christine Peacock (ed), *GST in Australia: Looking Forward from the First Decade* (Thomson Reuters, 2011) 369. See also Alan Schenk, Victor Thuronyi and Wei Cui, *Value Added Tax: A Comparative Approach* (Cambridge University Press, 2nd ed, 2015) 409.

[7] In the Mirrlees Review report, it was recognised that the consumption value of housing 'may change a great deal over time. Hence, their up-front price may prove to be a bad approximation to the value of consumption services they eventually provide': Institute for Fiscal Studies, *Tax by Design: The Mirrlees Review* (Oxford University Press, 2011) 380.

Peacock has noted that '[i]t has been recognised in the VAT literature that the theoretically correct approach for VAT purposes would be to include the imputed rent of a house or apartment in the VAT base'.[8] Imputed rent is the residential services that an owner-occupier receives for living in their home.[9] Including imputed rent in the VAT base would involve treating an owner-occupier as if they were supplying those services to themself.[10] VAT would not be charged on the first sale of the residential premises, but instead a value would be placed on those services for a specific period, such as a year, and this value could be updated as the immovable property appreciates. However, it has been recognised in the VAT literature that including imputed rent in the VAT base would involve administrative and political challenges.[11]

A feature common to much of the literature on the optimal VAT treatment of residential premises envisages an alternative approach of bringing sales of residential premises between otherwise unregistered homeowners into the VAT base, with deferred input tax credits for the initial acquisition.[12] The key research question that this article seeks to answer is: 'How could sales of residential premises between otherwise unregistered homeowners be brought into the VAT base?' This article will first review the earlier literature recommending this approach (Section II), before suggesting multiple ways in which VAT could be collected on each sale of residential premises (Section III), and considering issues relating to the appropriate quantum of input tax credits that should be available as deferred input tax credits (Section IV). It then questions whether homeowners should be able to claim deferred input tax credits (Section VI), before coming to a conclusion (Section VII).

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8 Peacock (n 3) 337.

9 Donald B Marsh, 'The Taxation of Imputed Income' (1943) 58(4) *Political Science Quarterly* 514, 514.

10 Sijbren Cnossen, 'Improving the VAT Treatment of Exempt Immovable Property in the European Union' (Working Paper No 10/19, Oxford University Centre for Business Taxation, 2010) 1.

11 See Sijbren Cnossen, 'A Proposal to Improve the VAT Treatment of Housing in the European Union' in Rita de la Feria (ed), *VAT Exemptions Consequences and Design Alternatives* (Wolters Kluwer, 2013) 225, 227; Sijbren Cnossen, 'Global Trends and Issues in Value Added Taxation' (1998) 5(3) *International Tax and Public Finance* 399, 405; Sijbren Cnossen, 'Three VAT Studies' (CPB Special Publication No 90, CPB Netherlands Bureau for Economic Policy Analysis, December 2010); Sijbren Cnossen, 'VAT Treatment of Immovable Property' in Victor T Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol 1, 235–6; Robert F Conrad, 'The VAT and Real Estate' in Malcolm Gillis, Carl S Shoup and Gerardo P Sicat (eds), *Value Added Taxation in Developing Countries* (World Bank, 1990) 102; Robert F Conrad, 'Value Added Taxation and Real Estate' (Discussion Paper No DRD224, Development Research Department, World Bank, February 1987) 25; Rita de la Feria and Richard Krever, 'Ending VAT Exemptions: Towards a Post-Modern VAT' in de la Feria (ed) (n 11) 28; Krever (n 2) 24; Peacock (n 3) 337–8.

12 Cnossen has proposed a tax on sales of residential premises between unregistered homeowners, to be applied on the difference between the selling price and purchase price of residential premises, and levied on the vendor at the time of sale: See Cnossen, 'Three VAT Studies' (n 11) 71–3. The application of this proposal would involve different considerations to the other proposals considered in this article, which involve VAT being imposed on the purchaser of residential premises at the time of purchase, and the homeowner later being entitled to a deferred input tax credit when they sell the residential premises. Therefore, Cnossen's proposal is not considered in this article.

II SUMMARY OF ALTERNATIVE PROPOSALS

First suggested by Conrad in his 1987 stock value added tax (or 'S-VAT') proposal, the idea of bringing sales of residential premises between otherwise unregistered homeowners into the VAT base was restated in a modified form by Conrad and Grozav in 2008. Later variations include Poddar (2009), *Value Added Tax: A Model Statute and Commentary* (1989) ('Model Statute'), van Brederode (2011), and Cnossen (2013).[13]

Conrad's proposed alternative of the S-VAT was one of the earliest proposals recommending that all sales of residential premises be included in the VAT base.[14] He acknowledged that, in theory, a VAT should tax flows of consumption, and that this would imply that VAT should operate as a tax on 'consumption' rather than on 'transactions'.[15] However, he suggested that there is 'no feasible way for the government to determine the value of these periodic rentals other than via some arbitrary rule'.[16] Instead, Conrad proposed that VAT should be payable on all sales of immovable property (including sales of residential premises), and that homeowners would receive the VAT that they earlier paid on the purchase of their residential premises as a refund if they later sell the residential premises.[17] The S-VAT was later modified by Conrad and Grozav's real estate VAT.[18] These authors also proposed that all sales of residential premises should be taxable,[19] and that homeowners should be entitled to claim input tax credits in relation to the purchase of residential premises if they later sell.[20]

Later, Poddar investigated three possible alternative VAT treatments of immovable property that could be considered if the US were to adopt a federal VAT. One of these options (Option A) was similar to the approach advocated previously, under which the resale of residential premises would be taxable, and a homeowner would have a right to claim input tax credits relating to the purchase of residential premises at the time of resale.[21] Poddar wrote:

> Conceptually, this option is the most comprehensive. It addresses the two gaps in taxation of housing consumption … It extends the scope of VAT to the consumption of

[13] See Satya Poddar, 'Taxation of Housing under a VAT' (2009) 63 *Tax Law Review* 443; Committee on Value Added Tax of the American Bar Association Section of Taxation, *Value Added Tax: A Model Statute and Commentary* (Tax Management Education Institute, 1989) ('Model Statute'); Robert F van Brederode (ed), *Immovable Property under VAT: A Comparative Global Analysis* (Kluwer Law International, 2011) vol 37, 1; Cnossen, 'A Proposal to Improve the VAT Treatment of Housing in the European Union' (n 11).

[14] See Conrad, 'Value Added Taxation and Real Estate' (n 11); Conrad, 'The VAT and Real Estate' (n 11).

[15] Conrad, 'Value Added Taxation and Real Estate' (n 11) 1.

[16] Ibid 25.

[17] Ibid 11–12.

[18] Conrad and Grozav acknowledged that the real estate VAT is a modification of the S-VAT proposal: Robert Conrad and Anca Grozav, 'Real Property and VAT' in Krever (ed) (n 2) 90.

[19] Conrad and Grozav noted that '[t]he fact that sales of real property would be taxed implies that all leases would also be taxed under the proposal; an action that would ensure neutrality between the uses of real property': ibid.

[20] Ibid 93.

[21] Poddar (n 13) 453–8. This option (Option A) will be considered in this article, whereas Poddar's Option B and Option C will not be considered in detail. Poddar's Option B was very similar to Option A, except residential rent would not be taxable under Option B, whereas it would be under Option A. Option B therefore would not achieve neutrality between homeowners and lessees. Option C involves regarding sales and leases of residential premises as exempt from VAT, and so it is not relevant to this article.

> existing stock of housing, as well as to any unanticipated future increases in the rental value of new housing units.[22]

The Model Statute, published by the Committee on Value Added Tax of the American Bar Association, included a similar proposal that casual sales by sellers who are not registered for VAT should be taxable, if the consideration that the seller receives exceeds a prescribed statutory threshold.[23] This proposal provided for a deferred credit of the VAT paid when the residential premises were acquired, which would become available at the time that the residential premises are sold.[24] The following example was provided of how this would work (it assumes a VAT rate of 10 per cent):

> Assume Consumer A purchased her home for $100,000 plus $10,000 VAT. She later sold her home for $120,000. Assuming the sale is taxable … Consumer A charges $12,000 VAT on the sale to Consumer B and claims a $10,000 credit … she remits the net $2,000 to the government.[25]

Similarly, van Brederode has proposed that homeowners should pay VAT on all purchases of residential premises. Under this proposal, homeowners would be assumed to use their residential premises for consumption purposes until they sell. At this point, a 'fiscal metamorphosis' would occur, and homeowners would then be regarded as registered for VAT, and able to claim input tax credits relating to the initial purchase of the residential premises.[26]

III How Would the Collection of VAT Occur?

Currently, an entity must be registered for VAT in order to make taxable supplies and receive input tax credits relating to the VAT paid on acquisitions in the course of its business. Generally, in order for an entity to be eligible to register for VAT, a business activity must be carried on, and aggregate taxable supplies made by that entity must exceed the registration threshold.[27] Registered entities must comply with various administrative obligations.[28] For instance, they are generally required to charge VAT on

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[22] Ibid 456.
[23] See Model Statute (n 13) ss 4003(a)(3A) and 4005(a).
[24] See Model Statute (n 13) s 4019.
[25] Ibid 76–7.
[26] Robert F van Brederode, 'Theory and Practice of VAT Treatment of Real Estate' in van Brederode (ed), *Immovable Property under VAT* (n 13) 16.
[27] Williams has explained that 'the law imposing the VAT usually makes it clear that only economic activities are within the scope of the tax. How this is defined varies among laws. Some laws require that the supply be made as part of economic activity, or the business activities of the supplier, or in the course or furtherance of a business carried on by the supplier. Others refer to supplies made by the taxable person acting as such, that is, acting in the capacity as a taxable person making taxable supplies': David Williams, 'Value-Added Tax' in Thuronyi (ed) (n 11) 164, 198. In the European Union, an entity must carry on an 'economic activity': Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International, 2003) 313. In New Zealand, an activity must be carried on 'continuously or regularly': *Goods and Services Tax Act 1985* (NZ) s 6(1)(a). Regarding the registration threshold that generally applies, see Williams (n 27) 171–81 and 60–4.
[28] Terminology used to describe entities that are registered for GST is different in different countries. In Australia, entities registered for GST are generally referred to as registered entities. In New Zealand, the *Goods and Services Tax Act 1985* imposes obligations on 'a registered person': *Goods and Services Tax Act 1985* (NZ) s 8(1). In the European Union, home of VAT, a registered entity is known as a 'taxable person':

the market value of their supplies, and are entitled to claim input tax credits on the VAT that they pay in relation to any acquisitions that they make in the course of their business. They also must submit regular VAT returns, and collect the VAT owing relating to sales of their taxable supplies, and remit this VAT to the tax administration, less any VAT claimable back as an input tax credit.[29]

VAT is not imposed on supplies made in the course of an activity that is regarded as personal.[30] For this reason, homeowners who purchase residential premises to live in those premises are generally regarded as not eligible to register for VAT.[31] Living in residential premises is not generally regarded as satisfying the requirement that there is a business activity being carried on. At first glance, a clear administrative argument against charging VAT on all sales of residential premises is that this would place an increased administrative burden on homeowners. One would think that, in order for sales of residential premises to come within the VAT base, the VAT registration rules would need to be changed in order to elevate homeowners to the status of a registered entity. In this regard, van Brederode has suggested that it would not be 'practically nor politically feasible to register all individuals who sell residential property and charge them with collecting tax from other private individuals'.[32] However, three possible ways in which VAT collection could occur without homeowners having to register for VAT will be outlined below.

The first possible option is that an intermediary could collect VAT on behalf of homeowners. For example, Conrad and Grozav have proposed that all sales of residential premises should be taxable, and homeowners should be entitled to input tax credits in relation to the purchase of residential premises if they later sell. To facilitate this, they have proposed that a 'closing agent, solicitor or tax official would collect and credit the VAT. Thus, VAT collection would not be dependent on whether the person is really a taxpayer in any traditional VAT sense of the term.'[33] Similarly, van Brederode has noted that sales of residential premises:

Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax [2006] OJ L 347/1, art 9 ('EU Directive'). Interestingly, a registered entity is also known as a 'taxable person' in Singapore (*Goods and Services Tax Act 2005* (Singapore) s 2(1)). This is likely to be because of the influence of the UK VAT system on drafters of the Singaporean GST legislation, the UK also being a country where the 'taxable person' terminology is used: *Value Added Tax Act 1994* (UK) s 3(1). The terminology used in the UK presumably comes from the EU Directive (n 28).

29 Sijbren Cnossen, 'A Primer on VAT as Perceived by Lawyers, Economists and Accountants' in Michael Lang et al (eds), *Value Added Tax and Direct Taxation: Similarities and Differences* (International Bureau of Fiscal Documentation, 2009) 138.

30 Williams (n 27) 197.

31 This has been recognised by Cui (n 6) 369; Schenk, Thuronyi and Cui (n 6) 409.

32 van Brederode, *Systems of General Sales Taxation* (n 4) 190.

33 Conrad and Grozav (n 18) 92. It is worth noting that some of the early proposals to include all sales of residential premises in the VAT base did not detail how VAT would be collected when sales of residential premises occur between homeowners who would not otherwise be registered for VAT. Poddar, for example, recommended that the resale of owner-occupied housing be included in the VAT base, but did not address how the VAT on resale would be collected: Poddar (n 13). Likewise, the Model Statute proposed that casual sales above a threshold be regarded as taxable, but did not address how the VAT on such sales would be collected: Model Statute (n 13). As part of his S-VAT proposal, Conrad proposed that VAT should be payable on all sales of immovable property, but '[c]onsumers would not be VAT taxpayers and they

> are generally mediated by legal professionals … involved in title verification and the disbursement of moneys. In most jurisdictions they are already responsible for the collection of transactional taxes, such as transfer or conveyance taxes. It makes practical sense to also charge these mediators with withholding of VAT due as regards a sale of real estate on behalf of the seller.[34]

Van Brederode's view is probably influenced by his experience working in the US. In Australia, homeowners can use either lawyers or conveyancers to assist in property transfers. For example, in the Australian State of Victoria, whilst some homeowners use lawyers to assist in transfers of residential premises, licensed conveyancers can perform tasks that include the transfer of title to the immovable property and the payment of stamp duty that is generally owed on the purchase of immovable property.[35] Whoever handles the transfer of residential property, whether it be a lawyer or conveyancer, may therefore be highly suited to collect VAT owing on the purchase of residential premises from the purchaser, and remit this VAT to the tax administration.

Alternatively, there may be some jurisdictions where it might be more suitable for the collection of VAT from the purchaser to occur not through an individual intermediary such as a conveyancer, but through an agency responsible for the transfer of title. This is the second possible way in which VAT could be collected from the purchaser. In jurisdictions with subnational governments, it might be appropriate for this to be done at a state or provincial level, perhaps in a similar way to how stamp duty may be collected.[36] There are several countries where stamp duty is levied, including Australia, Hong Kong, Singapore and South Africa.[37] However, it should be noted that in recent times there have been tax reviews that have recommended the abolition of stamp duty.[38]

The experience of some agencies in collecting tax revenue relating to when motor vehicles are sold also indicates that it is possible for agencies to perform a revenue collection role. For example, in the US and Canada, payment of sales tax owing on the purchase of used motor vehicles is a precondition to registration, and is regarded as a simple process. In this regard, van Brederode has written that consumer-to-consumer resales of durable goods:

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would never need to file any type of return': Conrad, 'Value Added Taxation and Real Estate' (n 11) 15. Conrad and Grozav's proposal builds upon this idea.

[34] van Brederode, 'Theory and Practice of VAT Treatment of Real Estate' (n 26) 16.

[35] 'Conveyancing work' is defined in the *Conveyances Act 2006* (Vic) s 4. Regarding the payment of stamp duty, see William DM Cannon, 'Fundamental Principles of Stamp Duty' (1996) 19(1) *UNSW Law Journal* 1, 2. Originating from England, stamp duty is described by Cannon as 'one of the most important sources of revenue collection for the States and Territories of Australia': at 1.

[36] For a detailed history of how the Australian states previously collected income taxes, see Peter Mellor, 'Origins of the Judicial Concept of Income in Australia' (2010) 25 *Australian Tax Forum* 339, 344–54.

[37] Jonathan Barrett, 'Property Taxes as a Policy Response to Foreign Investment as a Perceived Cause of Housing Unaffordability' (2018) 13(1) *Journal of the Australasian Tax Teachers Association* 1, 10. Regarding the transfer duty payable in South Africa, see Enid Slack, 'Property Taxation in Australia' in Richard M Bird and Enid Slack (eds), *International Handbook of Land and Property Taxation* (Edward Elgar, 2004) 203.

[38] See, for example, Treasury, Australian Government, *Australia's Future Tax System: Final Report* (2 May 2010) Recommendation 51; Institute for Fiscal Studies (n 7) 403; Productivity Commission, Australian Government, *Shifting the Dial: 5 Year Productivity Review* (Inquiry Report No 84, 2017) Recommendation 4.8. The frequency of recommendations to abolish stamp duty might be increased if all sales of residential premises were subject to VAT.

> that require registration, such as automobiles, motorcycles, boats and campers, are taxed in the majority of states for the single reason that this is a simple matter from an administrative perspective. Payment of sales tax is a precondition for registration, and payment can be made in many states upon registration with the Department of Motor Vehicles.[39]

As van Brederode has noted, similar rules exist in the European Union regarding cross-border sales of new means of transport, such as motor vehicles,[40] to a purchaser in another Member State when they are transported to the other Member State.[41] The example he has provided is of a Belgian consumer ('C1') who purchases a motor vehicle in a private capacity, and pays VAT on the purchase price but does not have a right to claim input tax credits. He purchases the motor vehicle for EUR25,000, plus EUR5,000 in VAT. He later sells the car to his nephew ('C2') in Germany for EUR20,000. The sale of the motor vehicle to C2 means that C1 is regarded as a registered entity.[42] However, because the sale involves a cross-border, intracommunity transaction, van Brederode explains that it is zero-rated in Belgium. C2 then pays VAT in Germany on the purchase price, and C1 is entitled to input tax credits for part of the VAT paid on the original purchase price.[43]

A third possible way to collect VAT on all sales of residential premises might be to leverage off the system, introduced in Australia in 2018, of generally requiring the recipient of a sale or long-term lease by a registered entity of new residential premises or potential residential land to pay the GST payable on that supply directly to the Australian Taxation Office ('ATO').[44] Under this system, the vendor is then entitled to an input tax credit of the amount of GST paid by the purchaser.[45] These rules could be

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[39] See Robert F van Brederode, 'A Normative Evaluation of Consumption Tax Design: The Treatment of the Sales of Goods under VAT in the European Union and Sales Tax in the United States' (2009) 62(4) *The Tax Lawyer* 1055, 1071–2. See also Pomp and Oldman (n 4) 427. In Canada, provincial sales tax may apply when a motor vehicle that was bought through a private sale is registered: 'GST/HST and Motor Vehicles', *Government of Canada* (Web Page, 15 April 2019) <https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/gst-hst-businesses/charge-collect-specific-situations/motor-vehicles.html>.

[40] See EU Directive (n 28) arts 2.2(a) and (b).

[41] van Brederode, 'A Normative Evaluation of Consumption Tax Design' (n 39) 1070–1.

[42] Ibid 1071. See also EU Directive (n 28) art 9.2.

[43] van Brederode, 'A Normative Evaluation of Consumption Tax Design' (n 39). See also EU Directive (n 28) art 172.

[44] ATO, *Purchaser's Obligation to Pay an Amount for GST on Taxable Supplies of Certain Real Property* (LCR 2018/4, 1 July 2018) paras 2, 3, 4 and 15. Australia's former Treasurer Scott Morrison explained that these rules were designed to prevent tax evasion by property developers who may dissolve their business before the GST owing would otherwise become payable: Australian Government, *Treasury Laws Amendment (2019 Measures No 1) Bill 2019 Second Reading*, House of Representatives, 27 February 2018 (Scott Morrison, Treasurer).

[45] ATO, *Purchaser's Obligation to Pay an Amount for GST* (n 44) para 4. Similarly, in Australia, precedent for one-off liabilities on people not otherwise registered for tax purposes exists in the capital gains tax ('CGT') rules. A CGT withholding requirement is generally imposed on purchasers of Australian immovable property, with a market value of AUD750,000, or more where the sale is made by a vendor who is deemed a foreign resident. In this situation, the purchaser must pay 12.5 per cent of the purchase price to the ATO as a foreign resident capital gains withholding payment. The foreign resident can then claim a credit for this amount once they have lodged an Australian tax return for the relevant year: 'Capital Gains Withholding — A Guide for Conveyancers', *ATO, Australian Government* (Web Page, 11 December 2017) <https://www.ato.gov.au/general/capital-gains-tax/in-detail/calculating-a-capital-gain-or-loss/capital-gains-withholding---a-guide-for-conveyancers>.

expanded to require all purchasers of residential premises to pay the GST payable on such supplies directly to the ATO.

IV Assuming Sales of Residential Premises Are Included within the VAT Base, What Is the Appropriate Quantum of Input Tax Credits That Should Be Available to Homeowners?

Generally, entities that are registered for VAT purposes are eligible to claim input tax credits for the VAT that they pay in relation to purchasing taxable inputs, in order to supply taxable outputs. For example, a commercial business that purchases, renovates, then sells buildings would be entitled to claim input tax credits in relation to the VAT that is paid on the purchase of the buildings, and any inputs into their renovation. This results in no net VAT effect to the commercial business, but some administrative burden in terms of the business having to comply with VAT requirements (see Section III).

As the VAT is a consumption tax, and the burden of the VAT rests on the consumer, a consumer purchasing residential premises for a non-commercial purpose is currently not entitled to claim input tax credits in connection with any VAT that they pay relating to the purchase or maintenance of the premises. The authors of the alternative proposals reviewed in Section II all propose, however, that if all residential premises are included within the VAT base, deferred input tax credits relating to the VAT paid in connection with purchasing the residential premises should be available when they are sold.[46]

The proposed deferred input tax credits give rise to questions about whether input tax credits relating to construction costs, alterations and renovations should be claimable. In this regard, Poddar proposed that the quantum of input tax credits claimable should include 'any improvements to the home … other than repairs and maintenance'.[47] This appears logical, as improvements increase the value of residential premises, and under the alternative proposals, the VAT payable relates to this value.

The authors of the alternative proposals appear to use the purchase price as a proxy for the consumption value of residential premises. Applying this logic, it would be consistent with the alternative proposals for deferred input tax credits relating to the VAT chargeable on construction costs of building residential premises to be claimable, as these costs are not unlike the costs of purchasing residential premises that have already been built.

According to Poddar's proposal, input tax credits relating to maintenance costs, including repairs, should not be deductible.[48] Following the logic of the alternative proposals, this appears to be the correct VAT treatment, as presumably, maintenance costs incurred would not result in any increase in the market value of residential premises when another

[46] Conrad, 'Value Added Taxation and Real Estate' (n 11) 11–12; Conrad and Grozav (n 18) 91; Poddar (n 13) 254 (regarding Option A); Model Statute (n 13) s 4019; van Brederode, 'Theory and Practice of VAT Treatment of Real Estate' (n 26) 16.

[47] Poddar (n 13) 454. Millar has also noted that '[p]rovided … the improvements form part of the value of the property when resold … they ought to be creditable because they are taxed as part of the price of the on-going sale': Rebecca Millar, 'VAT and Immovable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences' in de la Feria (ed) (n 11) 253, 277.

[48] Poddar (n 13) 454.

homeowner next purchases them. If residential premises suffered wear and tear, but maintenance costs were not incurred to address this issue, the value of the residential premises might depreciate in recognition of the use and consumption of the residential premises.[49] If maintenance costs were incurred that merely maintained the value of the residential premises, there would be no additional value of consumption to apply VAT to, and no corresponding input tax credits to provide to the homeowner.[50]

It would be important to clearly distinguish between repairs and improvements, as input tax credits should only be available when homeowners incur VAT on the cost of improvements (as it is only improvements, and not repairs, that increase the value of residential premises). Differentiating between deductible repairs and capital improvements for income tax purposes in Australia requires examining the ordinary meaning of these terms, as no legislative definition of what is a 'repair' appears in the income tax legislation.[51] Whilst the ATO has produced a ruling providing guidance on this issue in the context of revenue versus capital expenses,[52] there has been no consideration of this distinction for GST purposes, as GST law does not normally distinguish between capital and revenue expenditures. Whether there is a repair or an improvement in terms of law is a question of fact and degree.[53]

One factor in the context of revenue or capital expenses, which has been considered important in making this distinction by courts in the UK, Australia and New Zealand, is whether the entirety of an asset or just a part of the asset is changed. If the entirety is changed, there is more likely to be a capital improvement. If only a part of the asset is changed, this is more likely to be a deductible repair.[54] However, what will constitute a change to an entirety is not clear.[55] To promote clarity and consistency, perhaps tax legislation, regulations or even tax administration rulings could be adopted to differentiate repairs and improvements by reference to the relative cost of the expense of making a change to residential premises compared to the value of the relevant residential premises. For ease of simplicity, a proxy that could be used for the value of residential premises is its net annual value, which is determined on an annual basis for local tax purposes (see Section VI). The higher the cost of the expense in proportion to its value, the more likely the cost would be regarded as an improvement rather than a repair.

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[49] When discussing the VAT treatment of residential premises, Poddar has recognised that 'any decrease in value is presumed to be attributable to its use or consumption': Poddar (n 13) 455.

[50] In Australia, the costs of repairs to a home owned by an investor are deductible against assessable income: ATO, *Income Tax: Deductions for Repairs* (TR 97/23, 3 December 1997). However, different considerations apply in determining whether a homeowner (who would be regarded as a registered entity under the alternative proposals) should be entitled to claim input tax credits for repair costs.

[51] *Income Tax Assessment Act 1997* (Cth) s 23-10.

[52] ATO, *Income Tax: Deductions for Repairs* (n 50).

[53] This appears to be the case also in New Zealand and the UK.

[54] The distinction between an entirety and subsidiary was discussed in *Lurcott v Wakeley and Wheeler* [1911] 1 KB 905.

[55] For example, in *Elite Investments Ltd v Davstone (Holdings) Ltd* [1980] 1 QB EGLR, the cost of replacing an entire room was found to be a repair, whereas replacement of an entire aluminium cladding of commercial premises in *Credit Suisse v Beegas Nominees* [1994] EGLR 76 was found to be an improvement. Whilst these are cases from the UK, they have often been referred to in Australia and New Zealand in determining whether changes made to an asset are repairs or improvements.

VAT is generally payable in relation to fees charged to acquire property, such as lawyer's fees and conveyancing costs paid in relation to the transfer of title of residential premises, provided that the services are supplied by registered entities, as these are taxable professional services. Input tax credits should be available to homeowners when they incur lawyer's fees or conveyancing costs in connection to the transfer of title of residential premises, as following the logic of the alternative proposals would involve treating the homeowner as a registered entity. Further, incurring lawyer's fees or conveyancing costs would relate to the homeowner's consumption of the residential premises.

It has been highlighted by van Brederode that, where input tax credits are claimable, such as in relation to renovations, 'private individuals would need to keep and maintain records in order to be able to exercise their right of deduction at the time of closing'.[56] On face value, it might seem that this would be likely to result in a large extra administrative burden for homeowners. Tax administrations tend to only require taxpayers to keep general records relating to their tax affairs for a certain number of years. In Australia, for example, taxpayers must keep general tax records for five years.[57]

However, the requirement to keep records for the purpose of claiming input tax credits would not be dissimilar to requirements imposed for capital gains tax ('CGT') purposes. For example, in Australia, a taxpayer's main residence is usually exempt from CGT, but records should still be kept (either in hard copy or electronic format)[58] by homeowners, in case this exemption no longer applies at some point in the future (this might be the case if a homeowner later uses their home to produce income). For CGT purposes, records should be kept of the purchase and sale contract and all expenses relating to the purchase and sale, as well as of all costs of owning the residential premises, and capital expenditures on improvements.[59]

If homeowners do not want the burden of keeping records, they could simply not claim input tax credits.[60] Alternatively, a type of presumptive input tax credit entitlement system could be introduced (or any existing one in operation could be adapted) for the purpose of claiming input tax credits. Zu has explained that:

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[56] van Brederode, 'Theory and Practice of VAT Treatment of Real Estate' (n 26) 16.

[57] 'Keeping Your Tax Records', *ATO, Australian Government* (Web Page, 3 January 2019) <https://www.ato.gov.au/individuals/income-and-deductions/in-detail/keeping-your-tax-records>.

[58] ATO, *Income Tax: Record Keeping and Access — Electronic Records* (TR 2018/2, 14 February 2018). Generally, for Australian taxation purposes, records can be retained in hard copy or electronically.

[59] 'Keeping Records for Real Estate', *ATO, Australian Government* (Web Page, 30 March 2019) <https://www.ato.gov.au/General/Capital-gains-tax/Your-home-and-other-real-estate/Keeping-records-for-real-estate/#Recordsforyourhome>.

[60] Homeowners may opt to not claim input tax credits in relation to minor alterations, for example, but they would probably want to claim input tax credits relating to the purchase price and any major alterations. In Australia, homeowners owning homes for investment purposes would usually already keep records of these costs for CGT purposes. Owners of premises owned for residential premises are generally eligible to claim the main residence exemption: *Income Tax Assessment Act 1997* (Cth) sub-div 118-B.

> [p]resumptive input tax entitlement regimes seek to simplify the calculation of VAT liability by removing the need to record … input tax on all acquisitions and instead allowing qualifying persons to substitute a single presumptive input tax entitlement.[61]

A schedule of amounts claimable under such a regime could be introduced, including items such as a fixed amount for an addition of a balcony, addition of a bedroom, and so on. If homeowners desire to claim more than the fixed amount, they would need to keep records. Obviously, a disadvantage with such a regime would be its inaccuracy. Homeowners would often claim more or less than the VAT that they paid in connection with the improvements. This problem would need to be weighed against the cost of complexity if input tax credits were allowed in connection with the cost of improvements but such a presumptive regime were not introduced.

In some of the proposals considered in Section II, it is envisaged that the claiming of input tax credits be facilitated through the VAT paid in relation to the purchase of the residential premises being recorded on its title. For example, Conrad and Grozav proposed that 'VAT would be recorded as part of the closing documents'.[62] Similarly, van Brederode has suggested that a deferred input tax credit claim could be verified if the VAT paid on purchase was registered 'in the real estate registers that most jurisdictions require either at the local or regional level'.[63]

The Torrens title system of land transfer and registration used in a number of jurisdictions, particularly in Commonwealth jurisdictions including Australia, New Zealand, and some Canadian provinces, could be adapted so that VAT paid on the purchase of residential premises is recorded on the title documents evidencing their ownership.[64] This might be possible, particularly in Australia where GST revenue is collected by the government and distributed to the states and territories as part of Australia's formal system of horizontal fiscal equalisation. In this situation, the states and territories might be interested in keeping records of such information. However, it should be noted that the equity of which states and territories receive which amounts of GST revenue has been an ongoing, contentious issue.[65]

Regarding the quantum of input tax credit claimable, Conrad and Grozav have recommended that:

> inflation adjustments are necessary to adjust the VAT paid at the time of purchase to a current credit at the time of sale. This difficulty can be reduced to some degree by using one cumulative inflation index (presumably the GDP deflator) and publishing the value of that index annually.[66]

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[61] Yige Zu, 'VAT/GST Thresholds and Small Businesses: Where To Draw the Line?' (2018) 66(2) *Canadian Tax Journal* 309, 339. Zu explains how these regimes sometimes apply in the case of small businesses.

[62] Conrad and Grozav (n 18) 90. Earlier, Conrad had similarly proposed that 'when the real estate is sold, the title search (or deed) should contain prior first payment of the tax': Conrad, 'Value Added Taxation and Real Estate' (n 11) 16.

[63] van Brederode, 'Theory and Practice of VAT Treatment of Real Estate' (n 26) 16.

[64] For example, in the Australian State of Victoria, according to the *Transfer of Land Act 1958* (Vic) s 27(1), '[t]he Registrar must keep a Register of land which is under the operation of the Act'.

[65] See, for example, Productivity Commission, Australian Government, *Horizontal Fiscal Equalisation* (Inquiry Report No 88, 2018).

[66] Conrad and Grozav (n 18) 94.

Making adjustments for inflation appears logical, as $1 paid today is not the same as $1 paid in five years' time. However, this would add an extra layer of complexity, especially given that the rate of inflation generally tends to change from time to time. Perhaps there are lessons to learn from the Australian experience with indexing the cost base to take into account the inflationary effect for CGT purposes. As a result of the Ralph Report recommendations, the income tax law in Australia was amended so that it is not possible to index the cost base of CGT assets acquired from 21 September 1999.[67] Instead, a system of discounting the capital gain was introduced.[68] Calculating the discount capital gain is regarded as a simpler step than indexing the cost base for CGT purposes. However, a cost of this system is its inequity. As high-income persons are more able to afford residential premises, they are more likely to take advantage of the ability to discount the capital gain than low-income earners.[69] This inequity could be replicated if the alternative proposals were implemented and homeowners were allowed to claim deferred input tax credits, as it is more likely that such a system would benefit higher-income than lower-income persons.

V Should Homeowners Be Entitled to Claim Deferred Input Tax Credits?

In Section III, a discussion was provided of issues relating to the quantum of input tax credits claimable and how these could be claimed, assuming that homeowners are entitled to claim deferred input tax credits in relation to their purchase of residential premises. However, it will be suggested in this section that if sales of residential premises are included within the VAT base, then homeowners should not be entitled to claim input tax credits. The following example will be used to demonstrate why this is the case. Assuming a 10 per cent VAT rate, a homeowner might purchase residential premises for AUD1 million, pay AUD100,000 VAT and sell the residential premises 10 years later for AUD2 million. If this homeowner were entitled to the full AUD100,000 VAT paid as input tax credits, the neutral net VAT result would not reflect that the homeowner has effectively consumed some of the residential premises over the 10-year period. If the residential premises were a pure investment, then the correct result would be achieved.[70] However, residential premises have both an investment and a consumption component.[71]

[67] See *Income Tax Assessment Act 1997* (Cth) divs 114 and 115; John Ralph, Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (Treasury, Australian Government, 1999) Recommendation 18.1(b) ('Ralph Report').
[68] Ralph Report (n 67) Recommendation 8.2(a).
[69] By virtue of *Income Tax Assessment Act 1997* (Cth) sub-div 118-B, the effect of the main residence exemption is that homeowners generally do not pay CGT when they sell residential premises that they have regarded as their main residence. Therefore, in the context of residential premises, discounting the capital gain generally only applies to individual investors, trusts and complying superannuation funds who have held residential premises for at least 12 months.
[70] Conrad and Grozav have recognised that, consistent with VAT being a consumption tax, '[i]nvestment (savings) are not taxed … Stocks, bonds and other financial instruments are explicitly exempt from VAT taxation': Conrad and Grozav (n 18) 85–6.
[71] Several studies have also recognised that residential premises may have both a consumption and investment component: see Robert F Conrad, 'Commentary' (2009) 63 *Tax Law Review* 471, 473; Conrad and Grozav (n 18) 91; Millar (n 47) 260; Schenk, Thuronyi and Cui (n 6) 409.

It is possible to estimate the value of the consumption benefits that flow from the ownership of residential premises. For this purpose, we assume that homeowners live in the residential premises that they own. The accommodation services that the residential premises theoretically provide to the homeowner have a value that can be measured on a regular basis. For example, the accommodation services provided by residential premises in the Australian State of Victoria could be determined to be the net annual value (or imputed rent). This is calculated to be 5 per cent of the capital-improved value, which is determined on 1 January each year for rating purposes.

As the capital-improved value is determined on an annual basis, it is possible for it to appreciate or depreciate in the following year.[72] VAT could be applied to the net annual value. Using such an approach, homeowners should not be charged VAT upfront on their purchase, as they would pay VAT on an annual basis. They should also not be entitled to input tax credits, as homeowners would have paid the amount of VAT relating to the consumption component of the residential premises. VAT could be collected on an annual basis through an agency, as mentioned in Section III. In Australia, it might be appropriate for the VAT to be collected on a state basis. The State Revenue Offices may be appropriate agencies to collect this revenue, as they hold information on all owners of residential premises, including the purchase price of residential premises, and information for land tax purposes (this tax applies when people own more than one property).

VI Conclusion

Whilst it is possible from an administrative perspective for all sales of residential premises to be brought within the VAT base, and there are multiple ways in which VAT on these sales can be collected, this would give rise to housing affordability concerns. Homeowners would be faced with having to pay VAT on purchases of used residential premises, an area of the property market currently not subject to VAT. The price of used residential premises would be likely to rise if they were included within the VAT base, as the price of residential premises appreciates.

A potential increase in the price of used residential premises as a result of sales of all residential premises being included within the VAT base might be somewhat offset, however, by potential purchasers becoming less interested in purchasing used residential premises. Further, allowing homeowners the ability to claim input tax credits, as per the recommendations in the VAT literature (see Section II), would help to 'sweeten the deal' for homeowners, as the availability of input tax credits might ultimately give rise to a neutral net VAT result for the homeowner. For example, if Homeowner One purchased residential premises for AUD1 million, and sold those residential premises 10 years later to Homeowner Two for AUD2 million, assuming a 10 per cent VAT rate,

[72] Whilst the capital-improved value can fluctuate from year to year, on average over time the value of residential premises in metropolitan cities generally increases. For example, the per annum compound annual increase in the price of residential premises in Melbourne over a 14-year period, calculated using data published by the Australian Bureau of Statistics, is 1.067 per cent: 60.7 (Residential Property Price Index for September 2003 Quarter) x $(1 + x)^{14}$ = 150.4 (Residential Property Price Index for September 2017 Quarter), where x is 6.7 per cent.

Homeowner One would pay AUD100,000 VAT when they purchase the residential premises, but then receive AUD100,000 back as input tax credits 10 years later.

However, the relevant recommendations summarised do not take into account the fact that residential premises have both a consumption and an investment component. Allowing the homeowner full input tax credits would be to treat the residential premises as a pure investment, as there would be no net VAT effect of a homeowner paying VAT on the purchase of residential premises and then later receiving this VAT as a deferred input tax credit. The only significant change that would result from implementation of the relevant recommendations is added administrative complexity regarding the collection of VAT on residential premises, and also particularly regarding the administration of input tax credit claims available to homeowners. The fact that homeowners enjoy accommodation in residential premises and that this accommodation has a value that can be measured on a regular basis would not be taken into account. A better approach would be for homeowners to not be eligible to claim input tax credits, and a more appropriate result would be achieved, from a consumption tax perspective, if the value of residential premises were included in the VAT base on a yearly basis.

Including sales of used residential premises within the VAT base would result in a new revenue stream for the government. Using the details included in the above example, the government would collect AUD100,000 from Homeowner One's purchase, and AUD200,000 from Homeowner Two's purchase. If the proposals discussed in Section II were implemented, these amounts collected would later be returned to homeowners as input tax credits when they later sell the residential premises. However, the amount of VAT revenue that the government would gain each time residential premises are sold would generally increase as the value of residential premises appreciate. The amount of VAT revenue raised by the government from including used residential premises in the VAT base would be greater if homeowners were not eligible to claim input tax credits. As an approximation, using results reported by the Australian Bureau of Statistics for Melbourne in the December 2018 quarter, this would result in the government raising an extra AUD627 million from sales of used residential premises in that region for that quarter (assuming homeowners are not eligible to claim input tax credits).[73]

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