Improving the VAT Treatment of Exempt Immovable Property in the European Union

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Abstract

The treatment of immovable property is one of the most difficult issues under the VATs in the EU. Ideally, rents and rental values should be taxed just like other consumer goods and services, but doing so would present formidable practical difficulties. Under a second-best approach, the value of newly created property is taxed as a proxy for the exempt flow of building services. This implies, however, that future increases (and decreases) in the value of the exempt property are left out of the VAT base. To remedy this defect, this paper recommends the replacement of the current transfer/registration and stamp duties on the sale of immovable property, which are highly distortionary, by a VAT on the increase (decrease) realized at the time of sale. Beyond that, the various VATs can be improved by applying the standard rate to all transactions in or related to immovable property, except the sale of residential premises.

I. Introduction and summary

Most member states of the European Union (EU) levy value-added tax (VAT), transfer duty (also called registration duty), and often stamp duty on transactions in or related to immovable property. While VAT generally is neutral with respect to producer and consumer choices, transfer duty and stamp duty, on the other hand, can be likened to non-neutral cumulative turnover taxes whose burden increases capriciously the more often immovable property is sold. To remove these distortionary cascading effects, the paper recommends that the various transfer and stamp duties imposed on the selling price of immovable property should be converted into a new "transfer duty" on the value added (defined as the difference

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between selling and purchase price) of immovable property, residential or commercial, that is currently exempt, by law or by election. The remaining (conventional) stamp duties on immovable property (and other official acts and deeds) should be abolished.

It is proposed to tax the increase (refund the tax related to the decrease) in the value of exempt immovable property upon sale (since VAT is a transactions tax) at the going rate at which newly created property is taxed. However, since sellers and buyers of exempt immovable property are not registered for VAT purposes in respect of that property, the transfer duty legislation should be retained (to avoid confusion with the main VAT) and its mechanism should continue to be linked to the immovable property registrar's office (*cadastre*). This approach resembles the margin methods applied in connection with the VAT treatment of second-hand goods, such as cars and works of art. The proposal would promote the neutrality and equity of the EU VAT.

If the margin scheme would be adopted, the present and proposed application of VAT to transactions in immovable property can be summarized as follows.

(1) Sales of immovable property between taxable persons are considered a "normal transaction," i.e. VAT is imposed by the seller and a tax credit is available to the buyer.

(2) Sales of immovable property by taxable persons to non-taxable persons also attract VAT (which is included in the sale price) in the normal way, although the purchaser, not being a taxable person, cannot take credit for it.

(3) Sales of immovable property by non-taxable persons to taxable persons attract VAT under the capital goods scheme,[1] which entitles the buyer to a notional VAT credit if he or she opts for taxation.

(4) Sales of immovable property by non-taxable persons to other non-taxable persons are subject to a "reformed" transfer duty, i.e. a surrogate VAT, on the increase (decrease) in the value of the property. It is this reformed transfer duty that is the main subject of analysis in this paper.

These transactions would all be subject to VAT and no other transactions taxes would apply, but the new approach would not preclude the (annual) taxation of the ownership or use of immovable property, or, for that matter, the imposition of net wealth, estate duty and gift tax.

Last but not least, much can be done to improve the VAT treatment of other transactions relating to immovable property. First and foremost, it would be advisable to tax the lease and sale of all immovable property (except previously

[1] Under the capital goods scheme, adjustments are allowed to the initial amount of input tax claimed, which reflect (proportional) changes in the use of capital goods (buildings, computers) for business or private purposes.

occupied residential property) as is done under modern VATs, rather than exempt their lease and sale (except if the property is newly created) as prescribed under the EU's Common VAT Directive (Council Directive, 2006). Secondly, evasion and avoidance can be much reduced by the widest possible application of the standard rate to building land, construction, social housing, renovation and repair.

The remainder of the paper is organized as follows. The second section dwells briefly on the theoretical underpinnings of the VAT treatment of immovable property and its second-best practical application. Next, the third section provides an overview of the various ways in which transactions in immovable property currently are taxed in the EU – under the VAT as well as under other taxes, duties and levies. Subsequently, the fourth section attempts to give hands and feet to the proposal for taxing the increase (decrease) in the value of used residential and exempt non-residential property under VAT.

II. VAT treatment of exempt immovable property

In considering the nexus between VAT, transfer duty and stamp duty, as well as any recommendations for change, it is necessary to dwell briefly on the nature and design of the VAT, particularly as it relates to immovable property.

1. Theoretical considerations

It is widely agreed that the VAT should not distort market-based producer and consumer choices. This goal is served best if the VAT is imposed on the widest possible range of goods and services that are used or consumed by businesses and individuals. Exemptions violate the logic and functionality of the VAT. They distort input choices and harm exports. As an *in rem* tax, furthermore, VAT is ill equipped to influence the overall tax/expenditure distribution pattern for which the income tax and social benefit schemes are better targeted instruments.

These observations apply also to the VAT treatment of immovable property. All transactions in immovable property – land and buildings, residential or commercial, privately or publicly owned – should be included in the VAT base and taxed at the standard rate. This rate should apply to the construction, repair and maintenance, sale, lease or owner-occupancy of new and used immovable property. The VAT's tax credit mechanism should be relied upon to ensure that the VAT sticks only to consumer or end use of the services provided by immovable property, not to business use.

To elucidate the underpinnings of the correct VAT treatment of immovable property, it is instructive to view land and buildings as stocks that can be used for consumption or production purposes (Cnossen, 1996). If immovable property, such as a factory building, is used for production purposes, the services that it generates should not be subject to VAT. Normally, the value of these services will be incorporated in the price of production that, if sold, would be subject to VAT. Moreover, any VAT paid at the time of the purchase of the building should be creditable against the VAT

chargeable on the products made by the factory situated on the property. If there is no VAT on sales, simply because there are no sales, a refund would be due.
From a theoretical point of view, the same treatment should be accorded immovable property that generates housing services. The theoretically most attractive solution would be to register all persons, natural as well as legal, who own or buy residential immovable property for VAT purposes. By purchasing a house or an apartment, these persons would become producers (called taxable persons under VAT legislation) of housing services. In their role as producers, they would subsequently sell the housing services to consumers. These consumers could be lessees who buy the services for consideration, i.e. a rental charge, but it is also possible that the producers would put the dwelling at their own disposal. In other words, as owner-occupiers, they would "sell" the housing services to themselves in their role as occupier-consumers.

The VAT consequences of these events are obvious. The taxable person who buys a bundle of housing services in the form of a dwelling pays VAT on the purchase price, but at the same time, he is entitled to a tax credit (and refund, if due) for the same amount. If he sells the housing services to a lessee, he would have to charge VAT on the amount of the rental. The lessee, being a non-taxable consumer, would not be able to pass the VAT on; he would be stuck with it just like consumers of other services and goods. Similarly, in his role as owner-occupier, the producer of housing services would "charge" VAT on these services, whose value equals the rental value of the dwelling, rendered to himself as consumer. And like the lesser, he would have to remit that VAT (net of any VAT on inputs, such as repair and maintenance services) to the VAT authorities. And just like the lessee, he would be stuck with the VAT on the rental value of his dwelling.

In short, under a pure theoretical VAT, immovable property would always be a producer good.[2] Sales, rentals and rental values, would be taxable and a credit would be available for the VAT on purchase. The treatment of land would not differ from the treatment of buildings. If land generates production services, as in agriculture, it should be treated in the same manner as the factory above. If it is a producer good that generates consumption services because it is used for camping or hunting purposes, then the same reasoning holds as given above in respect of housing services. Feasibility considerations may dictate other solutions, but it seems incorrect to say that land should be left out of the base because it is not a consumer good. The issue is whether land generates (on balance, non-taxable) production services, or (in principle, taxable) consumption services.

2. Practical observations

In practice, the registration for VAT purposes of all owner-occupiers and the computation of all rental values would present formidable administrative (and political) difficulties that a VAT should not take on. But if rental values cannot be taxed, the taxation of rental charges would appear to favour owner-occupiers over lessees. Also, the practical problems of taxing small landlords might be severe. As a

[2] Accordingly, it does not seem useful to view immovable residential property as a combination of a consumption good and an investment good. See Conrad and Grozav (2008).

second-best approach, therefore, all countries with a VAT exempt rental values and nearly all countries rental charges as well. Instead, these countries tax new residential construction. But since the purchase price of a dwelling may be taken to represent the present discounted value of its future services, by extension the VAT on the purchase price may be considered a good proxy for the discounted value of the VAT that should have been levied on the flow of housing services. Thus, owners and lessors of dwellings are indirectly subject to VAT on the consumption of housing services by themselves or by lessees.

The equivalence between a VAT on rents and rental values and the "prepayment" of the same amount of tax through a VAT on the value of newly constructed (non-) residential premises, as well as the subsequent exemption of rents or rental values is illustrated in table 1. Working our way through the example, the value of the newly constructed dwelling is (for ease of calculation) supposed to be €2000, which attracts VAT at 20% or €400, invoiced to the purchaser and payable by the seller to the VAT authorities. However, since the buyer is subject to VAT on the rent that the dwelling fetches or the rental value if he "lets" the dwelling to himself, he is eligible for a tax credit of the same amount. Accordingly, his net VAT liability at the time of purchase in year 0 is nil.

[about here table 1]

Furthermore, in year 1, the rent or rental value can be calculated as the sum of the depreciation in that year, i.e. €50, plus the return on the investment, i.e. 10% of €2000, for a total of €250. Similarly, in year 2, the return is €50 plus 10% of the remaining investment of €1950, i.e. €195, for a total of €245, and so on for the remainder of the lifetime of the building. As shown, in years 39 and 40 (when the building is fully written down) the rents or rental values can be calculated at €60 and €55, respectively. The VAT collected on these rents or rental values in years 1 and 2 is €50 and €49, respectively, and €12 and €11 in years 39 and 40. The present discounted value of the sum of these VATs on all rents or rental values equals €400, the same amount of VAT that was charged on the sale of the dwelling but that was washed out through the tax credit mechanism.

The calculation is much simpler when the dwelling is taxed but rents or rental values are exempt. In this case, VAT is charged on the sale of the dwelling (charged to the buyer, but invoiced by the seller), while rents or rental values are not subject to VAT. The amount of VAT remitted to the tax office is €400, exactly the same as the present discounted value of the VAT collected in years 1 through 40 on the taxable rent or rental value.

3. Putting the equivalence notion into practice

This is a neat result, which shows that the exemption of lessees (and landlords) and owner-occupiers does not favour housing services over the consumption of other goods and services. It debunks the notion that housing services are not taxed, because their current use is exempted. Two approaches can be used to put the equivalence notion into practice: the exemption method and the tax method.

Under the exemption method, prescribed in the EU's Directive on the Common Value Added Tax (Council Directive, 2006), the sale, lease and use of immovable property (residential and non-residential) is, in principle, exempt, but newly constructed buildings, as well as alterations and maintenance of the existing building stock, are taxable without credit for tax. The exemption method needs a definition of specified non-residential use, such as hotel accommodation, boarding houses, camping facilities and parking space – all of which are taxable. Furthermore, since the business use and sale of existing non-residential immovable property also are exempt, an opportunity for optional registration and payment of VAT is desirable to avoid potential discrimination and cascading of tax.

Under the tax method, the sale and lease of all immovable property is, in principle, taxable, but residential rents (and rental values) are exempt (or outside the scope of the VAT), as is the sale of previously occupied residential property (unless sold by a taxable person). This implies that the construction, sale, lease, alteration, and maintenance of all non-residential buildings are taxable. Sales of existing buildings also are taxable, unless such buildings constitute residential property. The tax method requires a definition of residential use (but not of specified non-residential use, unless taxed differentially lower or higher), but optional registration and payment of VAT for commercial purposes does not have to be provided.

Relative latecomers to the VAT, such as Australia, Canada, New Zealand and South Africa have chosen the tax method for the treatment of immovable property. This method seems superior to the exemption approach on the philosophy that exceptions to the first-best VAT treatment of immovable property should be formulated restrictively. The tax method does this by including changes in non-residential property values in the VAT base (if the property is used for taxable purposes), while the exemption method does not do so if no use is made of the registration option. Since the reach of the tax method is greater than the reach of the exemption method, it results in more even-handed and neutral treatment.[3]

Both methods must address the VAT implications of the supply of land, which is traded even less often than buildings are and is used more often for productive purposes in exempt sectors. The EU's 2006 Directive and Canada exempt all land, except building sites. New Zealand, on the other hand, taxes land as a second-hand good.[4] Similarly, Australia taxes land under a modified margin scheme (see below). The VAT treatment of land is closely tied in with the treatment of the agricultural sector. If agricultural activities are exempt, as is the case in the EU, it seems to make

[3] Administratively, however, the tax method is more likely to involve contentious issues about splitting property into residential and non-residential use (for instance, a lawyer having an office at his home), which would occur less often under the exemption method. However, as in Canada, income tax rules can be used to solve most problems.

[4] For the taxation of land in New Zealand, see Harley (2008), and for the treatment of immovable property, Smith (2008). The Australian's GST treatment of immovable property is reviewed by Evans (2008).

sense to exempt land as well. If not, the case for including land in the VAT base is strong.
Neither the tax method nor the exemption method includes changes in residential and exempt non-residential property values in the VAT base. Implicitly, it is assumed that the rate of return (also the discount rate) does not change over the lifetime of the immovable property. Obviously, this is not a realistic assumption. Property values rise and decline with implications for the level of rents and rental values and, by extension, the VAT that, in theory, should be payable on the current use of building services.

4. Conclusions

Three conclusions can be drawn from the discussion of the second-best VAT treatment of immovable property, which can serve as guidelines for practical policy action.

(1) The taxation of newly created immovable property is a good but still second-best substitute for the exemption of rents and rental values, because the approach cannot take account of future changes in property values.[5]

(2) On the philosophy that, basically, VAT should tax all goods and services and that exceptions to this rule should be interpreted restrictively, taxing all immovable property except residential property is a broader and therefore better approach than exempting all immovable property (residential as well as non-residential), except newly constructed property.

(3) Equal treatment of taxed and non-taxable property requires the imposition of a surrogate VAT on transactions in exempt properties between non-taxable persons. The base of this VAT should be defined as the difference between the selling price and the purchase price of the property (net of, ideally, the cost of any subsequent alterations, which have been subject to VAT).

III. Actual VAT treatment of immovable property

Prima facie, the VAT treatment of immovable property in the European Union, highly complex and often obscure, does not easily fit the second-best theoretical framework developed above. This section summarizes the EU rules, as laid down in the 2006 Directive, and reviews the practice in the various member states. Additional or alternative taxes, duties and levies on immovable property transfers also are examined.

1. Common rules

The 2006 Common VAT Directive provides the following rules on the treatment of immovable property (Articles refer to Council Directive 2006).

[5] Also, it discriminates in favour of property existing before the introduction of VAT, if the pre-VAT tax burden on that property was lower than the hypothetical VAT burden would have been.

- The supply of land is exempt (Article 135(1)(k)), except building land (Article 12(1)(b)).
- Building materials, repair, maintenance and construction services are subject to VAT (Articles 14 and 24).
- New buildings (generally, before first occupation) together with the land on which they stand, are taxable (Article 12(1)(a)). Buildings are defined as including any structure immovable to or in the ground.
- Leasing and letting of used immovable property is exempt (Article 135(1)(l)), except hotel and holiday camping accommodation, parking facilities, permanently installed equipment and machinery (immovable by destination), and the hire of safes (Article 135(2)).
- The sale of used immovable property is exempt (see above), but taxable persons are allowed an option to be taxed (Article 137(1)(b-d)). The transfer of property as part of a going concern can be effected VAT free (Article 19).
- Input tax on property expenditure should be adjusted over a period of 5-20 years under the Capital Goods Scheme (CGS) when the property becomes taxable (Article 187).

2. Member state practices

Table 2 provides an overview of the VAT treatment of the construction, lease and sale of new and used property in the 27 member states of the EU (column 1).[6] Few member states apply the standard VAT rate (column 2) without further ado. Clearly, there is substantial variation (allowed under discretionary or transitional rules or by way of derogations) between member states, mainly because of historic, legal, budgetary or intergovernmental tax assignment reasons and the interaction with transfer and stamp duties. Perhaps the best way to try to get a grip on what is going on is to review the process of the creation of new buildings (starting with building land and construction work), move on to social housing and renovation and repair, and from there to leasing and letting, and the sale of used property. Along the way, the major VAT aspects in the various member states are noted.

[about here table 2]

a. Building land and construction

Non-building land is exempt in all member states, except Italy where its sale is exempt 'with credit' (i.e. zero rated), so that taxable persons can recover related input tax. In contrast to the rule prescribed by the 2006 Common Directive, which suggests that building land should be taxed, 14 member states exempt building land along with other land (Table 2, column 3). In Slovakia, building land is exempt, if unless it is supplied in connection with an exempt building. In Finland, Germany, Luxembourg, Portugal and the United Kingdom, developers can opt for taxation, so

[6] For an out-of-date but still interesting survey, see Scammell and Ernst & Young (2003), and Scammell (2004).

that they can recover any VAT incurred in preparing building land for construction purposes.

Construction work on new buildings (column 4) is taxed in all member states, although 10 member states apply a lower rate if the work involves residential buildings (in the Czech Republic and Slovenia this concession is due to expire at the end of 2010). In Luxembourg and Italy, the lower rate is confined to the principal dwelling – in other words, not to second homes, a provision whose compliance may be difficult to monitor. Ireland levies a lower than standard rate of 13.5% on all construction, whether residential or non-residential. Of course, in all member states, the VAT on construction work for new buildings, which are used for taxable purposes and for which the option of registration and taxation (if available) is being used, can be washed out through the tax credit mechanism. In Belgium, building work for a taxable person is subject to a reverse charge, which facilitates enforcement.

It might be expected that the VAT treatment of new buildings (column 5), including the distinction between residential and non-residential buildings, would follow that of the VAT treatment of construction work on new buildings, but this is not always the case. In several countries, the supply of new buildings is exempt. In Finland and Sweden, the exemption implies full taxation, because developers have to pay the full VAT on the "self-supply" of buildings (with credit for input tax) before they can sell them. In Denmark, the purchaser takes on responsibility for the developer's input tax under the capital goods scheme. In the UK, new buildings are only taxed if sold freehold; dwellings attract a zero rate. Some countries include rights *in rem* (rights falling short of outright possession, such as long leaseholds or rights as usufruct) in the VAT base. Various member states define reconstructed or renovated buildings as new buildings, so that they attract VAT.

In Austria, Denmark, Portugal and possibly some other member states too, developers incur cash-flow costs, because they cannot recover input tax until the time of sale of new buildings, although input tax can be recovered if the (non-residential) building is let to a taxable person. Conversely, cash-flow issues arise in Finland for developers who intend to let rather than sell. In most states, the rules for lettings and sales to exempt and partly exempt businesses create VAT costs, including costs for developers.

Some member states, e.g. France and Spain, provide a concessionary VAT rate to social housing (column 6), lower than the reduced rate already applicable to new residential premises. Generally, social housing is defined as housing that is partially or wholly financed by government. Of course, this implies that the lower rate or the exemption can exactly be replicated by an adjustment of the subsidy. In other words, the exception for social housing is redundant, and may result in tax avoidance.

Understandably, renovation and repair services (column 7) are more often taxed at the standard VAT rate than social housing or new buildings, because these services can be used for residential as well as non-residential purposes. Taxation at the standard rate without regard to end-use makes evasion more difficult. The reduced

rate on renovation and repair services regarding old dwellings in Belgium, France, Greece, Luxembourg, the Netherlands and Spain are an invitation to misclassify the end-use and evade VAT.

b. Leasing and letting

The letting of residential premises is exempt in all but two member states (column 8). Apparently, to achieve parity between 'rooms for rent' and hotel accommodation, Austria taxes lettings at 10 percent and Luxembourg at 3 percent. Leasing and letting of non-residential buildings also are exempt under the 2006 Common Directive, but 10 member states tax leasing and letting, while nearly all of the other member states allow the option of registration and taxation. Some states do not have an option to tax, but the exemption for non-residential buildings is so limited that the option would be redundant anyway.

In Hungary, Italy, Latvia, Poland and Spain lettings of non-residential property usually are taxable. Greece and Italy tax the letting of a dwelling by a developer and France the letting of furnished or equipped business premises. Ireland taxes leases of 10 years or more at 13.5% on the agreed sum at the start of the lease. Malta taxes the lettings by a limited liability company to a taxable person, and Belgium finance leases of new buildings used for the taxable purposes of a business.

c. Sales of used property

Sales of used non-residential buildings are also exempt under the 2006 Common Directive. In Hungary, Italy and Poland, however, the exemption is very limited and never applies to business premises. In France, property sales by a property dealer (*marchand de biens*) are taxable, but usually only on the dealer's margin.

All countries, except Greece, Italy and five new accession states have an option to tax, although in Belgium it is of very limited application. Another four states only allow an option for leasing or letting, but not for sales, while in several countries the option is only available if the purchaser or tenant has a certain level of VAT recovery. In various member states, the wide-ranging compulsory taxation of property transactions means that there is less need for an option. A disadvantage is sometimes that a taxable person or landlord cannot opt in advance, and so may not be able to recover input tax until a purchaser or tenant is found.

Member states are required to adjust input tax on immovable property (and other capital goods) over a period of up to 20 years under the capital goods scheme. Most member states have a 10-year period, but do not apply the adjustment to building work. Finland and Ireland do not permit adjustments, but their rules for new buildings deal with many of the same situations where a capital goods scheme might otherwise be applicable.

d. Crazy quilt of taxation

Most likely, there is less alignment in the treatment of immovable property and construction across the EU than in any other area of the EU-VAT. In most member states, the best-practice rule that all transactions in or related to immovable property should be fully taxed at the standard rate is honoured only in the breach. Possible exceptions are Hungary and Poland, which are noteworthy for the limited scope of their exemptions for immovable property. Several infringements of the neutrality criterion can also be noted. As an example, the rules in Belgium militate against speculative development; renovation as opposed to major reconstruction; purchasing second-hand property (because of registration tax); purchasing new property to sell on or to let, other than under a finance lease; the disposal of surplus business premises; and the inter-company letting or sale of existing building (which are exempt with loss of input tax) (Scammell, 2003).

The VAT treatment of transactions in immovable property in the EU would benefit from an examination of the approach found in Australia, Canada and New Zealand. Australia taxes all immovable property transactions, except sales of used residential property (and rents and rental values). A zero rate is applied to farm land and land owned by a taxable person as part of a going concern. In some cases a reverse charge is applicable to purchasers of immovable property, which eliminates potential cash-flow problems. Canada's federal GST treats immovable property in line with Australian practice. A similar approach is followed in New Zealand, which anticipated the VAT treatment found in Australia and Canada.

3. Additional or alternative taxes

All member states levy additional or alternative taxes on the sale or lease of new and used property, although the rationale for these taxes, which have not been harmonised, is weak. Table 3 provides an overview of their prevalence in the EU. Generally, revenues do not exceed 2% of total tax revenue, although Belgium, Ireland, Luxembourg, Malta, the Netherlands, Portugal, Spain and the United Kingdom are notable exceptions. Often the revenues accrue to regional or local governments (last column of table 3), complicating efforts at reform. The taxes can be a significant cost for business.

[about here table 3]

a. Overview

Generally, the taxes shown in table 3 go by the name of transfer duty, registration duty or stamp duty.[7] The difference between transfer duty and registration duty tends to be one of name only. Both are levied on the sale price agreed to between the parties to the transaction or on the fair market value. The same applies to the lands

[7] Elsewhere, the Australian States impose stamp duty on the transfer of immovable property, differentiated by state, property category (principal residences may attract reduced rates) and purchase price. There is no link between the federal VAT and the state stamp duty. In Canada, most provinces impose land transfer taxes, often at graduated rates. New Zealand does not levy transfer or stamp duties that complicate the picture.

and surveys taxes in Cyprus and the tax on legal (civil law) transactions in the Netherlands and Poland. Interestingly, various member states levy tax on new mortgages, which can be viewed as a proxy for the tax on the property which serves as collateral.

Various member states prevent the simultaneous application of VAT and transfer duty. In Cyprus, Germany, the Netherlands and Spain, for instance, transfer duty does not apply if the property transaction is subject to VAT. In Belgium, the registration tax is reduced to a nominal amount if VAT applies, but in the absence of a general option to tax, most sales are subject to higher rates of registration tax. Property sales in Italy are subject to high transfer taxes, which are reduced to a nominal sum if the sale is also subject to VAT. In Luxembourg, sales are subject to transfer tax of 7-10% whether or not they are also subject to VAT. This creates substantial tax costs, including for developers. In Spain, sales in exercise of an option under a finance lease are taxable, which creates costs for tenants who are not fully taxable. In Sweden, developers incur cash flow problems, if they let (adjustments under capital goods scheme) rather than sell property. In France, Italy, the Netherlands, Slovenia and Spain, the application of VAT means that the sale of building land is not subject to transfer duty or that it is taxed at a reduced rate. This may be advantageous, since transfer duty, in contrast to VAT, is a non-recoverable cost.

Nine member states subject residential leases to registration tax or stamp duty. These countries are Austria (1%), Belgium (0.2%), France (2.5%), Greece (3.6%), Ireland (1%), Italy (2%), Luxembourg (0.6%), Spain (0.5%), and the UK (2%). Austria, Ireland, Spain and the UK apply these taxes also to leases of business premises. Portugal treats long leases as sales, subject to transfer tax. Usually, the basis of assessment is the total rents under the lease, but the UK and Ireland assess stamp duty on the annual rent.

Of particular interest for the purpose of this paper are the various taxes levied on increases in property values. Denmark, for instance, imposes tax on the capital gain realized on the sale of immovable property. Although subject to capital income tax, the base of this tax is identical to the base under a VAT levied on the increase (decrease) in the value of exempt property. Also, Denmark imposes a “derestriction” tax on the gain in the value of property whose zoning designation changes from agricultural land to urban or cottage land, which implies permission to built up the land and hence a windfall gain. Similarly, Spain taxes the increase in the value of urban land, and Italy and Latvia have taxes that attempt to capture changes in value due to changes in the zoning designation of land.

The conventional stamp duties on official documents related to transactions in immovable property (and various other dutiable events) are a separate category. Although the rates, often specified by type of event, tend to be low, these duties exhibit the same cascading effects as transfer duties, at least to the extent that they do not represent a consideration for services rendered by government. As table 3 shows, many member states still are enamoured by these anachronistic levies.

b. Evaluation

This brief overview shows that there seems to be little rhyme or reason to the additional or alternative taxes on property transactions in the EU. In Italy, duplication and non-transparency has reached such proportions that the government has legislated a replacement tax (see table 3), purportedly in lieu of the registration duty, stamp duty, mortgage tax, cadastral tax and the duty on official concessions for medium- and long-term loans. Apparently, the duties that are supposed to be replaced are still being levied.

Little, if anything, can be said in favour of the present transfer (or registration) duties which act as cascading turnover taxes on property transactions. The more often a property is sold, the more often transfer duty has to be paid. Also, the transfer duty causes a locked-in effect, i.e. owners will hang on to their property longer than they would if there had been no transfer duty. In economic terms, ownership preferences and risk profiles diverge, similar to a tax on capital gains, and residential mobility suffers. If possible, tax systems should avoid such effects; they are a deadweight loss to the economy. Also, there is an element of double taxation if VAT as well as transfer duty apply, e.g. in the case of a newly built dwelling (subject to VAT), which is subsequently sold by its occupant (subject to transfer duty). Further, no case can be made for levying transfer duty on commercial property – final consumer expenditures should be taxed, not business inputs (unless externalities have to be accounted for).

Generally, there seems to be little pressure for less complexity and greater neutrality in the member states with respect to the taxation of immovable property, perhaps because the taxes are "old" and the European Commission does not provide much guidance. Beyond that, there is the issue that the disparities in the tax treatment of immovable property may be mitigated (or compounded!) by differences in the price and availability of property, differences in land law, the nature and security of tenure, in planning regimes and grant funding, and other factors. In other words, second-best considerations indicate that if one aspect of the treatment of immovable property is changed, all the other aspects should be changed, too. But even with this caveat in mind, there remains a case for improving the nexus between VAT and transfer duties to which I now turn.

IV. Improving the nexus between VAT and transfer duties

It is suggested to adopt a two-pronged approach to promote greater rationality and neutrality in the taxation of immovable property transactions. First, the tax method should be adopted in the EU, i.e. all transactions in or related to immovable property should be taxed, except rents and rental values and sales of residential and exempt non-residential property to non-taxable persons. This method is superior to the exemption method currently in use. The adoption of the tax method should be used to review the rationality of the disparities within member states shown in Table 2.

Secondly, the increase (decrease) in the value of exempt property, residential and non-residential, realized upon sale, should be brought into the VAT base. Importantly, if this margin scheme would be extended to all immovable property currently exempt in the EU, the explicit adoption of the tax method might not be necessary (although it would still be desirable to eliminate other disparities). Presumably, taxable persons then would more readily opt for registration and taxation which would automatically bring the increase (decrease) in the VAT base. Further, it is proposed to retain the transfer/registration duty collection mechanism for the margin scheme applied to transactions in exempt immovable property.

1. Applying the margin scheme to transfers of exempt property

Two situations can be distinguished in implementing the margin scheme for immovable property transactions in the VAT system: sales from non-taxable persons to taxable persons and sales from non-taxable persons to other non-taxable persons. No special consideration needs to be given to sales between taxable persons and by taxable persons to non-taxable persons, since the normal VAT applies.

a. Sales from non-taxable persons to taxable persons

The rationale for VAT schemes for second-hand goods is that their purchase and subsequent sale by taxable dealers, who would pay the full VAT on the sale price without any credit, would involve double taxation. After all, the VAT would be in addition to the old VAT for which no credit would be given. Thus, without good reason, the VAT would deter the re-use of goods and would divert the trade in second-hand goods to private channels. Accordingly, specialization would suffer.

In recognition of this fact, countries with sophisticated VAT systems allow taxable persons in second-hand goods a credit for the tax that may be assumed to be included in the purchase price. This credit can be given implicitly at the time of resale by applying the VAT to the difference between the selling price and the purchase price (second-hand goods method) or by allowing the tax credit immediately against sales at the time of purchase (margin scheme). Under the second-hand goods method, second-hand goods are not held VAT free by dealers, unlike other goods held in inventory. This violates VAT's philosophy, because the dealers incur an interest cost on the VAT until the time that the second-hand goods are resold. In contrast to the second-hand goods method, no interest cost is incurred under the margin scheme. Moreover, like new goods, the tax credit is also available if the dealer decides to use the second-hand good, say, a truck, in his own business.

In terms of technique, margin or second-hand goods methods do what they should do, i.e. eliminate double VAT, if second-hand goods have decreased in value while in the hands of non-taxable persons. Double VAT is eliminated by allowing the taxable purchaser a notional credit for the VAT (t) deemed to be still included in the purchase price, which can be calculated at $t/(1+t)$ of that price. Without a cap to the credit, however, more than the original VAT would be eliminated if the second-hand good had increased in value. Accordingly, the tax credit should be limited to the tax calculated on the purchase price or the selling price whichever is lower.

Generally, the capital goods schemes in the various member states permit this treatment also to sales of immovable property by non-taxable persons to taxable persons in whose hands the property is not exempt.[8] This promotes neutrality, although the periods during which the schemes must be applied are rather short.

b. Sales from non-taxable persons to other non-taxable persons

Apart from the revenue it raises (an important consideration), the only rationale for levying transfer duty on immovable property transactions between non-taxable persons is that the duty resembles a poorly designed surrogate VAT on the increase in rents and rental values associated with increases in property values. These increases are left out of the VAT base due to the "prepayment" feature of the VAT on exempt building services. But if this is its rationale, the base of the transfer duty should be redefined as the difference between the selling price and the purchase price (or some proxy if information on the purchase price is not available) of immovable property traded between non-taxable persons. This difference, which reflects the present discounted value of the increase in building services since the acquisition of the exempt property, should be included in the VAT base and taxed at the standard rate, either at the level of the seller or the buyer of the property through a reverse charge. This would eliminate the cascading effect of the present transfer duty, although the locked-in effect would remain.

The margin scheme (to be distinguished from the second-hand goods method) for immovable property can be incorporated in the VAT (and the transfer duty abolished) or it might continue to be called transfer duty, while retaining the procedures (only for individuals and non-registered entities) currently on the transfer duty statute. Since the new transfer duty should be levied in close cooperation with the administration of the immovable property registrar's office, retention of the transfer/registration duty mechanism for assessing and collecting the new tax probably is to be preferred. Although *de facto* separate taxes, obviously the new transfer tax is a supplemental VAT.

The major advantage of this approach is that it would achieve broad neutrality in the VAT cum (new) transfer duty treatment of taxable persons and non-taxable persons.[9] Basically, all transactions in immovable property between non-taxable persons

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[8] Theoretically, a credit should also be allowed for the non-creditable VAT paid by the non-taxable person on any repairs or alterations of the immovable property during the period in which he held the property. However, this may not be permitted for the obvious reason that it would be difficult to monitor the VAT paid in respect of repairs or alterations. The effect would be limited if major repairs and renovations are considered as supplies of new property.

[9] Of course, the VAT credit (calculated on the original acquisition price) allowed to a taxable person buying immovable property from a non-taxable person might have to be calculated on the basis of a price before the introduction of the VAT, but this may be acceptable on the philosophy that the previous sales tax also applied to construction and because of the enormous increases in property values. Australia introduced a margin scheme to ensure that only post-GST (=VAT) increases in the value of immovable property would be subject to GST. See Australian Government (2010), and C. Peacock, Changes to the Australian GST Immovable Property Margin Scheme," *International VAT Monitor*, September/October 2006, pp. 327-335.

should be subject to the reformed transfer duty, including those by or between governments and non-profit organisations. Also, the increase in value should be taxed if immovable property passes on to heirs and legatees. On feasibility grounds small value increases of, say, €25.000 or an amount which would mirror the current transfer duty exemption, might be exempted. The separate collection of the VAT on the margin (presumably over time confined to residential and non-commercial property) would make it possible to cede the revenue to regional and local governments in lieu of the revenue from the old transfer, registration and/or stamp duties.

c. Other issues

An interesting issue is whether or not the new transfer duty should be refunded if the property is sold below its acquisition cost. In principle, the answer is affirmative. The future value of the housing services embodied in the property has declined and so has the value of future consumption. In practice, the refund issue is unlikely to occur, because as a cash-flow tax the VAT is based on nominal, not real values of properties actually sold. Since the new transfer tax would only apply to transactions between non-taxable persons, any application for a refund should attract the attention of the VAT authorities, which can then check suspicious transaction.

Another issue which may be raised is whether the redesigned transfer duty resembles a capital gains tax. The answer is an unqualified “no”. Although the two taxes are imposed on the same base, i.e. the difference between the sale price and the acquisition price, the new transfer duty is a tax on consumption, whereas the capital gains tax is a tax on income. By analogy, the taxpayer whose gross earnings are subject to income tax and whose earnings after tax, which he spends, are subject to VAT, pays two taxes but is not doubly taxed.[10]

In considering the difference between a realized capital gains and an increase in value added, it may be pointed out that a taxable capital gain represents an ex-post adjustment for past accruals of income. Ideally, the tax should be imposed as the gain accrues rather than upon realization. Accordingly, it would be appropriate to levy interest on the tax on the realized capital gain over the period during which the gain accrued. By contrast, the VAT on the increase in value added should be considered an ex-ante adjustment of the discounted present value of future housing services. Interest or indexing arrangements would, therefore, seem inappropriate. True, the owner-occupier of housing services, whose present value has increased, has benefited from not having had to pay more VAT after he bought the dwelling, but this fortuitous result is inherent to a cash-flow consumption tax under which the VAT on durable consumer goods is prepaid rather than imposed as the services of the durable goods are consumed.

[10] Even the amount of the tax is the same if the income tax rate is expressed as a percentage of income excluding tax, or the VAT rate as a percentage of consumption including VAT. The formula $t_i = t_e (1 - t_i)$ can be used to convert a tax-inclusive rate, t_i, into a tax-exclusive rate, t_e.

2. Abolition of stamp duties

What to do with stamp duties, which are not another name for transfer or registration duties, as in Ireland and the UK? The answer is simple: abolish them. Generally, conventional stamp duties regardless of on what legal documents (deeds, bills of exchange, bonds, leases, marketable securities, etc.) they are imposed are archaic levies, which resemble distortionary, cumulative turnover taxes whose cumbersome administration may well cost more than the revenue collected. Often the duties can be avoided by changing the form in which business is conducted. Evasion is possible by misstating values, by using fake stamps or none at all, particularly on small transactions.

This applies also to stamp duties on leases and/or sales of residential and commercial immovable property, which, as argued above, cannot be rationalized as surrogate VATs on the increase in the value of building services not included in the base of the prepaid VAT. Further, the stamp duty is a poor proxy for government services rendered in the form of roads, sewage services, etc. If government provides services that benefit residents and businesses, direct payments should be preferred or payments based on a close proxy for the services rendered, such as municipal property rates.[11]

In the member states of the European Union, the complete abolition of the remaining stamp duties on immovable property, no doubt, would be welcomed by the business community and show the country that governments are not only interested in levying "more taxes," but also in rationalizing the existing tax system by weeding out nuisance levies. Part of the loss in revenue (very little) would be compensated by an increase in income tax receipts, because the stamp duty would not anymore figure as a deductible cost in ascertaining taxable profits.

[11] A fairly recent study carried out in Australia (Property Council, 2003) stated that the abolition of stamp duty on leases would deliver the following benefits: directly reduce the tax burden on businesses, large and small; reduce the cost of leasing space for business tenants; remove a complicated, onerous tax; remove the uncertainty associated with basing lease duty on forward estimates of rental flows, including the impact of rent reviews that would take place in unknown future circumstances; and remove the reliance on a tax that fluctuates with the property market.

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Table 1. Equivalence of taxation and exemption of rents and rental values

Assumptions: acquisition price of building = €2000; straight line depreciation (40 years) = 5%; rate of return = discount rate = 10 percent; VAT = 20 percent.

Years	*0*	*1*	*2*	*3–38*	*39*	*40*
A. VAT on rents and rental values						
VAT on building	400					
Input tax credit	-400					
Rents/rental values		250	245	….	60	55
VAT on rents/rental values	___	50	49	....	12	11
Total VAT	0	50	49	….	12	11
PDV of VAT	400					
B. No VAT on rents and rental values						
VAT on building	400	-	-			
Input tax credit	0	-	-			
Rents/rental values		250	245	….	60	55
VAT on rents/rental values	___	0	0	0	0	0
Total VAT	400	0	0	0	0	0
PDV of VAT	400					

Table 2. VAT treatment of immovable property in the European Union, 2010

Member State	**Standard rate**	**Construction, repair and maintenance** (residential / non-residential)					**Leasing and letting**	**Sale of used buildings**	**Comments**
		Building land	Construction work on new buildings	New buildings	Social housing	Renovation & repair*	(residential / non-residential)		*excluding materials if lower rate applies
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Austria	20	E	20	E^{o}	20	20	10 / $E^{\o}$	$E^{\o}$	
Belgium	21	E	6 / 12 / 21	21	6 / 12	6* / 21	E / T	$E^{\o}$	*dwelling ≥5 yrs old
Bulgaria	20	20	20	20	20	20	E / T	E / T	
Cyprus	15	E	15	15	15	15	E	E	
Czech Rep.	20	20	10* / 20	10* / 20	10	10	$E^{\o}$	E	*until end 2010
Denmark	25	E	25	E^{oo}	25	25	$E^{\o}$	$E^{\o}$	
Estonia	20	20	20	20	20	20	$E^{\o}$	$E^{\o}$	
Finland	22	E^{o}	22	E^{oo}	22	22	$E^{\o}$	$E^{\o}$	
France	19.6	19,6	19.6	19.6	5.5 / 19.6	5,5* / 19.6	$E^{\o}$ / T	E	*private dwellings ≥2 yrs old
Germany	19	E^{o}	19	E^{o}	19	19	$E^{\o}$	$E^{\o}$	
Greece	19	E	19	19	19 / E	9*/ 19	E / T	E	*old private dwellings;
Hungary	25	25	25	25	25	25	$E^{\o}$	E / T	
Ireland	21	E	13.5*	13.5*	13.5	13.5*	$E^{\o}$	E	*parking rate
Italy	20	20	4* / 10	4* / 10 / 20	4 / 10	10	$E^{\o}$ / T	E / T	*first housing
Latvia	21	E	21	21*	21	21	E / T	E	*first supply
Lithuania	21	21	21	21	21	21	$E^{\o}$	$E^{\o}$	
Luxembourg	15	E^{o}	3* / 15	E	3* / 15	3* / 15	3 / $E^{\o}$	$E^{\o}$	*principal dwelling (or >20 yrs old)
Malta	18	E	18	E	E	18	E / T	E	
Netherlands	19	19	19	19	19	6* / 19	$E^{\o}$	$E^{\o}$	*painting/plastering if >15 yrs old
Poland	22	22	7 / 22	7 / 22	7	7	E / T	E / T	
Portugal	20	E^{o}	5 / 20	E^{o}	E / 5	5 / 20	$E^{\o}$ / T	$E^{\o}$	
Romania	19	19	19	19	19	19	E	E	
Slovak Rep.	19	19 / E*	19	19	19	19	$E^{\o}$	$E^{\o}$	*if supplied with exempt building
Slovenia	20	20	8.5* / 20	8.5* / 20	8.5	8.5	$E^{\o}$	$E^{\o}$	*until end 2010
Spain	16	16	4 / 7	7 / 16	4 / 7	4 / 7*	E / T	$E^{\o}$	*brick laying for repair dwellings
Sweden	25	E	25	E^{oo}	25 / E	25	$E^{\o}$	$E^{\o}$	
United Kingdom	17.5	E^{o} / 17.5	17.5 / 0	0 / 17.5	17.5 / 0	17.5 / 5*	$E^{\o}$	$E^{\o}$	*Isle of Man

Notes: E = Exempt, but E^{o} indicates that developers can opt for taxation and E^{oo} that developers can recover input tax if the building is sold to a taxable person. In columns (8) and (9): T = taxable; $^{\o}$ = option for taxation by taxable persons.

Sources: European Commission, Taxation and Customs Union, VAT Rates Applied in the Member States of the European Union as at 1st January 2010, and "Taxes in Europe" database: Search Results, 2009; and country legislation. The table does not cover all exceptions to the main rules and some information may not be complete.

Table 3. Taxes on Transactions in Immovable Property in the European Union, 2009

Member State	English name	National name	Tax base or object	Most common rate(s)	Revenue yield (2007), % of		Beneficiary government
					Total tax	GDP	
Austria	Real estate transfer tax	Grunderwerbsteuer	Purchase price	3.5% (2% for relatives)	0.56	0.23	Central/Local
	Legal and administrative duties	Stempel- und Rechtsgebühren	Tenancy and loan agreements	Wide range of specific duties	0.70	0.29	Central
Belgium	Miscellaneous duties and taxes	Droits et taxes divers/ Diverse rechten en taksen	Deeds drawn up by notaries and banks	€50 for notaries; €2 for mortgages	1.05	0.46	Central
	Registration, mortgage and court rights	Droits d'enrigstrement, d'hypothèque et de greffe / Registratie-, hypotheek- en griffierechten	Contractual value	10% (12.5% in Walloon Region)	2.33	1.02	Central/Regional
Bulgaria	Taxes on acquistion of property	Данък при придобиване на имущества по дарение и по възмезден начин	Value sssessed by Municipal Council	1.3%-2.6%	1.63	0.55	Local
Cyprus	Lands and surveys taxes	Τέλη που επιβάλλονται και εισπράττονται από το Τμήμα Κτηματολογίον και Χωρομετρίας	Property value or amount of mortgage	3%-8%; 1% on mortgage	1.54	0.64	Central
	Stamp duty	Τέλος Χαρτοσήμων	Value of agreement or standard fee	1.5‰-2.0‰ or €34.17	1.11	0.46	Central
Czech Republic	Real estate transfer tax	Daň z převodu nemovitostí	Transfer price or officially assessed value	3%	0.76	0.28	Central
	Administrative fees	Správní poplatky	Transfers and mortgage deeds	Wide range of specific duties	0.30	0.11	Central/Local
	Fee on building land betterment	Poplatek za zhodnocení stavebního pozemku	Difference in value before and after improvement	Per m^2 specified by municipality	0.00	0.00	Local
Denmark	Registration tax (stamp duty)	Afgift af tinglysning og registrering af ejerog pantrettigehder mv.	Registration of ownership and mortgages	1,400 DKK + 0.6% of sale price (1.5% for mortgages)	1.04	0.50	Central
	Property release duty (derestriction)	Frigørelseafgift på fast ejendom	Increase in value due to change in zoning	40% on DKK 200,000 and 60% on balance	0.00	0.00	Central/Local
	Taxation of the sale of immovable property	Lov om beskatning af fortjeneste ved afståelse af fast ejendom	Sale price minus acquistion cost	Capital income tax rates	..	..	Central
Finland	Transfer tax	Variansiirtovero/ Överlåtelseskatt	Transfer price	4%	0.90	0.38	Central
France	Principal registration duties	Principaux droits d'enregistrement	Higher of price plus charges or market value	7.5%	1.24	0.53	Central/ Regional/Local
Germanuy	Real property transfer tax	Grunderwerbsteuer	Amount of consideration	3.5%	0.72	0.28	Regional
Greece	Real estate transfer tax	Φόρος μεταβίβασης ακτυήτων	Contractual sale price	7%-9%	1.86	0.59	Central/Local
	Stamp duties	Φορολογία χαρτοσήμου	Sales, rents and loans	3%	0.95	0.30	Central
Hungary	Property transfer tax	Vissszterhes vagyonátruházási illeték	Market value	10%	1.16	0.46	Central/Local
Ireland	Stamp duty on property	Stamp duty on property	Contractual consideration	0%-9% (over 1 million)	4.00	1.24	Central

Table 3. Taxes on Transactions in Immovable Property in the European Union in 2009 (continued)

Member State	English name	National name	Tax base or object	Most common rate(s)	Revenue yield (2007) as % of		Beneficiary government
					Total tax	GDP	
Italy	Registration tax on property transfer	Imposta di registro	Market value or estimated rent	0.5%-15% (first house: 3%)	0.97	0.41	Central/ Regional
	Mortgage tax and land registry tax	Imposte ipotecarie e catastali	Amount of mortgatge or value of property	Cadastre: 1%, mortg.: 0.5%-3%, or €168	0.38	0.16	Central/ Regional
	Stamp duty	Imposta di bollo	Deeds and documents	Most common: €14.62	0.79	0.34	Central/ Regional/Local
	Replacement tax	Imposta sostitutiva	Amount of mortgage	2%	0.44	0.19	Central
	Municipal tax on building licenses	Contributi concessioni edilizie	Amount of building cost and town planning	..	0.51	0.22	Local
Latvia	Duty for consolidation of ownership and legal liens in Land Register	Nodeva par īpašuma itiesību un ķīlas tiesību nostiprināšanu zemesgrāmatā	Property value or amount of loan agreement	2% subject to ceiling of LVL30,000	1.20	0.36	Central
Luxembourg	Registration taxes	Droits d'enregistrement	Market value	6%	7.45	2.72	Central
Malta	Duty on documents and transfers - Immovables	Taxxa fuq Dokumenti u Trasferimenti - Immobili	Market value	3.5% (5% for non-residential property)	3.60	1.25	Central
Netherlands	Tax on legal transactions	Belastingen van rechtsverkeer	Market value	6%	2.62	1.02	Central
Poland	Tax on civil law transactions	Podatek od czynności cywilnoprawnych	Market value or amount of mortgage	2% or 0.1%	0.64	0.22	Local
	Stamp duty	Oplata skarbowa	Type of document	Specific	0.16	0.05	Local
Portugal	Immovable property municipal transfer tax	IMT - Imposta municipal sobre as transmissões onerosas de imóveis	Higher of contractual price or taxable value	Rural: 5% Urban: 0%-8%	1.54	0.56	Local
	Stamp duty	Imposto do selo	Higher of contractual price or taxable value	0.8%	3.01	1.10	Central
Slovenia	Real propety transactions tax	Zakon o davku na promet nepremičnin	Selling price	2%	0.43	0.16	Local
Spain	Tax on capital transfers and documented legal acts	Impuesto sobre transmissiones partrimoniales y actos jurídicos documentados	Market value	6%; deeds: specific	4.46	1.65	Regional
	Tax on construction, installation and works	Impuesto sobre Constructiones, Instalaciones y Obras	Value of construction, installation or work	2.4%-4%	0.49	0.18	Local
	Tax on the increase in the value of urban land	Impuesto sobre Incremento del Valor de los Terrenos de Naturaleza Urbana	Increase in value upon sale	Up to 30%	0.36	0.13	Local
Sweden	Stamp duty	Stämpelskatt	Price of property or amount of mortgage	1.5% or 2%	0.63	0.30	Central
United Kingdom	Stamp duty land tax	Stamp duty land tax	Consideration for chargeable interest	1%-4% on sale and 1% on rent	2.03	0.74	Central

Source: European Commission: "Taxes in Europe" database: Search Results, downloaded 9 April 2010. Taxes on ownership and/or use of immovble property found in all member states are not shown. Taxes on transfers by gift or at death and some other duties or levies covered by the legislation also are not shown, but the revenues (which cannot be separated out) are included under yields.

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