Personal, Living or Family Matters and the Value Added Tax

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PERSONAL, LIVING OR FAMILY MATTERS AND THE VALUE ADDED TAX

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EDITORS' INTRODUCTION*

*Periodically, a federal tax on consumption expenditures is suggested as a means of raising revenue, lowering income taxes, discouraging consumption, and encouraging saving. In 1979, Chairman Al Ullman of the House Ways and Means Committee offered the Tax Restructuring Act of 1979,*** *which was designed to institute a value added tax (VAT) in the United States. Such a tax would be levied on the value added to each taxable item in the course of production. The tax would be collected at the point of sale to the ultimate consumer.*

While the introduction of the bill generated much comment, Professor Wright noted that no one had considered the need to define the bases — i.e., the goods and/or services — on which the VAT would be levied. Professor Wright had long been interested in the problems that European countries faced in defining the bases for their value added taxes. That background rendered him particularly well-qualified to analyze the VAT base problems that the United States would confront.

What follows is the only written portion of what Professor Wright had planned as a much wider project. It is set out here with minimal alterations. Professor Wright prepared the numbered footnotes; those with an asterisk were prepared by the editors.

INTRODUCTION

No tax is ever implemented in a manner which is perfectly responsive to the logical implications of its basic purpose. VAT is no exception.

Those who foster this tax basically intend that ultimate tax incidence be suffered only by individuals and then only in the degree to which they dip into society's pool of *consumer-type* goods and services. But their implementing legislation is always designed to fall short of reaching *all* consumer-type goods and services. Ullman's proposed Tax Restructuring Act of 1979 would have been no excep-

* The editors wish to express their appreciation to Professor Wright's Research Associate, Elizabeth Gaspar Brown, for her help in preparing both the editors' introduction and Professor Wright's text.

** H.R. 5665, 96th Cong., 1st Sess. (1979). *See also* 125 CONG. REC. 29,059 (containing a reprint of a press release by Rep. Ullman summarizing H.R. 5665).

tion. Under it, a substantial proportion of all such benefits actually would have been excluded.

Of the wide array of economic benefits which could have been consumed without tax incidence, *imputed* consumer-type benefits (*e.g.*, intra-family household services) were the largest in value. Also enjoying immunity would have been marketplace acquisitions of certain necessities (in order of monetary importance — food, housing, education, and medical care), and annual *imputed* income or benefits from current family *use* (deemed "services") of its own *durable* goods.

I. NON-MARKETPLACE INTRA-FAMILY SERVICES

The Ullman bill conformed to foreign practice in treating the "performance of services"[1] as a "taxable transaction"[2] *if* the transaction itself was of a "commercial-type."[3] However, this category, in the case of individuals, definitely extended only to those transactions carried out "in connection with a *business*."[4] In consequence, as is also true abroad, *intra-family household* services simply would not have been reached by the proposed act.

To accord tax immunity to these services was an important policy determination. These intra-family services make up a large share of all consumed services. Indeed, female homemakers' services alone had an estimated production value of $555.1 billion in 1978,[5] an obviously substantial figure when compared with that year's total *marketplace* consumer expenditures of $1,340.1 billion.[6]

However important, that policy determination was not unexpected. In this country, intra-family services constantly have enjoyed tax immunity, being beyond the reach of state sales taxes as well as the federal income tax.[7] As to the policy implications, in an

1. H.R. 5565, 96th Cong. 1st Sess. § 4003(2) (1979) [hereinafter cited as Tax Restructuring Act of 1979].

2. Tax Restructuring Act of 1979, *supra* note 1, § 4003.

3. Tax Restructuring Act of 1979, *supra* note 1, § 4003.

4. Tax Restructuring Act of 1979, *supra* note 1, § 4004 (a)(2)(emphasis added).

5. Estimated by extending across the nation data compiled for the Phoenix, Arizona Metropolitan area in McPheters, *The Economic Value of a Homemaker in Maricopa County*, 25 ARIZ. BUS., Feb. 1978, at 10-14. The estimate represents an amount equal to 32.7% of personal income otherwise derived from the marketplace in 1978. *See* DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 443 (1979) [hereinafter cited as STATISTICAL ABSTRACT OF THE UNITED STATES] (listing total personal income for 1978 as $1,708 billion).

6. STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 5, at 435.

7. *See generally* B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 80-85 (5th ed. 1980) (a general discussion of imputed income containing an excerpt from W. VICKERY, AGENDA FOR PROGRESSIVE TAXATION (1947)).

abstract sense such an immunity no doubt does tend to encourage a wife to confine her productive activities to the home, prompting some to oppose it — deeming that life-style outmoded and an "unjustified financial burden" on the entire nation.[8]

But probably decisive in preserving the immunity everywhere is the practical problem, if the law were otherwise, of trying to enforce accurate valuations. The task would be insurmountable, beyond the administrative capability of any agency. Such intra-family services are of infinite types and quality, with all normally being performed without any thought of record keeping. They range from the diverse quality of shaves, which men provide themselves, and of lawn maintenance and mechanical work they so frequently perform for the family, to grocery buying, cooking, housecleaning, childcare and sewing more often undertaken by wives (but also with varying degrees of skill, time, and attention).

However, this particular argument, supporting immunity for such services, is scant justification in the case of married couples for the Ullman bill's extension of a comparable immunity to the more than seven billion dollars in *marketplace* transactions involving domestic services performed for households by paid domestic servants numbering, in 1978, 1.4 million persons.[9] However, that extension does put *single* working females who must hire babysitters for their children on a par with those married couples where one spouse personally provides such care tax free.

Technically, freedom from tax on the compensation for such hired household services would spring from the fact that the bill, as does its foreign counterparts, excluded "employees" from the "taxable persons"[10] category with respect to activities engaged in as *employees*. In the more normal setting of an individually owned *commercial* enterprise, this technical exclusion of employees from that "taxable person" category would not result in actually freeing from tax the values the employees add. In that setting, a yet additional or second step occurs. The owner-employer normally includes the employees' compensation as a cost in figuring the employer's own price for his saleable products and, to this, he tacks on an additional amount for his own profit. Then, as a "taxable person," he completes that second step via a "taxable transaction" (sale) in

8. *See* Cuvillier, *The Housewife: An Unjustified Financial Burden on the Community*, 8 J. OF SOC. POL'Y. 1 (1979).

9. STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 5, at 403.

10. Tax Restructuring Act of 1979, *supra* note 1, § 4005(b).

which the ultimate consumer is charged an amount of tax covering *all* of the values added.

This latter second step, so essential to the roundabout way of applying the tax to value added by employees, is *not* reached, however, in the household situation. For the household employer does *not* go on to *sell* the values generated by his household servant and is not, therefore, a "taxable person."[11] Instead, he is the ultimate consumer of what becomes tax free service. Again, by way of contrast, there typically is a separate special provision which does tax the individual proprietor of a *"business"* if he *personally* consumes his own business property or services,[12] but the householder — *as such* — never comes within that provision; as a householder, he clearly is not engaged in a "business."

But in this particular instance, even though the household-employer's immunity clashes with a basic standard of *horizontal equity*, in actual fact little revenue would have been modified so as to bring household employees within the taxable category. For that bill *otherwise* provided a *"de minimus"* exception under which an individual whose taxable transactions did not exceed $10,000 a year could elect *not* to be treated as a "taxable person."[13]

Theory aside, the foregoing indicates that a family that either performs its own household chores or utilizes a servant-employee to that end will suffer less tax incidence than would be incurred if the family had utilized the services of an *independent* entrepreneur. The latter, being a "taxable person" engaged in a "business," would be entering a "taxable transaction" in performing the service, and his invoice to the householder would set forth the requisite tax. Thus, possibly prejudiced, at least in a tax sense, will be those parents who send an infant to an organized profit-making childcare center (in lieu of hiring an in-house babysitter) or who hire a "maid service" instead of a cleaning woman.

II. Family Housing

Out of all the problems created by VAT, those associated with housing not only are troublesome *per se* but apparently also defy any completely satisfactory solution. Each of the four principal alterna-

11. Tax Restructuring Act of 1979, *supra* note 1, § 4005(a).

12. Tax Restructuring Act of 1979, *supra* note 1, § 4033.

13. Tax Restructuring Act of 1979, *supra* note 1, § 4023(a) (Taxpayers can elect not to be treated as a taxable person if their taxable transactions do not exceed $10,000 for the calendar year *and* their taxable transactions for the next year are reasonably expected not to exceed $10,000.).

tive ways in which VAT might deal with housing is defective, but the defects of each do vary in type and, more importantly, in significance.

Listed below are the four methods available to deal with the VAT dilemma posed by housing, followed by a discussion of the problems created by each one:*

(A) Application of VAT's basic pattern without modification; (B) A modification: Taxing all purchases with rents being exempt; (C) A modification: Taxing only rents and, as to owner-occupants, imputed use value; and (D) A modification: Complete exemption.

A. *Application of VAT's Basic Tax Patterns Without Modification*

Application of VAT's normal tax pattern to housing would mean that the sale of a new home to one who intends to be an owner-occupant would be a taxable event, giving rise to a tax on the entire purchase price. A renter, on the other hand, would suffer VAT only on a piecemeal basis, as monthly rent is paid. While his landlord would have suffered a full tax on the entire purchase price at the time he first purchased the new property, that fact actually would not have resulted in any net gain in government revenue. That tax would have been rebated through a credit or refund allowed to the landlord, since his acquisition represented an investment for use in a business (*i.e.*, in an activity regularly engaged in for profit).

But no such credit or refund would be available to an owner-occupant as to the tax he suffered on his acquisition. He would have acquired the home for personal use, as distinguished from the business use.

To apply the foregoing tax pattern (the first of four methods that VAT might use) to housing would create the troublesome problems discussed below.

1. *A Windfall Effect.*

The first but also the least enduring of those problems concerns the large transition-generating windfall which *enactment* of such a tax automatically would accord to all of the *then* present owner-occupants of homes.

Because VAT's collection arrangement is transactional in nature, no tax would be applied to those existing homes resided in by owner-occupants until a *later* time, when those persons finally enter into a

* Editors' Note: Professor Wright finished only his discussion of the first method. The others are presented here only to indicate the direction that the unfinished portion of his work would have taken.

commercial transaction terminating residence in that particular house. In effect, even if VAT would be imposed on their subsequent *post-enactment* sale (or rental) of what then would be second-hand housing, it is their vendee who actually would suffer that tax. Thus, a large proportion of our forty-nine million[14] *pre-enactment* owner-occupants would have enjoyed tax free housing for a *substantial* period. That it would be for a substantial period is evident from the fact that owner-occupants now continue to reside in the same home for a median period of seven years.[15] And this opportunity to continue to reside in a home not burdened with a ten percent VAT might tempt many such persons to live in their then existing stock of homes for a longer period than prior experience would suggest. Further, even now one-fourth of all owner-occupants stay in the same house for over eighteen years.[16]

Thus, the tax preference or windfall for many such persons would involve a substantial amount even though the median value of our existing stock of homes is below the healthy $67,300 median value of 1979's *new* homes.

Moreover, assuming a VAT rate of ten percent, in the case of an owner-occupied home worth $50,000 at the time of enactment, the government is likely to suffer more than mere deferral of $5,000 in tax. Assuming a *stable economy*, when that house is sold, say seven years later, the government's take from the sale is likely to be less than $5,000, for presumably the house's value will have depreciated in the course of the post-enactment period during which the earlier owner-occupant continued to reside therein, resulting in a less than $50,000 post-enactment sale price.

To avoid a windfall to pre-enactment owner-occupants, it would be necessary, at the time of enactment, to impose a *full* value added tax on all of the then existing stock of owner-occupied houses. In all likelihood this would be a political impossibility, given the enormous number of such homes (forty-nine million in 1979) and the further fact that those homes shelter an even greater number of potential voters. Further, except for the then most recent acquisitions, would not the problem of valuing all such homes lead to an administrative nightmare and litigation galore?

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14. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, Annual Housing Survey: 1977, Part A, General Housing Characteristics TABLE A- 1, p.1.[hereinafter cited as Annual Housing Survey].

15. *See* Annual Housing Survey: 1977 Part A *supra* note 14, at 6.

16. *See id.*

2. *Conflict with VAT's Twin Goals.*

A second problem, should VAT's unusual tax pattern be applied to housing, would emerge from what then would become an inherent conflict between VAT's collection arrangement and that tax's twin goals.

VAT's twofold reasons for being are (i) to tax only consumption, thereby (ii) freeing investments or savings from its reach. The conflict in question would be generated because in some transactions a person's investment (or savings) is separated from his consumption *only in time*. VAT's collection arrangement, however, as it impacts on ultimate consumers, is not geared to time as such. It is, as noted before, purely transactional in nature.[17] Thus, a conflict between VAT's twin goals will arise wherever *durable* goods, purchased for immediate personal use (a type of consumption), generate immediate tax incidence on the *entire* value.

Such acquisitions, in varying but often substantial degrees, simultaneously consititute (whether or not deliberately) savings, or an investment which, if that component *alone* had been involved, would not have suffered current tax incidence either because it would be beyond the tax's reach (*e.g.*, corporate stock) or because the buyer would enjoy a credit or refund (property to be used in a business).

Purchase of a new house by one who intends to be an owner-occupant is simply the most dramatic example of a type of transaction which has a *dual* nature — partly consumption, partly investment. Thus, to apply a tax on the *entire* purchase price would build into VAT a relative bias against this particular major form of investment or savings. That it is a major form of investment is evident from the fact that in 1979 owner-occupants' investment in homes represented about twenty two percent of the assets of *all* individuals.[18]

Indeed, the bias against this form of investment would be even greater than appears at first blush, for to tax the *entire* purchase price *immediately* is to tax a much larger sum than even the actual current personal savings component involved in the average purchaser's acquisition of a home. That family's initial personal investment — a mere down payment — represents only a portion of the purchase price. The balance represents a liability (mortgage), not personal

17. Cost of Owning A Home: Going Through the Roof, 87 U.S. NEWS & WORLD REP., Dec. 10, 1979, at 76.

18. Indeed, collection practices aside, from *the consumer's* standpoint, the tax base itself, in contrast to that of an income tax, is also *purely* transactional in character, not being geared to any given tax-reckoning period.

savings. In the business sector, however, the application of VAT to the entire sales price, not merely to an owner-occupant's equity, would not create a comparable problem. The purchaser of property acquired for use in a business would be entitled, more or less immediately, to a credit or refund of the tax which had been paid.

In the end, the argument for taxing the whole (including the investment or savings and also any liability assumed) must rest on the fact that the purchaser, though satisfying twin goals (consumption and investment), in fact has withdrawn from society's pool of resources, for his *exclusive personal* use, the *entire* property. But even this argument ignores the actual transitory nature of the withdrawal: though our owner-occupant originally acquired a fee simple, his *ownership* is never permanent. It bears repeating: the median owner-occupant's period of residency in a particular home is only seven years,[19] following which he may purchase another new and probably larger home and again suffer a tax on the whole price.

Discussed later is the need for sales of such "second-hand" residences to be immunized from VAT in whole or in part so that the first owner-occupants can pass on to their own subsequent vendees, as part of the price, a portion of the earlier paid tax. Otherwise, the purchasers of new homes (for whatever reason) would incur VAT on the full purchase price of their successive purchases — with the median period between purchases being only seven years.

3. *Owner-occupants v. Renters.*

Should VAT's usual tax pattern be applied to new housing, a third problem would emerge from three differences in the impact on an owner-occupant and a tenant. The total net effect would be *unfavorable* to tenants as a class.

However, if viewed in isolation, the first such difference (the *timing* of tax incidence) actually may favor that tenant class. As noted earlier, the purchaser of a new previously unoccupied house would, upon its purchase, pay the entire VAT thereon. If the purchaser is an owner-occupant, the full amount would go into the treasury; if a landlord, the purchaser would be entitled to a refund or credit since the property's acquisition represented an *investment* for *use* in a business (*i.e.*, in a commercial activity regularly carried on for profit). His tenant, however, would enjoy piecemeal deferment of the VAT

19. See E. STEURLE, IS INCOME FROM CAPITAL SUBJECT TO INDIVIDUAL INCOME TAXATION? No. 42 (1980).

attributable to his use, making staggered payments of VAT with each payment of rent as it becomes due.

The tenant's normally attractive opportunity to defer VAT, whether or not ultimately advantageous, clearly would be disadvantageous under two sets of circumstances: during the period immediately following the adoption of VAT and during any period of inflation.

Persons owning their own homes at the time of first enactment would benefit from a previously discussed windfall, *i.e.*, they could continue thereafter to reside in that particular home without ever personally having suffered tax incidence. Renters, on the other hand, would encounter a taxable event on making their first rental payment following VAT's enactment.

Also, during inflationary periods, the timing difference in VAT's impact on the two classes would prejudice the tenant class. Owner-occupants, paying VAT only once, at the time of purchase, will find the amount of tax borne *unaffected* by their homes' *subsequent* inflationary increase in value. Rent, however, presumably increases with inflation, beginning in a given case at that time when a tenant next renewed his typical one-year lease. In consequence, also increasing at that point would be the amount of tax incidence periodically suffered.

Yet another difference between the effects on the two classes (owner-occupants and tenants) may appear, at first impression, to favor the tenant class. Since the latter's payments are periodic and cover only *currently* consumed use value, the typical tenant himself would not suffer tax incidence with respect to the long-term investment component in any given home. In short, he would not pay VAT on that portion of the house's original cost attributable to *future* uses by *succeeding* tenants. A purchaser, on the other hand, even if subsequently able to pass on to a succeeding purchaser (via an adjustment of the sales price) an appropriate part of the VAT previously suffered, will have prepaid the tax on the long-term investment component, since, on his own purchase, the tax paid was measured by the property's *entire* value.

The differential in their respective tax bases, coupled with the timing variation, produces, in terms of effects on the two classes, another important disparity best described by illustration, with the end result being unfavorable to the tenant class.

Assume the following: the economy is stable, a house (land aside) cost $40,000, a landlord acquired it with cash from his own funds, the house had a useful life of forty years, depreciation is most accurately reflected under the straight line method (here, at 2.5% or $1,000 annually), annual real property taxes will equal 2.5% of the *declining* value, and the going market rate of interest is ten percent.

Assume further, a ten percent net profit after expenses, and that both it and all of the foregoing expenses are covered by rents received from succeeding tenants. Over the forty-year period, the tenants then will pay total rent of $142,500 and, under a ten percent VAT, a total VAT of $14,250. In contrast, the owner-occupant, on acquiring in fee simple a comparable $40,000 house, would pay a mere $4,000 VAT.

Although the tenant class pays a much larger amount of VAT ($14,250 v. $4,000), much of the $10,250 difference actually is not prejudicial to the tenant class, arising as it does from the normal disparity between (i) the *present value* (based here on a ten percent discount rate) of the future staggered rents, and (ii) the *actual sum* of those future rents. But, as the table shows, this disparity accounts for the differential only insofar as the rental payments cover two of the three factors:

I Factor	II Actual Dollar amount over 40 years (Renter)	III Present Value of column I at 10% rate (Owner-occupant)
1. 10% Profit on declining value	$82,000	$30,221
2. S.L. Depreciation ($1,000 annually)	$40,000	$ 9,779
3. Total: Profit & Depreciation	$122,000	$40,000
4. 10% VAT attributable to profit plus depreciation totals in line 3	$ 12,200	$ 4,000

Observe from the foregoing table that the $40,000 purchase price paid by our owner-occupant (line 2, column III) precisely equals the *present value* of that portion of the future rents which tenants would pay to cover the landlord's (i) future staggered *profit* and (ii) *depreciation* (the total in line 3, column I, $122,000). Comparably, the $4,000 VAT paid in a single sum by the owner-occupant (at the time of his $40,000 purchase) is the present value of future staggered VAT payments of $12,200 (out of the total $14,250 in VAT payments) which tenants would suffer on that *portion* of their rental payments covering those same two factors (profit and depreciation). Thus, if "time is money," then *to the foregoing extent* the tenant class, though paying a larger actual amount, in reality was not prejudiced. The added amount paid ($12,200 versus $4,000) covering the two previously mentioned factors was nothing more than the "interest" cost of their deferral advantage or, conversely, was the relative "discount" garnered by owner-occupants for their prepayment of tax covering all future use.

No similar explanation, however, is available with respect to the remaining $2,050 of actual VAT payments suffered by the tenants ($14,250 − $12,200 = $2,050). That added amount was attributable to the third factor covered by their rental payments, namely, to the $20,500 in real property taxes which the landlord must pay over the forty-year period. That which was a real property tax *qua* "tax" to the landlord ($20,500) was passed through to the tenant as rent *qua* "rent" and, thus, as such, was a portion of the total amount on which tenants actually would pay a ten percent VAT ($2,050). But to an owner-occupant, the $22,500 in real property taxes paid over the same forty-year period remained a tax *qua* "tax" (being an exaction imposed directly on *him* by government to defray general governmental expenses) and, as such, normally would be exempt from VAT.[20] And to this extent, owner-occupants obviously would have an advantage over the tenant class.

But it must be emphasized that this rests on an assumption about which there is considerable dispute among economists. That underlying assumption, advanced as a theory particularly up through the 1960's, holds that real property taxes are shifted by property owners to those who consume the goods and services derived from the taxed property, *i.e.*, tenants in the case of rental property, consumers in the case of property used by business, commercial, and industrial enterprises.[21]

This assumption normally is not indulged in, however, in the case of *unimproved* land. That the supply of land is finite leads economists quite generally to conclude that the landowner in fact will bear the tax in that, when such a tax is first imposed or increased, the value of his land will fall by the capitalized value of the tax.[22]

Further, in the case of reproducible capital such as housing, yet another basic theory evolved during the 1970's, with the ultimate conclusion turning on the also debated question of whether the sup-

20. *See* note 15 *supra*.

21. The reasoning which follows in the text is valid on a *pro tanto* basis even if it be assumed that landlords, on average, are able to pass through only a portion, say half, of their real property tax.

22. *See* Blake, *Property Tax Incidence: An Alternative View*, 55 LAND ECON. 521 (1979).

ply of savings was responsive to the rate of return. To the extent the supply of savings was so responsive, increases in real property taxes would "discourage new investment" in housing thereby reducing "the supply of new buildings," facilitating increases in rents which, to that extent, passed the tax to tenants.[23] But if the supply of savings was only partly responsive to the rate of return, to the extent it was *not*, the tax would be borne by the owners of *all* capital, as in the case of unimproved land.[24] The pivotal point here is the fact that a VAT will not unfairly discriminate against tenants to the extent the real property tax is not borne by them in the form of higher rents which do suffer VAT.

The cost of repairs and the VAT attributable to such were not included in our illustration. While such costs inevitably are involved in housing, they were ignored here because they normally would be borne directly or indirectly by both classes *and* on a scattered basis. Relatively unimportant is the further fact that piecemeal accommodation of these costs typically will vary somewhat between the two classes.

Nor would the introduction of a mortgage and an interest factor generate significant additional differences between owner-occupants and renters. Our owner-occupant would have paid the same $4,000 in VAT at the time he purchased a $40,000 house even if it had been heavily mortgaged. The fact that he thereafter would have paid interest (thus deflecting what otherwise would have been profit to him) would not have created any additional VAT liability, for such payments are quite traditionally exempt from VAT. While a landlord may be expected to include the cost of interest in the rent charged, that should have little actual effect on the tenant's rent since inclusion of the interest component in his rent should simultaneously serve to reduce the landlord's own net profit component.

23. J. PECHMAN, FEDERAL TAX POLICY 261 (3d ed. 1977).

24. *See* H. AARON, WHO PAYS THE PROPERTY TAX? 39-52 (1975).