Canadian Federation of Apartment Associations

Fédération canadienne des associations de propriétaires immobiliers

CAPITAL GAINS INCLUSION RATE

Feb 27, 2017

The Canadian Federation of Apartment Associations ("CFAA") is the sole national association which represents rental housing providers across Canada. The private rental housing sector provides close to four million rental homes for nine million Canadians.

CFAA is opposed to any increase in the capital gains inclusion rate (CGIR).

This submission addresses:

A. Reasons the capital gains inclusion rate (CGIR) should not be increased.

B. Reasons why any increase in the CGIR should not apply to residential rental real estate (which is rental housing.)

C. If an increase in the CGIR is enacted, steps government should take to mitigate the impact, both generally and on rental housing in particular.

John Dickie President, CFAA president@cfaa-fcapi.org 613-235-0101	David Hutniak Chair, CFAA, and CEO, LandlordBC davidh@landlordbc.ca 604.733.9440 ext. 202

A. Reasons the capital gains inclusion rate (CGIR) should not be increased.

1. Partial inclusion for capital gains is desirable in order to promote investment, especially since investment is necessary for productivity increases.

2. Partial inclusion of nominal capital gains is necessary to offset the effect of inflation. Absent an inflation adjustment or a partial inclusion rate, a tax on capital gains is in large part a tax on capital. Taxes on capital are possible, but they are particularly destructive both of savings and investment. Taxes on capital are disastrous for investment, productivity and the long-term maintenance and growth of the tax base.

3. Partial inclusion for capital gains is desirable in order to compete for capital in the world markets for capital.

4. Over time, increases in the CGIR will erode the tax base, thereby failing to gain much revenue. Over the long term, due to relocation of people, an increase in the CGIR will likely degrade the amount of earned income in the tax base, so that the impact will be more than just on the capital gains subject to tax. Given strong and growing international mobility, and a tax system based on residence, an increase in the CGIR may erode the tax base relatively quickly so that little or no more revenue is produced, but capital investment falls, much to the detriment of Canadians.

B. Reasons any increase in the CGIR should not apply to residential rental real estate (rental housing), nor to REIT units of REITs which predominately hold rental housing

1. **Rental housing competes with home-ownership, which is exempt from <u>all</u> capital gains tax.**
2. Increases in the taxes on residential rentals would tend to raise rents, making rents less affordable, even though people paying rent are usually in the lowest two income quintiles. In effect, **increasing taxes on rental housing would be taxing the poor** rather than taxing the rich.[1]
3. Unlike shares in companies, **investment rental property is widely held.** People with capital gains look like they have high incomes because 50% of the gain is counted as income. When you remove their capital gains (which usually occur only once every five or ten years), their incomes are much more like average incomes. Finance Canada could provide up to date figures, but in the tax year 2005, when CFAA last obtained a special run from CRA, 65.9% of those who reported capital gains on rental real estate has less than $50,000 per year in income other than those gains. Those filers realized 57% of the dollar value of all such gains.[2] The income figures would be higher now, but the distribution through the income quintiles should be similar.
4. Rental housing typically has long hold periods, over which there is often much inflation.
5. A higher CGIR on rental housing and other rental real estate would make compact, environmentally friendly urban redevelopment more difficult than it is today, because the "lock-in" effect of capital gains tax encourages owners to hold their real estate assets even though the highest and best us of their land may be for re-development.
6. A higher CGIR on rental housing would raise the barriers to relocation by owner-managers, and lead to more landlords who do not live at or near their properties than is the case today.
7. A higher CGIR on rental housing will reduce the investment in rental housing, making current supply shortages worse and putting upward pressure on rents. That will raise demands for government spending to promote affordable housing.

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[1] Rental housing providers compete for capital in the various capital markets, both within and outside Canada. The capital and asset markets keep the risk adjusted after-tax rate of return at a similar level for different investments. Since gross returns (income and capital gains) are subject to tax before the after-tax rate of return is generated, that means that higher taxes on rental housing returns have to be paid by the consumers of rental housing, namely residential tenants.

One might think that an increase in the CGIR across-the board would not impact on the gross return, but rental owners are able to adjust their investment into their asset to reflect the returns which are achievable. The short term impact would be less capital repairs and upgrades. The long term impact would be less investment in new rental housing. The former would reduce rental quality. The later would increase rents. Equilibrium would be achieved when the increases in before-tax returns (i.e. rents) offset the higher tax rates generated by the increase in the CGIR.

[2] Those figures are reported at page 4 of the Canadian Real Estate Association submission entitled "Reinvestment in Real Property", Jan 25, 2008, found at https://cfaa-fcapi.org/pdf/CREAreinvestCapitalGBroch0801.pdf

C. If an increase is applied, steps government should take to mitigate the impact generally and/or on rental housing

Any increase in the capital gains inclusion rate on rental housing would be devastating for the rental housing industry. However, if an increase is enacted, then it would be important that the change be made fairly and prospectively rather than retroactively or retrospectively. Here are measures that would make the negative impacts of an increase in the CGIR less problematic, although such a reform would still be highly problematic for the sectors to which it applies.

Measures for any increase
1.Capital gains tax increases should apply only to gains after a current Valuation date
Provides fairness by avoiding an increased tax on past gains (was done when CG were first taxed, but not for the increase to the 75% rate)
2.Provide an inflation adjustment in exchange for the higher inclusion rate
This is necessary for fairness and also to avoid the higher inclusion rate turning into a tax on capital. Taxes on capital are possible, but they are particularly destructive both of savings and investment. Taxes on capital are disastrous for investment, productivity and the long-term maintenance and growth of the tax base.
Measures to target the increase away from rental housing
3.Provide different CGIRs for different types of capital gains (e.g. 25% for residential real estate, 50% for commercial real estate, 75% for stocks)
This would enable the government to target the capital gains tax at areas which the government wants to discourage, as opposed to those it wants to encourage. For example, industries which generate a lot of GHGs or provide relatively low value add could face a higher inclusion rate. Examples would be the oil sands and extractive industries generally. Industries the government want to encourage could face lower rates. Examples could be green technology and rental housing.
4.Provide different CGIRs depending on the time frame during which the gain has occurred (e.g. at 100% for a hold period of less than one year, at 75% for a hold period of one to two years and at 50% for a hold period of longer than two years
Gains earned very quickly feel more like income than capital gains. In fact, gains on short term stock trading are considered to be income. This idea would extend the definition of short term, and introduce a mid rate (of 75%) between those gains which are included in income at 100% and those included at 50%.
As well, gains earned quickly need less (or much less) compensation or adjustment for inflation.