TAX DEFERRAL ON REINVESTMENT– FACTS AND RECOMMENDATIONS

September, 2008

Under the current Canadian federal income tax rules, when a rental real estate property is sold, the owner must pay tax on the recaptured CCA (at up to 48%) and on any nominal capital gains (at up to 24%). Capital gains are not adjusted first for inflation, and therefore much of any gain may be eaten up by inflation, even before the tax is applied. Due to the tax impact, an even trade of properties of the same value is not possible. The inability to defer the tax burden on the sale and reinvestment in rental real estate creates numerous economic problems and inequities.

The Canadian Federation of Apartment Associations and many other groups propose that the Canadian tax system be changed to allow rental property owners to defer the tax on the sale of a property if the proceeds of a sale are reinvested in a replacement property within 12 months of the sale. Tax deferral on reinvestment is advocated by the Canadian Real Estate Association, the Real Property Association of Canada, the Ontario Non-Profit Housing Association, the Federation of Canadian Municipalities and the Canadian Chamber of Commerce. The latter three groups are quoted on page 4.

To allow tax deferral on reinvestment is not a tax reduction; rather it is merely a tax deferral. The tax on capital gains and the recaptured CCA will ultimately be paid. The proposal is only to defer the tax, and only if the proceeds of a sale are reinvested in a replacement property within 12 months of the sale. On that basis, no capital gains have been realized; only an exchange of properties has taken place. Moreover, given that a lower undepreciated capital cost will apply, the taxes received on the income from the replacement property will be higher than they would be without the deferral.

Benefits of Tax Deferral on Reinvestment – In Summary

Allowing tax deferral on real estate reinvestment would:

1. Reduce the cost of rental housing, and improve affordability and housing supply
2. Promote efficient capital allocation across the economy
3. Promote more compact, environmentally sound urban redevelopment
4. Help small investors and middle-income families
5. Permit relocation by owner-managers
6. Level the rules between rental property and other businesses
7. Level the rules between businesses which rent and which own their premises
8. Level the rules between rental property and shares in companies
9. Provide fairer and more efficient help in promoting rental housing development than construction subsidies.

Benefits of Tax Deferral on Reinvestment – In Detail

Allowing tax deferral on real estate reinvestment would:

1. Reduce the cost of rental housing, and improve affordability and housing supply

When producers of a product are more heavily taxed, the price charged to consumers is increased. Rental property is no exception. Because rental property owners cannot defer taxes, they incur immediate tax costs on any property reinvestments, and in the long run those costs are passed on to tenants in the form of higher rents. Lower costs will result in lower rents (i.e. improved affordability) and a larger supply of rental housing.

Allowing tax deferral would facilitate rental property sales and purchases. Because they come with "fresh eyes," new owners frequently see ways to improve rental properties. With the ability to defer tax on capital gains upon reinvestment, existing owners will likely become buyers of new rental properties for several reasons: they may want to buy a building in a new area; to acquire a property with fewer maintenance requirements or to change the size of their holdings. That will tend to improve the use and maintenance of both the property that is sold and the property that is bought.

2. Promote efficient capital allocation across the economy

The absence of a tax deferral on reinvestment creates a "lock-in" effect; in other words, to avoid negative tax consequences, investors retain real estate assets when other assets would provide a higher return. That is a drag on the economy, and results in lower economic growth and less productivity across Canada. Allowing tax deferral would eliminate that effect.

3. Promote more compact, environmentally sound urban redevelopment

The lock-in effect also inhibits the redevelopment of land in urban areas. It discourages the redevelopment of significant pieces of land into their most productive uses, contributing to urban decay and to urban sprawl. In this regard, Mayor Hames of the City of Chilliwack wrote this to the Chilliwack & District Real Estate Board in November 2007:

> The City of Chilliwack has been working to rejuvenate its aging downtown for many years. We have … attempted to assemble property in order to facilitate development. Unfortunately, some property owners have owned their properties for many years and are not willing to sell their rental properties even at prices above market value because they would have to immediately pay significant taxes on the capital gains created. The proposed change that would allow a property owner to defer capital gains by transferring the gain to a new property would greatly assist the City of Chilliwack in stimulating the redevelopment of its aging downtown.

Allowing tax deferral would facilitate the rehabilitation of brownfield sites and compact, environmentally sound redevelopment in cities.

4. Help small investors and middle-income families

Investment rental property is very widely held, much more widely held than shares in public or private companies. For example in 2005, 66% of those who reported capital gains on rental real estate had less than $50,000 per year in income other than those gains. For those people the gains averaged $40,000 each. Allowing tax deferral on reinvestment would help middle-income families increase their retirement savings.

5. Permit relocation by owner-managers

Rental property owners have the same relocation needs as other investors. If a person moves across their province or across Canada, they can easily take their stocks and bonds with them, but the owners of rental property cannot move their rental buildings. To be able to manage their property in their new location, rental property owners have to sell one property and buy another. Enabling investors to do that more freely would reduce absentee ownership and improve communities, as well as improving labour mobility across Canada, which is important for economic productivity.

6. Level the rules between rental property and other businesses

People who own small business corporations can defer taxes on sale of their business and reinvestment in another small business now, but people who own rental real estate do not have any ability to defer taxes upon reinvestment.

7. Level the rules between businesses which rent and which own their premises

To relocate, downsize or expand, business owners who own their premises can defer taxes on sale and reinvestment in their premises now. For example, the owners of a print shop operating in a building worth $500,000 can sell it, buy a building worth $1,000,000, and roll over their tax position to defer tax until the latter building is sold. However, if the business owner rents their premises, the property owner cannot defer taxes, they incur immediate tax costs on any property sales. In the long run that raises the rents real estate investors need to charge to their business renters.

8. Level the rules between rental property and shares in companies

Three quarters of company shares are held in tax deferred vehicles such as pension plans and RRSPs. Real estate is not eligible for RRSPs. Allowing a tax deferral would result in between 50% and 75% of real estate gaining tax deferral, which would still be less than the deferral level which applies to company shares. That would move toward a level playing field between investment in rental real estate and other businesses.

9. Provide fairer and more efficient help in promoting rental housing development than construction subsidies provide

Construction subsidies tend to provide little increase in rental supply relative to the cost of the subsidy because subsidized rental housing typically crowds out private developments, whether by discouraging new building or by causing demolitions. Construction subsidies are also inefficient because they are inevitably distributed on a political basis, when the actual demand for development would probably call for a different use of resources. The housing markets in some cities may justify more new rental housing, while other rental markets justify more repairs or rehabilitation, or no investment at all.

In addition, applying for subsidies is complex and time-consuming, and therefore favours large companies with past experience. By contrast, permitting tax deferral helps developers of all sizes. Allowing tax deferral on sale and re-investment makes investment in rental housing more attractive, and that will result in increased private investment in purpose-built rental housing.

The deferral cost of the proposal is reasonable

The government revenues that would be deferred by the proposal in the first year after implementation are approximately the following:

	Federal	Total Provincial/ Territorial
Deferred tax on capital gains	$ 258M	$ 129M
Deferred tax on recapture of CCA	$ 157M	$ 79M
Total revenue deferral	$ 415M	$ 208M

In the years that follow the first year, the direct deferral amount should decrease given that taxes payable (deferred from the first and subsequent years) would appear as an additional tax payable thereafter. Besides that, the increase in transactions resulting from reducing the lock-in effect would generate increases in economic activity and thus higher taxes on that activity. Increased income and capital gains from reducing the lock-in effect would also tend to raise tax revenue in future years. Over time, the deferral “cost” would decrease toward zero, while the economic benefits would quickly make the overall impact on government revenue positive.

What do other organizations say about tax deferral on reinvestment?

Federation of Canadian Municipalities:

"… there is a need to increase overall levels of rental construction (at any rent level). This requires addressing barriers and deterrents to private-sector rental investment. …decades of regressive changes to the tax code have made rental housing investment unattractive. We should therefore consider a variety of tax-related measures to reverse this, in particular deferring tax liability if proceeds from sale of investment property are reinvested."

(National Action Plan for Housing and Homelessness, January 2008)

Sharad Kerur, Executive Director, Ontario Non-Profit Housing Association::

"Canada needs a National Housing Strategy which includes as top priorities the maintenance of the existing social housing stock and funding to stimulate the creation of more affordable housing, with an emphasis on non-profit housing. The strategy should also include government initiatives to increase overall levels of rental construction. Tax changes over the last 35 years have created disincentives for rental housing developers, and those changes must be reviewed and, in many cases, reversed. We particularly support the reintroduction of the ability to defer the capital gains tax on the proceeds of rental property sales, provided the proceeds are reinvested in other rental housing. Deferring taxes in this way, seems a small price to pay for the resulting market liquidity and renewal. This would be of benefit to both the private and non-profit sectors and to tenants across Canada." (January 2008)

Canadian Chamber of Commerce:

The Canadian Chamber of Commerce recommends that the federal government:
"Create a tax and regulatory environment that promotes the building of new affordable housing by allowing investors to defer CCA recapture and capital gains on the proceeds from the sale of rental property when the proceeds are reinvested in another rental property within a reasonable amount of time (as allowed under the Canadian system prior to tax reform in 1972). … "

(2005 Affordable Housing Policy Statement)

What other housing and tax policy reforms are needed?

Government housing policy needs to recognize that over the last 35 years, tax changes have made investment in rental housing unattractive relative to other investments. That has resulted in a decline in purpose-built rental housing starts across Canada from an average of 60,000 starts per year to an average of less than 15,000 starts per year, despite Canada's growing population. To restore a higher level of investment in new purpose-built rental housing will require thorough tax reform, beginning with tax deferral on sale and reinvestment.

Besides tax reform for the private housing sector, government policy needs to address the income shortfalls of low-income Canadians, preferably through portable housing allowances. (See CFAA's companion piece entitled "Portable Housing allowances – Facts and Recommendations.) In addition, government policy needs to address the funding shortfalls and needed repairs in Canada's existing social housing stock, as well as the need for more supportive and special needs housing to address the needs of Canada's growing and aging population.

Conclusion

Providing tax deferral on sale and reinvestment in rental real estate would increase fairness among investments and businesses, promote efficient capital allocation, help middle-income families, promote environmentally sound urban redevelopment and improve the affordability and availability of rental housing. CFAA urges the government of Canada to enact tax deferral on sale and reinvestment.

The Canadian Federation of Apartment Associations represents the owners and managers of close to one million residential rental suites in Canada, through 17 organizations across Canada. See www.cfaa-fcapi.org.