FISCAL IMPACT OF FEDERAL TAX LEGISLATION ON RESIDENTIAL RENTAL RATES IN CANADA

Prepared for:

The Apartment Owners' and Property Managers' Association of Vancouver Island and the Canadian Federation of Apartment Associations-Federation Canadienne des Associations de Proprietaires Immobiliers

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INTRODUCTION

Since 1972, a series of changes in federal tax legislation and policies have worked to the detriment of the residential rental sector, with the overall result being a death of new construction or investment in this vital industry. For evidence of the impact of these changes, the reader is directed to the November 1998 research study, Economic Impact of Federal Tax Legislation on the Rental Housing Market in Canada prepared by Clayton Research Associates.

Based on the findings of the Clayton study, this report attempts to quantify the economic impact on both the owner of a residential rental property and the tenants within that property. In the interests of clarity, simplification and conservatism, this report employs the following assumptions:

1. The construction cost of the properties studied is equivalent to their current resale value.
2. The properties are fully paid for, with the result that the owner is paying no mortgage interest or financing charges.

The Clayton study identified four key areas of discriminatory tax differences between residential rental property owners and other business owners such as motel operators. These differences are as follows:

1. Impact of GST on operating costs
2. Impact of GST on capital costs
3. Impact of Income Tax rates on active income versus rental income.
4. Impact from lack of ability to defer tax implications resulting from the sale of property by the property replacement rules in the Income Tax Act.

This report attempts to compare the impact of tax differences as between an investor in a rental housing operation and an investor in a motel operation.

GOODS AND SERVICES TAX

1) On-going operations

Prior to the introduction of the Goods and Services Tax (GST) in 1991, the building materials used in the construction of new rental housing and motel units were both subject to a Federal sales tax. Thus only a portion of the costs of building new construction were subject to this tax. With the GST replacing the federal sales tax the total value of the new properties is now subject to the 7% GST.

Most ongoing operation costs of both rental properties and motel properties such as management fees, repairs and maintenance, supplies, utilities, advertising and professional fees were not subject to a Federal sales tax and are now subject to GST.

However, since the operation of a motel is considered to be an "active business", as defined in subsection 125(7) of the Income Tax Act, the GST paid on the capital costs and the operating costs can be claimed as an input credit to lower the net amount of GST payable by the investor in a Motel property.

As the operation of an apartment is considered to be GST exempt the investor is not able to claim the additional GST paid on capital and operating costs as input tax credits. Therefore the additional GST payable on the full new rental value of a rental suite together with the added GST payable on the operating costs must now be passed on to the tenant by way of an increased rental rate.

A comparison of five apartment buildings with a total of 408 rental suites in the Greater Victoria area is shown on Schedule 1. From this schedule it was determined that the net impact on rental rates due to the GST impact on operating costs was about $10.36 per month.

2) Investment cost

The amount of GST paid on the construction of new rental housing is difficult to determine due to the lack of data available on the current cost of construction. There has been very little new rental housing construction in the last few years and therefore the construction costs per suite are not readily available. However, if we assume that the current sales value of existing rental housing is an indication of the replacement cost of new units then a review of recent apartment building sales might give us an estimate of a per suite cost.

We reviewed the sales of 10 apartment buildings in the Greater Victoria area over the past 18 months. These buildings contained a total of 236 suites with a reported sale value of $13,094,000. This would then mean that the average value of a rental suite was $55,500. Therefore the total GST included in this value is $3,630. As this GST is not recoverable by way of input credits it must now be passed on to the user of the suite by way of increased rental costs. Assuming a 20-year hold period the additional rent required to recover this tax at an implied interest rate of 7.0% is $27.95 per month. This is shown on schedule 2.

As stated in the introductory assumptions, these investment cost calculations have been based on the average current resale value, rather than the more accurate current construction costs. The reason for using this assumption is primarily because there has been little to no new apartment building construction during the past several years, hence construction costs would have to be artificially derived. Suffice it to say that, if such costs were readily available, they would reflect a higher per suite investment cost- and ultimately a higher rent-than the resale methodology revealed.

INCOME TAX CONSIDERATIONS

1) On-going operations

Currently under the provisions of section 125 of the Income Tax Act, (Canada) business income that is defined as being "active business income" is afforded a Small Business Deduction. This reduction in the basic corporate tax rate effectively reduces the combined federal and BC provincial corporate rate of tax to 21.62% as compared to 45.62% for other business incomes. Unless the investor is a Principal Business Corporation (PBC) rental income is specifically excluded from the definition of "active business income" and therefore is subject being taxed at the higher rate. To qualify, as a PBC the investor must be a corporation whose principal business is the leasing, rental or sale, or the development for lease, rental or sale of real property owned by them and they must have more than six full-time employees throughout the period. Most investors that provide the bulk of Canada’s rental housing do not meet these criteria and therefore are taxed at the higher rate

In comparison the income from a motel operation is considered "active business income" as defined in subsection 125(7) of the Income Tax Act and therefore is afforded the lower rate of income tax for a total difference of 24.0% (45.62%-21.62%). Schedule 3 demonstrates the overall impact of this Income Tax difference on the average monthly rent charged on a typical rental suite in the Greater Victoria area. It is estimated that the net impact on the current average monthly rental rates is about $55.31 per month.

2) Sale of rental property

All rental properties with an acquisition cost of $50,000 or more are required to be entered as a separate class under the Income Tax Act. In comparison a building used in an active business such as a motel can be entered into one class in combination with other similar properties. Therefore, if a building is sold at a price in excess of its undepreciated capital cost (UCC) any capital cost allowance (CCA) deducted previously up to the difference between the sales price and the UCC is recaptured and full income tax rates are applied. The sales price that is in excess of the original cost of the property is treated as a capital gain and 75% of this gain is taxed at full income tax rates.

Under subsections 13(4) and 44(1) of the Income Tax Act active small businesses (i.e. motel operators) can defer payment on the recaptured CCA and capital gains if they purchase another similar property within the prescribed time period. This is generally referred to as the "replacement property rule" or "rollover". Prior to 1972, investors in rental housing could also use these "rollover" provisions but are now precluded from doing so.

Recognizing that they will be facing a significant income tax liability on the ultimate sale or deemed disposition on the death of the investor an investor in rental housing will factor this into rental rates to be charged. Schedule 4 attempts to demonstrate the impact of these differences in tax treatment. It is estimated that the impact on monthly rental rates is about $31.16 per month.

SUMMARY

The income tax provisions contained in the Income Tax Act (Canada) regarding rental housing investment have become more severe since 1972 when the Income Tax Act was reformed. Changes in the tax treatment of losses due to the claiming of capital cost allowances (CCA), the amount of the CCA deductible, allowable soft costs, the deferral of taxes payable on recaptured depreciation upon reinvestment, and the application of a tax on capital gains at the time of sale have severely reduced the attractiveness of investing in rental housing. The application of the Goods and Services Tax (GST) to the full cost of new construction, as well as on-going operating costs, aggravated an already serious situation. When introducing income tax reform and the GST there was little, if any, consideration of the adverse consequences on the flow of private capital into the rental housing market, the production of new rental housing, **or the cost of the rental units to the tenants.**

The added monthly cost to the tenants as shown on the attached schedules is as follows;

1) GST on on-going operating costs	$10.36 schedule 1
2) GST on the cost of construction	27.95 schedule 2
3) Added income tax on passive income	44.35 schedule 3
4) Added income tax on recapture of CCA on sale due to lack of "rollover".	31.16 schedule 4
Total	**$113.82**

If an investor in rental housing was afforded the same treatment for GST and Income Tax as is given an investor in a motel then it is estimated that residential rental rates could be reduced by as much as $110 per month. The attractiveness of investment in new rental construction would also be enhanced. It is not being suggested that if the changes to the Federal Tax Legislation were made today that landlords would reduce their rents tomorrow. This can not be done since the existing inventory of rental units already has these taxes capitalized in the current cost structure. However, it would increase the overall attractiveness of new residential rental construction that would then come on stream at lower rates than would otherwise be possible.

It is worth noting that the results of this study can also be used to indicate the Return on Investment to the typical apartment building investor. Based on an annual after tax net income of $2,200 per suite, on a value of $55,500, the typical owner in the study would realize a ROI of something less than 4.0%-approximately equal to the return on a GIC!

CONCLUSION

Clearly, these tax provisions-specific to the residential rental industry-have directly led to substantially increased rents, both in absolute terms and in terms relative to other investment opportunities such as motels. These provisions have also made it virtually impossible for new rental construction to compete with condominium or commercial construction, with the results as noted in the Clayton Report.

About the Author

David A. Paterson, FCA is a partner with Crawford Paterson Campbell, Chartered Accountants a local firm in Victoria, B.C. with four partners and a professional and support staff of 15. The firm has been in practice since 1979 and has built a practice committed to helping owner-managed businesses, professionals and not-for-profit organizations succeed in a complex environment. The construction industry forms a large part of the practice as well as apartment and hotel/motel operations.

The firm offers a full range of professional services including accounting, auditing, income tax and estate tax planning, management advisory services, business valuations for purchase and sale, financing proposals and computerized management information solutions.

Schedule 1

	IMPACT OF GST ON OPERATING COSTS								
	ON THE AVERAGE APARTMENT SUITE								
							Annual		
						Total	per suite	Monthly	
# OF SUITES	16	89	47	35	221	408	Average	Average	
Gross rents	$ 138,138	$ 452,207	$370,729	$240,685	$ 1,845,405	$ 3,047,164	$ 7,469	$ 622.38	
Other (note 1)		26,119	8,062	6,526	40,246	80,953	198	16.53	
	138,138	478,326	378,791	247,211	1,885,651	3,128,117	7,667	638.91	
Expenses									
Advertising	571	6,475	2,756	6,168	8,337	24,307	60	4.96	*
Insurance & dues	750	6,664	4,947	3,485	22,055	37,901	93	7.74	
Professional	1,376	1,448	973	1,639	2,894	8,330	20	1.70	*
Management	26,092	28,797	12,007	12,946	100,424	180,266	442	36.82	*
Property taxes	14,427	51,848	37,317	22,238	125,628	251,458	616	51.36	
Repairs	4,900	75,199	41,082	38,156	235,371	394,708	967	80.62	*
Utilities	5,686	28,788	28,799	9,246	80,007	152,526	374	31.15	*
Wages & benefits		37,391	16,608	15,840	93,377	163,216	400	33.34	
Miscellaneous		1,630	348	826	2,642	5,446	13	1.11	*
Office	4,363	621	492	1,032	3,599	10,107	25	2.06	*
	58,165	238,861	145,329	111,576	674,334	1,228,265	3,010	250.87	
Operating income	$ 79,973	$ 239,465	$233,462	$135,635	$ 1,211,317	$ 1,899,852	$ 4,657	$ 388.04	
* gst included							$ 124.38	$ 10.36	
Notes									

1) Other revenues include interest, laundry and parking revenues.					

Schedule 2

	IMPACT OF GST ON ORIGINAL COST							
	OF AN AVERAGE APARTMENT SUITE							
The average per suite apartment cost is based upon the current market value from the sale of buildings in the Greater Victoria area over the past 18 months is about $55,500 per suite.								
	Land costs			$ 22,200				
	Building costs			33,300				
	Total GST portion			$ 55,500				
	Total GST paid in above costs				$3,629.70			
	Average monthly cost per suite at 7.0%				$ 27.95			

Schedule 3

IMPACT OF HIGHER INCOME TAX RATE ON RESIDENTIAL RENTAL RATES							
Corporate tax rate for active business income (motel)							22.12%
Corporate tax rate for non-active income (apartment)							45.62%
Differential rate between two operations							-23.50%
Year	Net	Present		Deduct	Taxable		tax
	Operating	value		CCA	income	x 23.5%	increase
1	$4,657.00	0.9661	$4,499.13	$ 593.00	$3,906.13		$ 917.94

2	4,796.71	0.8714	4,179.85	1,163.00	3,016.85		708.96
3	4,940.61	0.8135	4,019.19	1,117.00	2,902.19		682.01
4	5,088.83	0.7594	3,864.46	1,072.00	2,792.46		656.23
5	5,241.49	0.7089	3,715.70	1,029.00	2,686.70		631.37
6	5,398.74	0.6617	3,572.35	988.00	2,584.35		607.32
7	5,560.70	0.6177	3,434.85	948.00	2,486.85		584.41
8	5,727.52	0.5767	3,303.06	910.00	2,393.06		562.37
9	5,899.35	0.5383	3,175.62	874.00	2,301.62		540.88
10	6,076.33	0.5025	3,053.36	839.00	2,214.36		520.37
11	6,258.62	0.4691	2,935.92	805.00	2,130.92		500.77
12	6,446.38	0.4379	2,822.87	773.00	2,049.87		481.72
13	6,639.77	0.4088	2,714.34	742.00	1,972.34		463.50
14	6,838.96	0.3816	2,609.75	713.00	1,896.75		445.74
15	7,044.13	0.3562	2,509.12	684.00	1,825.12		428.90
16	7,255.45	0.3325	2,412.44	657.00	1,755.44		412.53
17	7,473.12	0.3104	2,319.66	630.00	1,689.66		397.07
18	7,697.31	0.2898	2,230.68	605.00	1,625.68		382.03
19	7,928.23	0.2705	2,144.59	581.00	1,563.59		367.44
20	8,166.08	0.2525	2,061.93	558.00	1,503.93		353.42
Total							$10,644.99
Average monthly increase in suite rent to cover additional tax factor							$ 44.35

Schedule 4

	INCOME TAX ON THE CAPITAL GAIN AND RECAPTURED							
	CAPITAL COST ALLOWANCE ON SALE OF AN APARTMENT							
	UNIT AFTER 20 YEARS OF OPERATION							
Assumptions:								
1) That the growth rate on the original cost is about 3.0% per annum throughout the period								
2) maximum capital cost allowance is claimed in each year								
3) The rates of income tax remain the same as they are today.								
4) The replacement property rules contained in subsections 13(4) and 44(1) of the Income Tax								
Act remain in place for business properties.								

Over a 20-year period at a 3.0% growth rate per annum the value of an average apartment suite at $55,500 will become $100,250. This will result in a net capital gain of $44,750 per suite for

the apartment owner. The apartment owner is not permitted to utilize the provisions of the Income Tax Act to defer this gain as can a motel owner.

As demonstrated on Schedule 5 the total amount of capital cost allowance claimed over a 20 year period is $16,283 and this amount will be fully recaptured on the sale of the building.

Income tax payable by apartment owner				
Capital gain on sale		$ 44,750		
Taxable capital gain at 75%		$ 33,563		
Income tax payable thereon after refundable dividend				
tax on hand has been considered	25.62%		$ 8,599	
Recaptured CCA		$ 16,283		
Income tax payable on recaptured CCA	45.62%		7,428	
Total income tax payable per suite on sale			$ 16,027	
Discounted to present value		0.2525	$4,046.82	
Added monthly cost over 20 years at 7.0%			$ 31.16	

Schedule 5

SCHEDULE OF CAPITAL COST ALLOWANCE CLAIMED ON AN

APARTMENT UNIT AT AN AVERAGE COST OF $55,500

During the period Jan 1/98 to July 30/99 there were 10 sales of apartment buildings

in the Greater Victoria area. The buildings contained a total of 236 suites and the total

sales value was reported to be $13,094,000 for an average suite price of $55,500.

The allocation as between land and building is assumed to be 40/60 which in turn

gives an adjusted cost base to the building portion to be $33,300.

Since we have calculated the impact of the GST component separately at $3,630 per

suite it is removed from the calculation of the CCA

The appropriate Capital Cost Allowance Class as prescribed by the Income Tax Act is Class 1 at 4% per year on a declining balance basis.

		CCA		
Year	cost	rate	CCA	UCC
1	$29,670.00	0.02	$ 593.40	$29,076.60
2		0.04	1,163.06	27,913.54
3		0.04	1,116.54	26,796.99
4		0.04	1,071.88	25,725.11
5		0.04	1,029.00	24,696.11
6		0.04	987.84	23,708.27
7		0.04	948.33	22,759.94
8		0.04	910.40	21,849.54
9		0.04	873.98	20,975.56
10		0.04	839.02	20,136.53
11		0.04	805.46	19,331.07
12		0.04	773.24	18,557.83
13		0.04	742.31	17,815.52
14		0.04	712.62	17,102.90
15		0.04	684.12	16,418.78
16		0.04	656.75	15,762.03
17		0.04	630.48	15,131.55
18		0.04	605.26	14,526.29
19		0.04	581.05	13,945.23
20		0.04	557.81	13,387.42
Total			**$16,282.58**	