CANADIAN FEDERATION OF APARTMENT ASSOCIATIONS

Active versus investment business income **August 31, 2015**

The Canadian Federation of Apartment Associations represents the owners and managers of nearly one million residential rental suites across Canada. Our members run the whole gamut of the industry from REITs with 35,000 rental apartments through corporations with thousands of rental units to “mom and pop” operators with a handful of rental suites, or even a double house in which a tenant lives on one side and the owner lives on the other. CFAA is the sole national voice of the for-profit rental housing industry in Canada.

This is our submission in the consultation on active versus investment business income.

Current situation

Currently, we understand that income earned by a corporation from rental housing is generally subject to one of three different rates of tax.[1] The three rates arise from the basic rate of Part 1 corporate tax, the federal tax abatement, the general tax reduction, the “refundable tax” and the small business deduction. As well each province sets different rates of provincial corporate tax following the pattern set by the federal tax rates. The three rates of total tax are set out below for rental housing providers in Ontario (and in BC) respectively:

1. When the rental income is treated as investment income, it attracts the highest rate of corporate tax, namely 46.17%[2] (45.67% in BC.)
2. When the rental income is treated as active business income in the hands of a corporation that is not a small corporation, that income attracts tax at the rate of 26.5% (26% in BC.) (To be treated as active business income, rental income must be received by a corporation with more than five full-time employees.)
3. When rental income is treated as active business income in the hands of a small Canadian-controlled private corporation, that income attracts the small business tax rate of 15.5% (13.5% in BC.) Very little rental income qualifies for that lowest rate of tax because very few small landlord corporations have more than five full-time employees.[3] Instead most small corporate landlords pay tax on rental income at 46.17%.

Yet at any size above a few units, the business of being a residential landlord feels like an active business, and is an active business as people use those words. Residential rental operations are relatively labour intensive, with numerous services and active work being included with the rental of space.

[1] Rental income received by an individual is subject to tax at that individual’s marginal rate of tax, which may be at any of the rates from highest to the lowest.

[2] Unless otherwise indicated the rates stated are combined federal and provincial rates for Ontario.

[3] Note that the requirement is based on full-time employees. A landlord could have 12 employees all working half-time, and that would not qualify.

More than commercial landlords, residential landlords provided services such as:

- Cleaning of common areas
- Lawn maintenance
- Snow and ice clearing
- Repairs to common areas and en-suite, both by staff and by contractors
- Utilities (which have to be managed)
- Resolving inter-tenant disputes
- Storage facilities (often)
- Recreation facilities (sometimes)

Other services provided by landlords that demonstrate the active nature of the business of being a landlord include:

- Managing staff
- Hiring and overseeing contractors
- Collecting revenue from multiple sources
- Managing multiple payors, who are not always prompt with the rent
- Managing tenant turnover and all aspects of vacancy marketing
- Managing the tenant selection process
- Managing and communicating with tenants through a complicated notice and eviction process
- Dealing with many aspects of local government regulation

Despite the similarities between managing 600 units with six employees and managing 500 units with five employees, the former corporation pays a tax rate of 26.5%, while the latter pays a tax rate of 46.17%. The tax rate differential applied to rental housing operations with 600 units compared to rental housing operations with 500 units is inequitable, and should be addressed to bring increased fairness to the application of rental housing tax rates.

Proposed test

CFAA proposes that the test for active business income be changed from more than five full-time employees to more than three full-time equivalent employees (which could be four full-time employees, or two full-time employees and three half-time employees, for example.)

More than many other businesses, mid-size and small residential landlords use part-time employees. It seems unfair that Landlord A with six full-time employees qualifies for active business treatment, but Landlord B with three full-time employees and six half-time employees does not. If anything, Landlord B is doing more work to supervise, train and manage nine employees, but because those employees are not full-time, Landlord B is not considered to be running an active business. Setting the threshold at more than three full-time equivalents would provide greater horizontal equity.

Estimated cost of proposal

The attached spread sheet shows CFAA’s estimate of the industry structure, and **the likely maximum cost** of the proposal.

Most landlord corporations with more than 750 units are able to report their rental income as active business income because they would have more than five full-time employees. The entities which are prejudiced by the current situation are corporate landlords which have fewer than 750 units. Most of them have fewer than six full-time employees. So as corporations with four or five full-time employees, they are paying tax at the highest rate even though if they grow over the hurdle of five full time employees, they will attract tax at the middle rate.

The cost estimate suggests that the ultimate cost to the federal and provincial treasuries would be less than $72 million per year, and possibly much less. The initial cost would be much less than $72 million since many landlords do not operate their properties through corporations. Even in the long-term, some landlords would not qualify because they would not restructure to hold their properties through a corporation.

The cost in any year would be a deferral rather than tax permanently given up. The income would attract tax at each individual’s personal tax rate once the income passes into their hands as dividends.

On a per company basis, the proposed tax deferral would be an average of $240,000 per year, which would be a substantial help to enable those landlord corporations to grow, thereby increasing employment and providing additional rental housing to more Canadians.

Alternative Proposal

In the alternative, CFAA would also support a test in terms of the number of units being managed. The work involved in managing rental units, or campground sites, or self-storage units, is directly proportional to the number of units. The threshold could be 300 units, 100 units, or even 5 units. The cost would vary with the level chosen.

Conclusion

Please feel free to contact CFAA for more input as options are explored, by connecting with John Dickie, CFAA President at president@cfaa-fcapi.org or at 613-235-0101.

CFAA agrees that the government may post this submission on the Department of Finance website. It is a submission of the Canadian Federation of Apartment Associations.

CFAA SUBMISSION - ACTIVE BUSINESS TEST FOR RENTAL PROPERTY

REDUCE THE NUMBER OF EMPLOYEES RENTAL HOUSING COMPANIES NEED TO HAVE TO REPORT THEIR
INCOME AS ACTIVE BUSINESS INCOME FROM MORE THAN 5 FULL TIME EMPLOYEES TO MORE THAN 3 FULL TIME EQUIVALENTS (FTEs).

ESTIMATE OF THE INDUSTRY STRUCTURE
(Corporate and non-corporate entities)

SIZE RANGE (UNITS)		AVE SIZE	NUMBER	TOTAL UNITS	CUMM. TOTAL	AVERAGE # FTEs	AVG # FT Employees	TAX TREATMENT	
from	**to**	**(units)**	**of entities**					**current rate**	**proposed rate**
20000	40000	25000	6	150000	150000	313	250	middle	unchanged
10000	20000	14000	20	280000	430000	175	140	middle	unchanged
5000	10000	7000	40	280000	710000	88	70	middle	unchanged
2500	5000	3500	60	210000	920000	44	35	middle	unchanged
1250	2500	1750	125	218750	1138750	22	12	middle	unchanged
750	1250	1000	200	200000	1338750	13	7	middle	unchanged
300	750	500	300	150000	1488750	5	3	**high**	changed to middle for most
100	300	200	1000	200000	1688750	2	1	Varies - sometimes at individual rates	
20	100	40	5000	200000	1888750	0.4		Varies - often at individual rates	
3	20	5	40000	200000	2088750	N/A		Varies - often at individual rates	

COST ESTIMATE

THE LANDLORDS POTENTIALLY AFFECTED BY THE CHANGE

SIZE RANGE (UNITS)		AVE SIZE	NUMBER		AVERAGE # FTEs	AVG # FT Employees		
from	**to**	**(units)**	**of entities**	**TOTAL UNITS**				
300	**750**	**500**	**300** (see note below)	**150000**	**5**	**3**	**high**	changed to middle

NUMBER OF UNITS MANAGED		150000
TOTAL NUMBER OF UNITS (3 UNITS AND UP)		2088750
PERCENTAGE OF THE PURPOSE-BUILT RENTAL SUPPLY		7.2%
NET INCOME OF THE INDUSTRY (3 UNITS AND UP)	$	5,000,000,000
		7.2%
NET INCOME OF THE COMPANIES IN QUESTION (TOTAL)	$	360,000,000
TAX RATE DEFFERAL (Federal & provincial)		20.0%
TAX SAVING (DEFERRAL) TOTAL - PER YEAR	$	72,000,000
COMPANIES AFFECTED		300
TAX DEFERRAL PER COMPANY (AVG)	$	240,000

JOHN DICKIE, CFAA PRESIDENT
31-Aug-15

NOTE: The Finance Department study of tax expenditures on small business found at http://www.fin.gc.ca/taxexp-depfisc/2013/taxexp1303-eng.asp#toc9 reported 32,000 small corporations in “real estate and rental and leasing” in the year 2011, out of a total of 590,000 such corporations in all sectors. The estimate for residential landlords with between 3 and 750 units given above is 46,300 (40,000, 5,000 1,000 and 300). The two overall numbers seem in line for the following reasons. First, the study includes commercial real estate, whereas the estimate above covers only rental housing. Second, many small landlords are not incorporated. Third, many other small landlords operate with the use of a management corporation, so that the management portion of the total income from owning and operating real estate receives the benefit of the small business tax rate now. (That factor would somewhat reduce the cost of the proposed change to the test.)