Canadian Federation of Apartment Associations

Fédération Canadienne Des Associations De Propriétaires Immobiliers

Rental Housing in the 2011 Federal Budget

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INTRODUCTION

The Canadian Federation of Apartment Associations represents the owners and managers of close to one million rental suites across Canada through 17 local and provincial apartment associations. We are the sole national voice of the for-profit rental housing industry in Canada.

The need for the reform we propose arises from the divergence in the current tax treatment of homeowners from the tax treatment of renters.

Policies that favour homeowners

For many years in Canada, public policies at all levels of government have promoted homeownership. Those policies include explicit incentives for homeownership and several benefits under the income tax system which accrue to homeowners. The most significant of those policies and programs include the following long standing programs:

- tax-free status for capital gains on principal residences
- lower property tax rates applied to owner occupied homes in many cities
- tax-free treatment of the imputed income from living in an owned dwelling

Most recently, in the 2009 Federal Budget, homeowners were given billions of dollars under the Home Renovation Tax Credit while renters were ignored.

However, most low-income Canadians are not home-owners, and the larger part of the income tax benefits of homeownership do not accrue to low income households even if they are homeowners.

Tax treatment of rental housing

By contrast, between 1970 and 1990 the tax treatment of rental housing was made steadily worse. Here is a list of the tax changes which have disadvantaged the rental housing industry and renters:

- capital gains on rental properties become taxable, with an inclusion rate of 50%[1]
- the ability to pool properties to delay recapture of CCA from the date of sale of properties is eliminated
- serious inflation results in illusory capital gains being taxed, in effect turning the tax on capital gains into a tax on capital itself
- the capital cost allowance for depreciation (CCA) for wood frame construction is reduced from 10% to 5%, advancing significantly the date taxes are payable
- deductibility of soft costs in first year is restricted
- the CCA rate is cut in half in the year of acquisition by the “half-year rule”
- deductibility of soft costs in the year of acquisition is further restricted for rental property owners not in the business of real estate.
- MURB rules are repealed retroactively preventing the application of CCA deduction to offset income from other sources
- the capital cost allowance for depreciation (CCA) for all buildings is reduced from 5% to 4%
- the inclusion rate for capital gains is increased to 66.67% with effect retroactive to 1972 or the date of acquisition, whichever is later
- the inclusion rate for capital gains was increased to 75% with retroactive effect (this has since been reduced to 50%)
- GST introduced and applied to rental housing construction and operation

[1] Tax becomes payable on capital gains on other income earning assets as well, but capital gains were and are a major driver for real estate investment. Setting the inclusion rate at 50% rather than higher, is alleged to allow a reward for the risk involved; however, with the amount of inflation that has occurred since 1972, the exclusion of 50% of capital gains may not even allow sufficient adjustment for inflation, let alone any compensation for risk.

The current tax position means that Canada's housing markets are not providing the housing opportunities in the rental sector needed by households with low and moderate incomes, and by people who move between cities. Excess home ownership inhibits labour mobility and raises unemployment rates. Home owners tend to look for work within commuting distance of their homes, whereas renters tend to look for work wherever it can be found and then move if necessary.

Rental housing does not receive the tax benefits of ownership housing, and in addition it does not receive the various tax benefits available to other businesses. For example, businesses can sell a property and buy a more expensive replacement property, and rollover their tax position, thus deferring tax on capital gains and recapture of CCA, whereas rental property owners cannot. Canadian controlled private corporations have a preferential tax rate on the first $500,000 of income, but that preferential rate is not available for rental income. The various extra taxes paid by owners of rental housing form part of their cost base, and drive up rents, so that it is renters who ultimately pay the extra taxes.

How should the 2011 Budget redress the balance between home owners and renters?
In order to move toward a balanced housing policy, we suggest that the Budget should provide improved tax rules for rental housing to move the tax position of renters closer to that enjoyed by homeowners. In the 2011 Budget, the improved rule should be a tax deferral of capital gains and recapture (of CCA) when rental real estate is sold and another property of equal or greater value is bought within 12 months. (If a rental property of lesser value is bought, then a pro rata deferral should be provided.)

TAX DEFERRAL ON SALE AND RE-INVESTMENT

Currently, when a rental property is sold, the owner must pay tax on the recaptured CCA (at up to 48%) and on any capital gains (at up to 24%). Due to the tax impact, an even trade of properties of the same value is not possible. That tax burden discourages property asset reallocation, discourages renovation of the housing stock and raises the costs of rental housing.

The current tax rules on rental properties also create an uneven playing field between rental properties (whose owners cannot defer taxes on sale and reinvestment) and other types of capital property, including buildings used for businesses (whose owners can defer taxes on sale and reinvestment). In addition, rental property owners have the same re-investment needs as owners of other capital. We want to expand or downsize, or to reduce our investment in one type of property or increase it in another. Rental property owners also have the same relocation needs as other property owners. In some ways, rental owners need more ability to relocate. If a person moves across their province or across Canada, they can easily take their stocks and bonds with them. Businesses can relocate their equipment and their know-how. But the owners of rental property cannot move their investment. They have to sell one property and buy another.

Allowing tax deferral on real estate sale and 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 their existing 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. Allowing tax deferral would facilitate the rehabilitation of brownfield sites and compact, environmentally sound redevelopment in cities.

4. Help small investors, middle-income families and seniors

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 / Reduce absentee ownership

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 or TFSAs. Because not all those who sell a rental property would buy another one within one year, and other people would not use the deferral, allowing a tax deferral would result in a take up rate of between 50% and 75%, which would 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 in other businesses.

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 $450 million. 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.

Other groups which support tax deferral for rental housing

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)

REALpac

We support a tax deferral for real property. A change to the Income Tax Act (ITA) would enable our Members to defer capital gains and recapture taxes if a replacement property was purchased within 12 months. This deferral already exists in the United States under Section 1031 of the Internal Revenue Code. (Pre-Budget submission to the Minister of Finance December 2008)

Canadian Real Estate Association

Tax deferral on reinvestment will also support the increasing pace of labour mobility that is essential to Canada's economic posterity. Canadians are increasingly migrating to where the new jobs exist and they must be able to move their assets with them. Households can move their furniture, and their stocks and bonds but not their real estate investments without substantial tax consequences. Reinvestment should be facilitated for purposes of repositioning existing investments without punitive tax measures if we are to encourage the level of labour mobility that is essential to maintaining growth. (Reinvestment in Real Property April 2009).

Conclusion

Permitting owners of rental real estate to defer capital gains and recapture (of CCA) would benefit both tenants and investors, and move the tax system toward greater equity and fairness. Such a tax deferral would provide a current benefit to the rental housing sector (and thus to renters) far in excess of its modest cost to the federal Treasury.