CFAA 2020 BUDGET SUBMISSION ON THE INTEREST DEDUCTIBILITY LIMITATION PROPOSAL

The Canadian Federation of Apartment Associations represents the owners and managers of close to one million residential rental suites across Canada. Our industry provides homes for nine million Canadians at all income levels.

The interest deductibility limitation proposal

CFAA is very concerned about the Liberal platform proposal to impose an earnings-based interest deductibility limitation on Canadian corporations, including rental housing providers. The proposed limit is 30% of earnings before interest, taxes, depreciation and amortization (EBITDA). The proposed limit would artificially inflate taxable income on rental properties by disallowing some of the actual costs incurred.

CFAA understands that the proposal to enact an interest deductibility limitation for most major corporations in Canada flows largely from an OECD recommendation, which is intended to stop base erosion and profit shifting (BEPS) among international corporate groups. However, rental housing corporations are typically not part of such international corporate groups, and the issue of income shifting does not apply. As well, as explained below, Canada and the US have a very different rental housing environment than all other OECD countries.

We also understand that the US enacted a form of the limitations as part of the *Tax Cuts and Jobs Act*, Pub. L. No. 115-97 (the “TCJA”), adopted on Dec 22, 2017.

Canadian/US Rental housing sectors unique in the OECD

Canada and the US have similar rental housing sectors, which are very different from those in the rest of the OECD. In “Literature Review of International Rental Housing Policies”, prepared by Carleton University Centre for Urban Research and Education (CURE) for CMHC, April 2015, the authors examined in detail Germany, Ireland, the UK, Australia, New Zealand and the US. At page 8, they state, “Only the US (and Canada) has any significant presence of large-scale corporate developers creating and holding large portfolios of multi-unit (residential) properties. And similarly, an extensive participation of large-scale corporate institutional investors (pension funds, life insurance companies) is found only in North America.”

In the rest of the OECD, Real Estate Investment Trusts (REITs) and principal business corporations (PBCs) play a much smaller role. In many countries, until very recently, REITs and PBCs were virtually unknown in rental housing, and all rental housing was provided by individuals (or “Mom and Pop” owners) or government agencies. Even if a building was large, the ownership was divided among individual units. In fact, the term “purpose-built rental housing” is unknown outside Canada and the US, because there is so little of it. The OECD recommendation does not apply to “Mom and Pop” owners (because of the recommended minimums), and there are virtually no principal business corporations in rental housing to be concerned about in OECD countries other than Canada and the US.

Rental housing is capital intensive

Rental housing is also unusual in that it is inherently very capital intensive. Rental owners certainly provide on-going services like cleaning and repairs, and pay utilities and insurance, but the bulk of what rental owners provide is the use of a suite in a building. That has been paid for by equity and borrowing, and most buildings are still encumbered with substantial mortgages on which substantial interest is paid. As mortgages are paid down over time, mortgage financing is typically increased to pay for major repairs and renovations. Most rental owners finance their properties to 40 or 50 or 60% of value on an on-going basis. To encourage rental development, CMHC insures new mortgages at up to 75 or 90% of property value. As a result, **most rental owners pay between 30% and 50% of EBITDA in interest payments!**

See Appendix A for the information CFAA was able to collect on short notice to document the industry situation across several large portfolios of purpose-built rental buildings. See Appendix B for the impact of the proposal on rental housing providers operating at 50%.

The current low interest rate monetary policy is intended to encourage business expansion and investment. The proposal would negate those initiatives. Many rental housing investors have set up their business and expansion plans based on the existing tax rules. For years to come, their financing is based on rules in application at the time of acquisition and financing.

The proposed interest deductibility limit of 30% of EBITDA would have a devastating effect on rental housing providers, and on investment in the development of new rental housing. The proposal runs contrary to government policy (of all orders of government in Canada) which seeks to encourage the development of more rental housing.

What reforms has the US introduced?

In 2017, the US applied a version of the OECD rules on interest deductibility through the TCJA. Under the TJCA, the US rental housing sector (and the rest of the real estate sector) can opt out of the 30% limitation. The only condition for the opt out is that the corporation accept the "alternate depreciation approach". The US depreciation approaches address the same issues as the Canadian Capital Cost Allowance (CCA) system.

Under the TJCA, the "regular US depreciation approach" is a 27½ year straight-line depreciation. The alternate depreciation approach (needed to opt out of the 30% of the new EBITDA interest limitation) is a 30 year straight-line depreciation. Over the life of the rental housing asset, Canada's system for depreciation (the CCA system) is already less positive for rental housing than the US approaches for principal business corporations, and much less positive for rental investment corporations. See the details in Appendix C.

In summary, the US allows rental housing corporations to opt out of the interest limitation rule in exchange for adopting a depreciation system which is more favourable to rental owners than Canada's current CCA system.

Conclusion and process suggestions

Canada needs to recognize the inapplicability of the OECD norms to Canada's rental housing sector, and the example of the US exemption; and provide Canadian rental housing an exemption from the proposed 30% EBITDA limitation on interest deductibility. Based on the US example, Canada can fairly and safely allow Canadian rental housing an exemption from the 30% EBITDA limitation on interest deductibility without any condition.

If the proposal is applied to rental housing in any respect, then CFAA submits that transitional arrangements and grandfathering of existing financing would be needed to avoid retroactive effects, and to avoid significant harm to taxpayers who made investments in good faith under the existing tax rules. CFAA would work with the government to create such transitional arrangements, or any special rules that the government wants to provide for the limited number of rental housing corporations that borrow abroad, or that operate as part of an international corporate group. We would prefer to do that in a less compressed time frame than the introduction and enactment of Budget 2020. However, if need be, we will work with the government on ways and means measures within the Budget 2020 process.

CFAA is sure that the associations representing other real estate sectors (such as office buildings, shopping malls and industrial buildings) would also work with the government to design reasonable rules for the real estate sector. In providing rental space to businesses, the rest of the real estate sector faces the same issue of the intense use of capital that rental housing providers face in providing rental housing to residential renters.

APPENDIX A: SAMPLE RENTAL HOUSING OPERATIONS - EBITDA VERSUS INTEREST PAYMENTS
(dollars in thousands, or percent where indicated)

Corporation or REIT	**A**	**B**	**C**	**D1**	**D2**	**D3**	**E**	**F**	**G**	**H**
EBITDA	$ 49,100	$ 2,231	$ 1,156	$ 29,300	$ 29,300	$ 29,300	$ 129,300	$ 102,402	$ 195,100	$ 27,366
Interest	$ 17,933	$ 512	$ 443	$ 9,083	$ 11,134	$ 11,427	$ 46,800	$ 32,830	$ 72,400	$ 12,457
Percentage	36.5%	22.9%	38.3%	31.0%	38.0%	39.0%	36.2%	32.1%	37.1%	45.5%

Corporation or REIT	**I**	**J**	**K**	**L**
EBITDA	$ 6,047	$ 1,049	$ 211,428	$ 121,511
Interest	$ 2,965	$ 392	$ 88,520	$ 42,648
Percentage	49.0%	37.4%	41.9%	35.1%
Simple average	**37.1%**			
Weighted average	**37.4%**			
Sample Range	22.9%	to	49.0%	

Notes

The companies A through H consist of all the companies who responded to my urgent request for information up to the deadline I set them, and two public REITS.
The companies I through L are companies whose data came in later, and two more public REITS.
The companies include four based in BC, one based in Manitoba, and companies and REITS which operate in Ontario and nation-wide.
The identification D1, D2 and D3 are three different Investment Funds run by one management company.

John Dickie. President, CFAA
4-Feb-20

APPENDIX B: IMPACT OF A 30% INTEREST DEDUCTIBILITY LIMITATION ON RENTAL HOUSING PROVIDERS

The table below shows two typical situations for a building which has been held for five or ten years: first, a typical income, expense and tax situation for a principal business corporation (a PBC), and second, the situation for a real estate investment company, with five or fewer full-time employees. All the figures are based on one unit in a multi-unit building.

Section	Building item (per rental unit)	Principal Business Corp (PBC)	Real Estate Investment Corp
Basic building facts	Building rental income	$12,000	$12,000
	Building operating costs	$4,800	$4,800
	NOI (which is similar EBITDA)	$7,200	$7,200
	Property value	$180,000	$180,000
	Borrowing ratio (loan-to-value)	50%	50%
	Interest payments per year (at 4%)	**$3,600**	**$3,600**
	Capital cost allowance claimed	$2,000	$2,000
Current tax situation	Net income before tax	$1,600	$1,600
	Total corporate tax (Federal & Ontario)	$585	$803
	Net income after tax	**$1,015**	**$797**
Apparent proposal	**Interest payment allowed (30% of EBITDA)**	**$2,160**	**$2,160**
	Notional net income for tax calculation	$3,040	$3,040
	Total corporate taxes (Federal & Ontario)	$1,110	$1,526
	Actual net income (from above)	$1,600	$1,600
	Actual net income (loss) after tax	**$490**	**$74**
Comparison	Increase in tax (in dollars)	$525	$723
	Increase in tax (as percentage)	90%	90%

A new 30% limit on interest deductibility for Canadian corporations would dramatically increase income taxes on rental housing, taxing notional income which owners do not actually receive.

Across Canada virtually all governments have encouraged the rental housing sector to expand in order to obtain a larger supply of rental housing, and thus make rental housing more affordable. During the 2015 to 2019 mandate, this Liberal federal government put a great deal of effort and money into the National Housing Strategy to promote rental housing affordability. It would run directly contrary to that important housing policy objective to apply an interest deductibility limitation to rental housing. Such a measure would increase income tax on precisely those who responded to the government's housing policy initiatives, and financed those projects in compliance with the tax rules that applied at the time of construction.

Notes

1. Net operating income is a real estate term, which is similar to EBITDA. To derive EBITDA from NOI, one must deduct any applicable administrative expenses that have not been reported before NOI. However, NOI would include modest ancillary income. The two adjustments are minor and work in offsetting directions. Therefore, using NOI based on rents for the calculations is a close approximation of EBITDA.
2. Provincial taxes on corporations vary slightly. Some are slightly above Ontario's, and some are slightly below Ontario's.

APPENDIX C: US versus Canadian depreciation systems

Under the *Tax Cuts and Jobs Act*, Pub. L. No. 115-97 (the “TCJA”), adopted on Dec 22, 2017, the “regular US depreciation approach” is a 27 ½ year straight-line depreciation. The alternate depreciation approach (needed to opt out of the 30% of the new EBITDA interest limitation) is a 30 year straight-line depreciation.

Over the life of the rental housing asset, Canada’s system for depreciation (the CCA system) is already less positive for rental housing than the US approaches. Canada uses a declining balance method at 4%, whereas the US uses a straight-line method (at either 3.64% or 3.33%). Subject to the loss restriction rules, Canada’s system allows slightly more CCA in the initial years, but substantially less after 12 or 15 years.

As shown in Table on the next page, for principal business corporations, the Canadian CCA system yields a slightly higher allowance up to year 6 versus the US regular system, but the difference is slight. The Canadian system yields a slightly higher allowance up to year 10 versus the US alternate system, but the difference is still slight, and maxes out at 1.76% at years 5 and 6. The Canadian disadvantage begins at year 11, and continues to rise each year until it reaches 28.80% at year 31. The disadvantage continues for the rest of the life of the asset.

For real estate investment corporations (which are not PBCs) and unincorporated investors and partnerships, the Canadian depreciation rules are affected by the rental loss restriction rules. Each rental building with a capital cost in excess of $50K must be placed in a separate prescribed class, and CCA or depreciation cannot be used to create a loss for tax purposes. Accordingly, the comparison with the USA rules is fundamentally different, because in the initial years after construction many Canadian investors cannot claim CCA to any significant extent. They fall far behind their US counterparts, and never catch up.

APPENDIX C: COMPARISON OF DEPRECIATION/ CCA BETWEEN CANADA AND U.S.

	Canada		**US "regular system"**		**US "alternate system"**		**Canadian system vs. US alternate system**
Year	CCA allowed (of declining balanace)	Amount not writen off to end of year	Depreciation allowed (straight line)	Amount not writen off to end of year	Depreciation allowed (straight line)	Amount not writen off to end of year	
1	2.00%	98.00%	1.82%	98.18%	1.67%	98.33%	0.33%
2	4.00%	94.08%	3.64%	94.55%	3.33%	95.00%	0.92%
3	4.00%	90.32%	3.64%	90.91%	3.33%	91.67%	1.35%
4	4.00%	86.70%	3.64%	87.27%	3.33%	88.33%	1.63%
5	4.00%	83.24%	3.64%	83.64%	3.33%	85.00%	1.76%
6	4.00%	**79.91%**	3.64%	**80.00%**	3.33%	81.67%	1.76%
7	4.00%	**76.71%**	3.64%	**76.36%**	3.33%	78.33%	1.62%
8	4.00%	73.64%	3.64%	72.73%	3.33%	75.00%	1.36%
9	4.00%	70.70%	3.64%	69.09%	3.33%	71.67%	0.97%
10	4.00%	67.87%	3.64%	65.45%	3.33%	68.33%	0.47%
11	4.00%	**65.15%**	3.64%	61.82%	3.33%	**65.00%**	**-0.15%**
12	4.00%	62.55%	3.64%	58.18%	3.33%	61.67%	-0.88%
13	4.00%	60.05%	3.64%	54.55%	3.33%	58.33%	-1.71%
14	4.00%	57.64%	3.64%	50.91%	3.33%	55.00%	-2.64%
15	4.00%	55.34%	3.64%	47.27%	3.33%	51.67%	-3.67%
16	4.00%	53.12%	3.64%	43.64%	3.33%	48.33%	-4.79%
17	4.00%	51.00%	3.64%	40.00%	3.33%	45.00%	-6.00%
18	4.00%	48.96%	3.64%	36.36%	3.33%	41.67%	-7.29%
19	4.00%	47.00%	3.64%	32.73%	3.33%	38.33%	-8.67%
20	4.00%	45.12%	3.64%	29.09%	3.33%	35.00%	-10.12%
21	4.00%	43.32%	3.64%	25.45%	3.33%	31.67%	-11.65%
22	4.00%	41.58%	3.64%	21.82%	3.33%	28.33%	-13.25%
23	4.00%	39.92%	3.64%	18.18%	3.33%	25.00%	-14.92%
24	4.00%	38.32%	3.64%	14.55%	3.33%	21.67%	-16.66%
25	4.00%	36.79%	3.64%	10.91%	3.33%	18.33%	-18.46%
26	4.00%	35.32%	3.64%	7.27%	3.33%	15.00%	-20.32%
27	4.00%	33.91%	3.64%	3.64%	3.33%	11.67%	-22.24%
28	4.00%	32.55%	3.64%	0.00%	3.33%	8.33%	-24.22%
29	4.00%	31.25%			3.33%	5.00%	-26.25%
30	4.00%	30.00%			3.33%	1.67%	-28.33%
31	4.00%	28.80%			1.67%	0.00%	**-28.80%**
32	4.00%	27.65%					-27.65%
33	4.00%	26.54%					-26.54%
34	4.00%	25.48%					-25.48%
35	4.00%	24.46%					-24.46%
36	4.00%	23.48%					-23.48%
37	4.00%	22.54%					-22.54%
38	4.00%	21.64%					-21.64%
39	4.00%	20.77%					-20.77%
40	4.00%	19.94%					-19.94%