



Canadian  
Federation  
of Apartment  
Associations

Fédération  
Canadienne Des  
Associations  
De Propriétaires  
Immobiliers

# Rental Housing in the 2010 Federal Budget

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## **EXECUTIVE SUMMARY**

The Canadian Federation of Apartment Associations represents the owners and managers of over one million rental suites across Canada through 17 local and provincial associations. We are the sole national voice of the rental housing industry.

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

By contrast, between 1970 and 1990 the tax treatment of rental housing was made steadily worse. 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.

### **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%). That tax burden discourages property asset reallocation, discourages renovation of the housing stock and raises the costs of rental housing. Providing a tax deferral on sale and reinvestment would have many benefits for the Canadian economy, and would make the tax system fairer for both landlords and tenants.

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. Over time, the deferral "cost" would decrease toward zero, while the economic benefits would quickly make the overall impact on government revenue positive.

### **Zero-Rating the GST/HST**

Since its inception in 1995, CFAA has been calling for the rental housing industry to be zero-rated for GST purposes, the same status as is accorded to food and groceries. In effect, adopting the HST model acknowledges that a higher tax is a cost of business like any other, which businesses manage by passing it on in price of services (in our case in the rents we charge) as market conditions permit. By failing to zero-rate the rental housing industry the government has raised the cost of rental housing, which has raised market rents and made rental markets tighter. CFAA estimates that the cost of providing zero-rating to rental housing would be in the order of \$500M to \$670M per year.

### **GST/HST on Self-Supply**

In the alternative to zero-rating rental housing, one smaller reform which would promote rental housing construction would be the reform of the rules for determining the GST (or HST) to be paid on the self-supply of new rental buildings so that buildings are valued on the basis of "cost plus". That reform would better reflect the purpose of the self-supply rules, and promote the construction of new rental housing. CFAA estimates that the cost would be in the order of \$10M per year. Because the main gain for developers would be through increased certainty rather than through tax savings, the stimulative effect would be far in excess of that normally obtained for \$10M.

### **Recommendations**

For the 2010 Federal Budget, the CFAA recommends that the government and Parliament provide for fairer taxation of rental housing through two of the following three measures, namely:

1. providing a tax deferral on the sale of one rental property and purchase of another;
2. zero-rating rental housing for GST/HST; or in the alternative
3. reforming the determination of the GST/HST on the self-supply of new rental housing to charge the tax on "cost plus".

## INTRODUCTION

The need for the reforms 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 many homeowners. The most significant of those policies and programs include the following:

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

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

### 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%<sup>1</sup>
- 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 rate of 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
- rate of 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

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.

Rental housing does not have 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 \$400,000 of income, but that preferential rate is not available for rental income.

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<sup>1</sup> 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.

## **How should Parliament act to redress the balance between home owners and renters?**

In order to move toward a balanced housing policy, we suggest that Parliament should provide improved tax rules for rental housing to move the tax position of renters closer to that enjoyed by homeowners. In the 2010 Budget, such measures should include providing a tax deferral on re-investment, and zero-rating rental housing for GST/HST (or in the alternative, reforming the determination of GST/HST on self-supply.)

### **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 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**

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 TFSA's. 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.

#### **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.

Permitting rental property owners to defer both the recapture of capital cost allowances and capital gains taxes 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.

### **ZERO-RATING RENTAL HOUSING**

Since its inception in 1995, CFAA has been calling for the rental housing industry to be zero-rated for GST purposes, the same status as is accorded to food and groceries. This issue has become important to many more tenants and landlords now that Ontario and BC have agreed to harmonize their retail sales tax with the GST.

#### **GST-Exempt Businesses**

Residential rental housing is one of the few types of businesses in Canada that are 'GST-exempt'— other types of businesses treated similarly are health and dental services, certain financial services, day-care services and educational services. These types of businesses pay GST on their inputs, but do not collect GST on their services. However, unlike rental housing, those are typically labour-intensive businesses so their losses from being stranded with the GST are relatively small compared to rental housing.

Adopting the HST model for Ontario and BC acknowledges that a higher tax is a cost of business like any other cost of doing business, which cost is to be managed by passing it on in price of services (i.e. in the rent) as market conditions permit.

#### **Groceries – Zero-Rated Goods**

The GST treatment of groceries is much more favourable than rental housing (another basic necessity). Like residential rents, no GST is collected on basic groceries. However, groceries are 'zero-rated goods' – i.e. no tax is collected on the final sale, but sellers can claim input tax credits on their purchases. Thus, all tax paid at the intermediate stages is stripped away and no tax is buried in the price. So, while GST does not apply to either groceries or residential rents, the providers of groceries (e.g. supermarkets and farmers) do not bear the GST – *no*

GST is payable on many inputs (e.g. seed and fertilizer), and producers receive refundable input tax credits for those purchases on which GST is payable.

Unlike the case with basic groceries, the GST has raised the cost of rental housing – which reflects back in higher required rents in order for investors to achieve the same return. The actual result has been a reduction in the attractiveness of investment in new rental housing – and tighter rental markets. Harmonization and the extension of the HST to a wide variety of new products and services will further exacerbate this problem in Ontario and BC.

**Zero Rating** – The preferred solution for the rental housing industry is zero-rating across Canada. There is a strong argument for fully removing rental housing from the tax base for the proposed HST. The justification for rental housing to receive the same type of treatment as basic groceries is similar to the justification for zero-rating groceries, namely this: shelter (especially rental housing which is predominantly occupied by low and middle-income people) and food are basic necessities, and a tax on such goods and services is highly regressive. CFAA estimates that the cost of providing zero-rating to rental housing would be in the order of \$500M to \$670M per year.

### **GST/HST ON SELF-SUPPLY**

In the alternative to zero-rating rental housing, one much smaller reform which would promote rental housing construction would be the reform of the rules for determining the GST (or HST) to be paid on the self-supply of new rental buildings.

Currently the GST audit department seeks to charge GST on the fair market value of the building as rented up, or sometimes on the value as if the building were sold as individual condominium units. Those values include the premium paid for condominiums which would be earned through a costly marketing campaign, or at least the value gained through the specialized business of renting up a new rental building. Both additions to the value go well beyond the value of the building itself created by the “employed labour, financing costs and profit” put into the construction of the building.

By its current approach CRA is actually creating an advantage for a person who contracts to buy a new building because in today’s marketplace most agreements to buy new buildings do not include the rental income stream value, and they certainly do not include the condo value. The value which the self-supply policy seeks to tax would be more accurately captured by a building value determined on the basis of “cost plus [profit]”.

Determining building values for the self-supply rules on the basis of “cost plus” would

- accurately reflect the purpose of the self-supply rules
- eliminate the current advantage buyers have over builder-developers, and
- provide certainty for builders.

In turn, certainty would

- eliminate a barrier to entry for would-be builders
- promote the construction of new purpose-built rental housing.

An additional reform which would improve the GST self-supply rules would be

- to allow disputed sums to be paid (with interest) after the dispute is resolved.<sup>2</sup>
- to ensure that the trigger date for tax can be ascertained in advance rather than depending in part on when 90% of the costs have been incurred (when one cannot tell that date with certainty until the building is 100% complete).

CFAA estimates that the cost of charging the GST on self-supply on the “cost-plus” basis would be in the order of \$10M per year. The Canadian Federation of Apartment Associations urges the government to reform the application of the GST self-supply rules in the ways set out above.

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<sup>2</sup> That rule applies to disputes about income tax, which is analogous to this category of GST payments. The Income Tax Act used to match the current GST rule under the Excise Act. The current GST rule may be appropriate for most GST when the tax remitter has collected the GST and held the money in trust. However, in the self-supply situation no unpaid GST has been collected; therefore the new income tax rule is more appropriate.