Increasing Rental Inventory Through Fair Tax Treatment

A healthy rental market is important to business operations as the rental inventory provides housing for employees at all levels of the employment spectrum, and most importantly, for entry level employees. Employers are increasingly finding the issue of rental availability to be a hurdle to recruitment and retention of employees. In some areas, extremely low vacancy rates may have adverse effects on the ability of businesses to grow.

Issue

Our economy relies upon a wide variety of labour to meet its needs. Rental housing provides accommodation for those who are early in their work careers or those who choose not to pursue home ownership. The lack of supply of rental housing is acute across the country and limits both the supply and mobility of labour. The lack of affordable housing is a significant risk to our economy. There are a number of areas of affordable housing that could be addressed. This policy seeks to address rental inventory specifically.

Tax changes introduced over the past 25 years have disadvantaged the treatment of investment in real property and rental housing in particular. The tax changes have created inequitable taxation on these investments when compared to other forms of investment. The result has been decreased activity in the rental housing market, such as less property turnover and revitalization and less purpose built rental property construction. This has been reflected in the erosion of available rental units, which according to the Canada Mortgage and Housing Corporation, has fallen from an average Canadian vacancy rate of 4.5 per cent in 1994 to 2.7 per cent by the spring of 2014.

Treatment of Capital Gains

In the 1990s, investments in real property were eliminated from the lifetime capital gains exemption. The rationale for the tax move was to direct investment dollars to more “productive” investments. The capital gains tax formula on the sale of rental property is applied immediately upon the disposition of the asset, whereas capital gains on other assets, such as “former property” or “former business property” are eligible for tax deferral when a replacement property is purchased within a specific time frame. Rental property, oddly, is specifically excluded from the definition of “business property”.

In addition to the capital gains tax, property owners must also pay tax at their full tax rate on the recaptured amount of capital cost allowance depreciated over the period of their ownership tenure. Together these two tax measures result in a significant “lock-in effect”, where owners of real property hold on to the assets rather than re-invest in more productive properties. The tax measures also act as a disincentive to maintain or revitalize the overall quality of both commercial and residential assets, as doing so would result in higher capital gains tax payment upon eventual disposition.

The Canadian Real Estate Association, through the services of Dr. Thomas Wilson, a leading authority on taxation and the University of Toronto’s Institute for Policy Analysis, has determined that the cost to government to introduce a deferral on capital gains for real property is minimal. The approximate cost in the first year is estimated to be $415 million to the federal government and $208 million in total to provincial and territorial governments. The Association asserts that the cost would actually decrease in subsequent years as the deferrals of gains would come into play and that increased business activity from newly freed capital would more than compensate through increased tax revenue. The Altus Group estimates the typical multi-unit residential income property transaction in the Greater Toronto Area, Greater Calgary Area and Greater Vancouver Area generates $287,850 in ancillary spending. The Altus study also found more than one job was created for every two transactions.[1] The increase in ancillary spending and job creation mitigates the loss of Capital Gains Revenue to the government and approximates a revenue neutral effect of this measure.

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[1] http://www.torontorealestateboard.com/about_treb/lobbying/submissions/2010/CREA-Capital_Gains.pdf

Explanatory Notes Capital Taxes

If one disposes of a depreciable piece of property there two things that could be triggered:

- Recapture of Capital Cost allowance: This would be if the property were sold and it sold for more than the depreciated value. The difference between depreciated value and actual cost would be recaptured and considered income in the year of disposition.
- Capital Gains: This is the difference between cost of the property and any gain over cost. 50% of this gain is considered income.

In summary, the difference is recapture of capital cost allowance is 100"% of the recapture is taxable vs capital gains where only 50% is taxable.

Tax Deferral – is a process of deferring the recognition of income over a longer period. This facilitates taxes being paid on income but in the case of this policy would serve to reduce the balloon increases in income.[2]

Tax Treatment of Rental Income

In addition to the treatment of capital gains on rental properties, the rental income they generate falls under the definition of "aggregate investment income" in the Canada Income Tax Act (CITA). Since it is not "active business income", a Canadian Controlled Private Corporation (CCPC) is not able to take advantage of the small business credit, which reduces the corporate tax rate to only 13.5 per cent on the first $500,000 of active business income. Furthermore, since "aggregate investment income" is excluded from the definition of "full rate taxable income", the CCPC will also not be eligible for the General Rate Reduction. This means that the starting point of the corporate tax rate on this type of income can exceed 40 per cent. To potentially qualify for a lower rate, the business must be classified as a "Principal Business Corporation" (PBC). A PBC's primary business must be the leasing, rental, or the development for lease, rental or sale of real property owned by them, and they must employ at least six full-time employees. Most of the companies that provide the majority of rental housing in Canada do not meet these requirements and therefore are taxed at the higher rate.

Furthermore, governments have moved to discourage the use by corporations to defer tax on investment income, instituting an "Additional Refundable Tax" (ART) on aggregate investment income that qualifies for a dividend refund. This is an additional tax on corporations that aggregate investment income and don't pass along the income through dividends to their shareholders. The ART adds a tax of 6.7 per cent on the aggregate investment income of CCPCs, which makes the corporate tax rate for CCPCs roughly equal to the highest individual marginal tax rate.

The effect of these definitions and requirements has been to deter investment in rental housing, directing it to other real estate sectors such as the hotel and accommodation industry, where the requirements and tax treatment on active business income are more favourable.

Effects of the GST on Rental Housing

Since it was introduced in 1991, the GST has discriminated against rental housing by providing a rebate for ownership housing but none for rental units. In addition, because residential rents are classified as exempt rather than zero-rated under the GST, landlords are unable to recover tax paid on the purchase, repair or improvement of residential buildings. Allowing for a zero-rated designation would mean that because landlords cannot charge GST on rent, they would be able to claim GST on their Input Tax Credits.

All taxes induce people to behave in certain ways. It is clear that the changes in tax policy of the last 25 years applying to investment in real property, and specifically rental property, have resulted in a lock-in effect, less activity in the

[2] CD How Institute No. 94 April 2006, "Removing the Shackles Deferring Capital Gains Taxes on Asset Rollovers" http://www.cdhowe.org/pdf/backgrounder_94.pdf

rental housing industry, and an overall decrease in rental accommodation availability. Yet as noted at the outset, a healthy rental market is important to business operations since rental inventory provides housing for all levels of the employment spectrum.[3]

Recommendations

That, when fiscal conditions allow, the federal government:

1. Enact deferral of capital gains tax on the sale of residential rental and mixed-use property, when the proceeds of sales are reinvested within a twelve-month period into other residential rental and/or mixed-use property investments;
2. Defer the recapturing of the value of depreciated capital cost allowances on residential rental and mixed-use property;
3. Include rental income under the definition of "active business income" for CCPCs in the CITA legislation;
4. Allow a 100 per cent refund of GST paid by businesses investing in rental housing; and,
5. Zero-rate rental housing operations to allow landlords to claim ITCs on their expenses.

[3] http://www.hafezrealty.com/news/25.pdf