Canadian Federation of Apartment Associations

Fédération Canadienne Des Associations De Propriétaires Immobiliers

Rental Housing in the 2008 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.

Addressing housing and the needs of the homeless across Canada is a key issue for community leaders and policy-makers. Making sound decisions on housing policies depends on an understanding of housing markets and of Canadians' needs and preferences. Many Canadians choose to rent their housing for a variety of reasons. For many low-income Canadians, renting is the cost-effective way for them to obtain suitable and adequate housing.

However, for many years in Canada, public policies at all levels of government have promoted homeownership. Those policies include various explicit incentives for homeownership, and several benefits under the income tax system which accrue to many homeowners. However, most of those income tax benefits do not accrue to low income households, even if they are homeowners.

Also for many years, the tax system has been amended in ways that further disadvantage residential landlords, developers and renters. The tax changes have meant that Canada's housing system is not providing the housing opportunities in the rental sector needed by households with low and moderate incomes. In addition, a modern economy which relies on a mobile workforce, such as Canada's, is not necessarily well served by the promotion of homeownership at the expense of rental housing, and the Canadians who choose to rent should not be excluded from the benefits of public policy.

Many low-income families are being hurt by the policies, pressure and rhetoric promoting homeownership. Recent developments in the U.S. sub-prime mortgage market show the damage to low-income families which can be caused by promoting home buying mortgages to those who lack an adequate down-payment and the income to weather a downturn in house prices, or in their household income. Beyond that, the sub-prime crisis shows that the dangers of undue mortgage lending apply to the economy as a whole, not just to the households directly affected.

In order to promote a sound and balanced housing policy, we suggest that Parliament and CMHC should:

a) eliminate the 0% and 5% down mortgage programs

b) adopt policy measures to promote housing quality and affordability for those whose income and wealth place them in a poor position to access the tax and other benefits of home ownership (Such measures could include a national housing allowance program.)

c) provide improved tax rules for rental housing to provide benefits to renters analogous to those received by homeowners, so that public policy exerts a more neutral impact on the choice of tenure decision (Such measures should include providing a tax deferral on reinvestment, and increasing the CCA rates on rental housing.)

In the consideration of public policy measures, attention should be given to the question of equity between renters and owners and equity between residential rental investors and other investors, as well as to addressing the income and affordability issues of renters. Immediate measures should include providing a tax deferral on reinvestment, and increasing the CCA rates on rental housing.

Policies that favour homeownership

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. Such 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
- the Ontario Home Ownership Savings Plan (OHOSP)
- the Nova Scotia Home Ownership Savings Plan
- rebates on land transfer tax for first time buyers
- tax-free treatment of the imputed income from living in an owned dwelling
- the imputed income from living in an owned dwelling is not considered in determining the eligibility and level of payments under the Guaranteed Income Supplement (GIS) program
- the former Assisted Home Ownership program (AHOP)

Recent policies provide even more incentive for households to choose home ownership. These policies include

- mortgage insurance for very high ratio loans (95% and even 100% of value, i.e. 0% or 5% down)
- programs to promote home ownership among renters in public housing through the various federal-provincial affordable housing agreements.

However, most 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, since the 1970s the tax treatment of rental housing has been 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 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.
- a lifetime capital gains exemption of $20,000 is introduced for individuals, which is to increase to $500,000
- MURB rules are repealed retroactively preventing the application of CCA deduction to offset income from other sources
- the lifetime capital gains exemption is capped at $100,000; and cumulative net investment loss rule reduces the value of the exemption
- 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 lifetime capital gains exemption is eliminated.

The tax changes have meant that Canada’s housing system is 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, deferring tax on capital gains and recapture of CCA, but 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.

Misleading information about home ownership versus renting

Numerous studies proclaim home ownership the "silver bullet" to improve the financial, social and even physical health of low income Canadians. One recent study compared the wealth that would be accumulated by renters investing the difference between their rent and their costs as owners (in stocks yielding the average return achieved on the Toronto Stock Exchange between 1979 and 2006) with the wealth of homeowners. The study finds that such a renter would accumulate 20% more wealth than a homeowner in Edmonton, Halifax, Montreal and Regina, after taxes and fees. For Ottawa, Vancouver and Winnipeg, the difference would be lower but still in favour of renters. Only for Calgary and Toronto would the wealth of owners be higher.[2] Despite those findings, the study endorses homeownership as "a unique opportunity for households to accumulate wealth," in large part because of tax policy.[3]

CMHC produces data comparing the cost of home ownership versus renting. The comparison is the average rent of a two bedroom apartment against the principal and interest required on a mortgage on a resale condo apartment.[4] However, in addition to their mortgage payment, homeowners need to make a downpayment (on which they forego other investment opportunities) and pay property taxes, insurance, repairs, utilities and condominium fees. The CMHC figures do not provide an apples-to-apples comparison, but they are reported in the media and used in advertising as if they were.

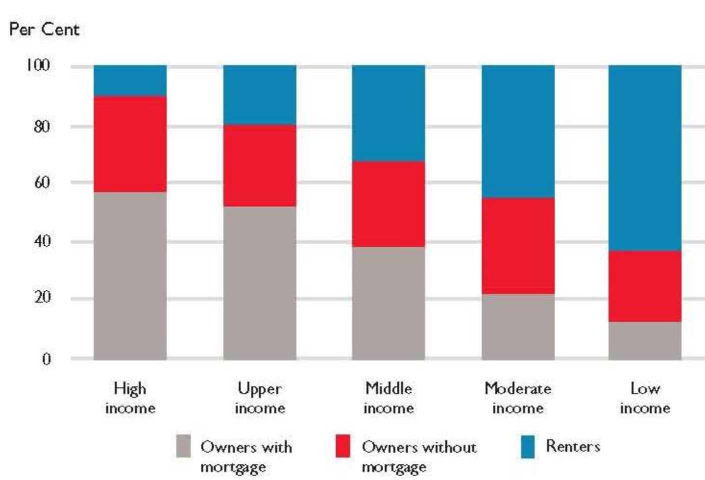
The benefits of homeownership

As noted above, homeowners receive many benefits. Two largest benefits are from the income tax system: first, any capital gain on a principal residence is free of tax;[5] and second, the benefit of imputed income of living in the home is not taxed. That benefit varies according to how much equity a person has in their home. With a large amount of equity, the benefit is large since the household has a large amount on which it is essentially earning tax-free income in the form of untaxed housing services. With a small amount of equity, the benefit is correspondingly small.

Moreover, both benefits also vary with the income of the household. The higher the income (and thus the higher the marginal income-tax rate), the larger the benefit for any given amount of equity in the home. Similarly, the lower the income, the smaller the benefit. In fact at a low income, there may be no such benefit at all. Consequently, the benefits of home ownership apply mostly to high income earners, especially those with a lot of capital (i.e. wealth), who are able to inject a lot of equity. The factors mean that **home ownership is not necessarily an economic benefit for low-income people, and especially people with both low income and little wealth**.[6]

Economically rational behaviour would result in fewer low-income households owning their homes, and of those who do own, one would expect to see substantial amounts of equity. That is exactly the pattern one sees in the data, as shown in the figure below.[7]

DISTRIBUTION OF HOUSEHOLDS BY TENURE, CANADA, 2001



Source: CMHC (census-based indicators and data)

The disadvantages of home ownership

Home ownership also has numerous disadvantages and risks. Any gains made through house price appreciation may be offset by the cost of buying and selling. Those transaction costs also interfere with labour mobility, with negative impacts on workers and the economy. The possible benefit due to house price appreciation is uncertain and highly variable. **In many years and many markets, house prices fall**. For example, between 1981 and 1986, Vancouver's average house price fell by 38% in real terms, and between 1989 and 1994 Toronto's average house price fell by 32% in real terms and by 24% in current prices.[8] Given recent rapid increases in house prices, one can expect similar "corrections" within the next few years. This is particularly devastating to those with low equity, or the need to sell. For owners paying a high percentage of their income in mortgage payments, even a modest increase in interest rates can be devastating. Such an increase can raise the required payment, and at the same time will cause house prices to fall. Policy makers need to remember the foreclosures and financial losses which occurred under the Assisted Home Ownership Program (AHOP) of the late 1970s and early 1980s in order to avoid a similar policy error.

American commentators on low-income homeownership programs

Even before the recent sub-prime mortgage crisis, numerous American commentators expressed the view that American housing policy has gone too far in promoting home ownership for all households. American home ownership benefits are higher than benefits in Canada. However, American home ownership benefits are mitigated by larger tax benefits for rental housing than in Canada, which tends to keep the homeownership-cost-to-rent ratio, and the effects on tenure choice, in line between the two countries. Therefore, the comments are highly instructive.

In *The Crisis in America's Housing: Confronting Myths and Promoting a Balanced Housing Policy*, the National Low Income Housing Coalition says:

> Veteran housing counsellors said that providing low-income homeownership was a very time- and money-intensive endeavour that required significant subsidies to help a small number of families. Homeownership cannot replace successful rental assistance programs such as housing vouchers, and many low-income families are being hurt by the pressure and rhetoric to become homeowners.

In *Rethinking Rental Housing: Expanding the Ability of Rental Housing to Serve as a Pathway to Economic and Social Opportunity*, William Apgar of the Joint Center for Housing Studies of Harvard University, and former Secretary of Housing and Urban Development, writes:

> There are downsides to excessive focus on promoting homeownership. Owning a home may prove unhelpful or even financially disastrous. Many low-wealth and low-income families are being "pushed" into homeownership because they are told that homeownership is a prerequisite for economic and social success, and they perceive (or rather hope) that homeownership in and of itself will help them achieve a better life.
>
> In fact, lower-income homeowners may become trapped in declining neighbourhoods with little access to employment, good quality schools or social services and equally limited potential for price appreciation. In these situations, all too often the dream of homeownership becomes the nightmare of a financially devastating foreclosure.

In *Who's Dreaming? Homeownership Among Low Income Families*, Dean Baker of the Center for Economic and Policy Research, writes:

> Low-income families are less likely to benefit from homeownership because: (1) they have no income tax liability, so they receive no tax benefits from owning; and (2) high transaction costs from buying and selling have a greater impact on low-income families because they have shorter median ownership periods—just four years.
>
> In a scenario in which home prices rise in step with inflation, a typical low-income homebuyer will lose an amount equal to approximately 25 percent of their total rent over the four-year median period of homeownership.

Recent developments in the U.S. sub-prime mortgage market

Recent developments in the U.S. sub-prime mortgage market show the damage to low-income families which can be caused by promoting home buying mortgages to those who lack an adequate down-payment and the income to weather a downturn in house prices, or in their household income. Beyond that, the sub-prime crisis shows that the dangers of undue mortgage lending apply to the economy as a whole, not just to the households directly affected.

The policy implications

The facts set out above have two main implications:

1) promoting home ownership to those who will need to move, or to those with low or moderate incomes, and low equity, is bad public policy; and

2) the income tax system confers large benefits on homeowners with high incomes and substantial equity, without any matching benefits to renters or people with low incomes or little equity.

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

In order to promote a sound and balanced housing policy, we suggest that Parliament and CMHC should:

a) eliminate the 0% and 5% down mortgage programs

b) adopt policy measures to promote housing quality and affordability for those whose income and wealth place them in a poor position to access the tax and other benefits of home ownership (Such measures could include a national housing allowance program.)

c) provide improved tax rules for rental housing to provide benefits to renters analogous to those received by homeowners, so that public policy exerts a more neutral impact on the choice of tenure decision (Such measures should include providing a tax deferral on re-investment and higher CCA rates on rental housing.)

Tax Deferral on Sale and Re-Investment

One attractive reform to improve the relative income tax position of rental housing is to provide tax deferral on the sale of a rental property and reinvestment in another rental property.

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 33%). 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). Some have argued that rental income is a passive form of income while investment in other forms of capital results in active income, which deserves preferential tax treatment. In truth, it is not clear that the active/passive distinction between rental property and other forms of capital is realistic. Rental property must be managed, and often, significant services must be provided to tenants on an on-going basis.

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. Rental buildings are largely immobile. 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.

Note that the proposed reform is not a tax reduction, rather it is a tax deferral. The tax on capital gain and the recaptured CCA will ultimately be paid. The proposal is only to defer the tax, and only if the proceeds of a sale are reinvested in a replacement property within 12 months of the sale. On that basis, no capital gain has really been realized; only an exchange of properties has taken place. Moreover, given that a lower undepreciated capital cost will apply, the tax received on the income from the replacement property will be higher than it would be without the deferral.

When producers of a product are heavily taxed, the price charged to consumers is increased. This is the case for most products, and rental property is no exception. Because rental property owners cannot defer taxes, they incur immediate tax costs on any property sales. Through the working of the rental housing market and the capital markets, those costs are passed on to renters. Unlike renters, homeowners are able to enjoy the fruit of an investment in their house without paying tax on it. Renters have substantially less wealth than homeowners, but the current tax regime imposes a tax burden on renters which homeowners are spared.

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.

CCA Rate

Another cost-effective improvement in the tax treatment of rental housing would be an increase in the Capital Cost Allowance (CCA) rate. In the 2007 budget, the CCA rate was increased for industrial and commercial buildings. Only for rental housing is the rate still 4%. (Until 1988 the CCA rate was 5%, and before the late 1970s it was 10% for wood-frame construction.)

The inadequacy of the Canadian allowances can be seen by contrasting the proportion of a building which has been "written off" under the American, German and Canadian tax systems.

Proportion of a building which has been "written off"			
Years from construction or purchase	Current Canadian CCA system	Current U.S. CCA system	1989 German system
5	17%	18%	33%
10	32%	36%	58%
15	45%	55%	64%
20	55%	73%	70%
25	63%	91%	77%
30	70%	100%	85%

Wood-frame is the construction method of choice for the more affordable new construction, consisting of row-houses or stacked townhouses in the suburbs. A modest increase in the CCA rate to 5% for concrete structures and 6% for wood-frame structures would be an important step toward rebalancing the tax system for renters across Canada. 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.

Conclusion

In the consideration of public policy measures, attention should be given to the question of equity between renters and owners and equity between residential rental investors and other investors, as well as to addressing the income and affordability issues of renters. Immediate measures should include providing a tax deferral on reinvestment, and increasing the CCA rates on rental housing.

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[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.

[2] Tsur Somerville, Li Qiang and Paulina Teller, “Are Renters Being Left Behind? Homeownership and Wealth Accumulation in Canadian Cities”. Centre for Urban Economics and Real Estate, University of British Columbia, January 29, 2007, pp 12-13.

[3] Ibid, p. 2.

[4] For example, see Figure 3 on p.2 of the CMHC Rental Market Report for Toronto released December 2006.

[5] That benefit varies according to whether the home grows in value at or above the rate of inflation. If the home grows in value at below the rate of inflation, there is little if any net benefit (compared to renting).

[6] These policies may in fact hurt low income people since the tax expenditures implicit in these homeownership tax benefits requires higher taxes generally, including higher taxes from low income households. Since low income households pay little income tax, the extra taxes on low income households would be mostly higher consumption taxes, like the PST and GST and taxes on cigarettes and alcohol.

[7] Figure 58, p. 69, 2006 Canadian Housing Observer, CMHC

[8] Marion Steele and Rakhal Sarker, “Estimates of the Private and Societal Costs and Benefits of Homeownership in Selected Canadian Cities”. CMHC, October 2005, p. 55.