



Canadian
Federation
of Apartment
Associations

Fédération
Canadienne Des
Associations
De Propriétaires
Immobiliers

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Executive Summary

For the last 10 years, fewer than 20,000 purpose-built rental units were added to the rental housing supply each year. Before 1975, Canada had a thriving rental housing industry, producing between 50,000 to 70,000 purpose-built rental units annually.

Most members of the public perceive landlords as wealthy individuals with high incomes. This view is largely incorrect. However, the view of landlords as wealthy, high-income earners has tainted the tax reform process.

Prior to tax reform in 1972, residential rental property was treated in a manner similar to the treatment accorded to other capital property held to produce income. The tax reforms of 1972 and subsequent years imposed some changes on all capital property, and other changes specific to residential rental property. In many cases, residential rental property is now treated less favourably than other income-producing property. Our key request is for the restoration of equity between residential rental property and other capital property.

For example, prior to 1972, the sale of rental property could be undertaken without tax being payable (on the recaptured CCA) if the proceeds were reinvested in another rental property. Now that still applies to other businesses but not to rental investors. Consequently, the expected return to the rental investor is reduced, liquidity is decreased, risk is increased, and the investor requires a higher pre-tax price on the disposal of the rental property. It is clear that the requirement to pay tax on the disposition of a rental property and reinvestment in another is a significant deterrent to investment in rental property.

We ask the government to allow the deferral of capital gains tax and recaptured CCA upon re-investment in rental housing.

Besides the issues of equity between rental housing investors and other income-earners, there is also the question of equity for tenants vis-à-vis homeowners.

It is well known that the Canadian tax system provides favourable treatment for homeownership. Homes are treated as consumption goods rather than investment goods. The value that people enjoy in using a home is not recognized as being part of their income. Homeowners are able to invest in a home and enjoy the “fruit” of that investment without paying tax on it; whereas if a person invests in another asset and earns income they must pay tax on that before paying their rent. In addition, capital gains on the primary residence are exempt from income tax.

It is also well known that the average homeowner has both much more wealth and more income than the average tenant. CMHC reports that the average Canadian homeowner has a substantially higher income (\$71,946) than the average Canadian renter (\$38,797). Renters under the age of sixty-five have only about 13% of the wealth of homeowners, while renters over the age of sixty-five have only about 26% of the wealth of homeowners in the same age group.

Some argue against tax relief for rental housing because of a view that such relief would be a tax expenditure which would be less efficient than direct subsidies to increase housing supply. We submit that such concerns should not apply at all to tax relief to bring equity to the taxation of rental housing compared to other investments. When or if we reach the point that rental housing is not taxed more heavily than other sectors, then and only then, will consideration of the efficiency concern have some validity. We argue that economic efficiency arguments actually favour the broad based tax reforms over direct subsidies.

Requested Tax Reforms

We ask the government to:

1. Allow income tax deferral on sales when the proceeds are reinvested in rental property.

1A. In the alternative, to raise the property limit for pooling to \$1,000,000.

2. Zero rate the rental housing industries for GST, or

2A. In the first alternative, fully rebate the GST on new rental housing projects, or

2B. In the second alternative, for the GST self-supply rules, allow developers to base the value of new construction on cost to avoid taxing non-realized condominium value, and encourage the rental of new units.

3. Allow small landlords to qualify as active businesses.

4. Increase the CCA rates on rental housing and extend eligibility for CCA losses.

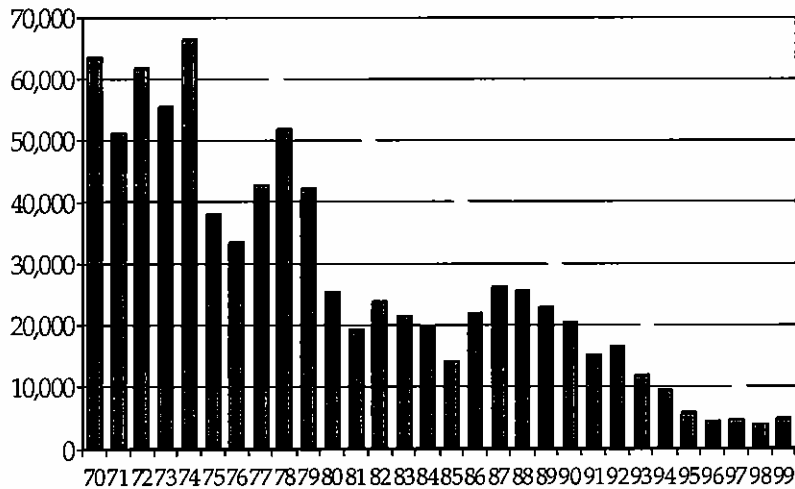
Who We Are

The Canadian Federation of Apartment Associations (“CFAA”) represents the owners and managers of one million residential rental suites in Canada, through 16 organizations across Canada. Our membership includes publicly traded corporations, REITs, pension plans, social housing providers, and large and small private investors. Our membership includes thousands of rental owners who own one or two small buildings, as well as thousands of rental owners who own only one or two rental units. CFAA is the sole national organization representing the interests of Canada’s \$30 billion rental housing industry, which is owned by over one million Canadians.

Status of the Rental Housing Industry

For the last 10 years, fewer than 20,000 purpose-built rental units were added to the supply each year. Before 1975, Canada had a thriving rental housing industry, producing between 50,000 to 70,000 purpose-built rental units annually. Purpose-built rental units are known as the primary rental stock. That stock is what CMHC usually surveys, as it is found in buildings of 3 units or more. (See the chart below.)

Primary Private Rental Supply in Decline



Source: Clayton Research & CMHC, 2001

As will be discussed below, a number of federal tax changes have played a major role in the dramatic reduction in investment in the primary rental stock across Canada.

Non-Conventional Rental Supply

The private sector responds to opportunities to profit from providing additional rental housing in one of two ways, namely by providing additional conventional rental housing, e.g., purpose-built rental buildings, which are counted in CMHC's monthly housing starts survey and by providing additional non-conventional rental housing, e.g., through the creation of basement apartments or the renting out of condominium units, single family homes or duplexes. That is known as the secondary rental stock.

For the Federal Government, the secondary rental stock has a number of distinct disadvantages relative to conventional rental housing in terms of tax revenues and housing policies. Investors owning houses with basement suites have the opportunity not to declare or to under-report their rental income. The stability of the rental housing stock provided through non-conventional sources is at risk since the individual owners can remove the units from the rental housing stock at any time. On the other hand, the secondary rental stock provides flexibility because much of it can be rented or used for owner occupation, whereas conventional rental stock can only be used for rentals.

Characteristics of Rental Housing Owners

Most members of the public perceive landlords as wealthy individuals with high incomes. This view is largely incorrect.

According to a report prepared for CMHC¹, there were 3,900,000 occupied rental units in Canada in 1996, of which 600,000 were in the social housing sector. The 3,300,000 privately owned rental units were distributed as follows:

1. Individuals who owned from 1 to 6 units - approximately 50% or 1,650,000 units

¹Canada: Canada Mortgage and Housing Corporation. (1999). *Understanding Private Rental Housing Investment in Canada*. A report prepared by Clayton Research Associates Limited and Fish Marks Jenkins Real Estate Consulting. pp. 4, 45-46.

2. Institutional investors - less than 5% or 165,000 units

3. Individuals who owned more than 6 units, partnerships, joint ventures and private corporations - approximately 45% or 1,485,000 units.

In 1998, 19% of individuals who reported rental income indicated that rental income was their major source of income.² They had an average net rental income of \$7,581 per year.³ For 81% of rental owners, rental income was not their major source of income.⁴ They had an average net rental income of \$440 per year each.⁵

Between 81% and 85% of individuals reporting rental income earned less than \$60,000 total income each year.⁶ Even for individuals earning over \$50,000 total income per year, the average net rental income in the year 2000 was only \$15,936.⁷

Even among the owners in the third group, many are not wealthy. Some of the individuals own a 10 or 12 unit building as their main source of retirement income. Others own a 50 unit building as a partnership of several people. A recent trend has seen numerous sales from private corporations or individuals to REITs, pension plans and publicly traded corporations. The holdings of such entities are wide-spread like other stocks. Through pension plans, the ultimate owners are ordinary working Canadians.

However, the view of landlords as wealthy, high-income earners has tainted the tax reform process.

Income Tax Changes

Since 1972 the rules governing taxes on real estate rentals have been closely examined for “loopholes.” Numerous provisions were changed to “eliminate loopholes”.

In particular, the following tax changes have had a negative impact on investment:

- CCA rates were reduced considerably;
- Tax deferral on reinvestment and pooling were eliminated, forcing rental owners to pay capital gains tax and recapture of CCA if selling one building and purchasing another, unlike other industries, including the hotel and motel industry (and unlike the U.S. situation where rental housing providers are allowed “like property exchanges” on a tax deferred basis);
- The GST was applied to both construction and operations of a rental building, unlike a number of other industries (there is no GST rent, but GST is collected on all the inputs except financing costs and insurance);
- Lower taxes were provided to small businesses in Canada, except that if one is a small residential landlord, one is not eligible;
- Deductibility of CCA losses against other income was eliminated; and

²Canada: Canada Customs and Revenue Agency. Income Statistics 2000. Table 7.

³\$1,689,384,000 divided by 222,850 investors = \$7,581.

⁴Ibid

⁵\$416,964,000 divided by 946,260 investors = \$441.

⁶Canada Mortgage and Housing Corporation (CMHC). 2002. *Research Report: An Evaluation of Housing Taxation Measures*. Ottawa: Canada Mortgage and Housing Corporation. p 33

⁷ Calculated from Table 2-2, *ibid*, p. 34. (\$421,490,000 + \$336,652,000 + \$738,510,000) divided by (46,958 + 19,956 + 27,004), i.e. \$1,496,652,000 divided by 93,918 = \$15,936.

- Deductibility of a number of soft costs during construction was eliminated.

In the making of the tax changes there was little, if any, consideration of the adverse consequences of the changes on the flow of private capital into the rental housing, on the production of new rental accommodation, or on the cost of rental units to tenants.⁸

What Should Be Done (In Brief)

The rental housing industry should be taxed fairly. In particular, the federal government should immediately move to:

- Restore tax deferred reinvestment provisions;
- Eliminate the GST on rental housing operations; or at least
- Use cost-plus to assess value for the GST self supply rules;
- Allow rental housing to qualify for small business tax treatment; and
- Increase CCA rates and allow CCA deductions against other income.

All of these negative tax practices must be changed in the interests of equitability and stimulating rental housing production. Should the government determine that all changes cannot be made concurrently, our priority would be to address the tax deferral on re-investment provisions. This submission will focus on those provisions.

Reinvestment in rental property

Prior to tax reform in 1972, there was no tax on capital gains on the disposition of real estate or other capital properties. In addition, the sale of rental property could be undertaken without taxes being payable on the recaptured CCA, *if the proceeds were reinvested in another rental property*. The imposition of capital gains taxes and the removal of the ability to defer taxes on re-investment were two critically important features of the changed tax environment for rental housing.⁹

As a 2002 CMHC report puts it,

the involuntary disposition portion of the exchange-of-property rules apply equally to rental and non-rental properties. However, ... the voluntary disposition rules apply only to former business properties. There is no similar voluntary disposition rule for rental properties.

... One can conclude that, with respect to business properties, it is equitable to defer the tax consequences of the disposition, given that the proceeds are reinvested in the business. This measure is, therefore, a tax expenditure that is warranted.

However, as this preference is not extended to “former rental properties”, an element of inconsistency (a dimension of fairness) is introduced into the tax system. Whereas one can debate the conceptual difference and significance of active versus passive income, it is not so evident that a similar differentiation exists with respect to capital properties owned and used to generate business versus rental income. ... Rental

⁸ Clayton Research Associates Ltd. 1998. *Economic Impact of Federal Tax Legislation on Rental Housing Market in Canada*. Scarborough: Clayton Research Associates p. i

⁹ Lambert, Greg and Steve Pomeroy 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.26

property owners have the same re-investment and relocation needs as business property owners.¹⁰

Unlike the case with rental properties, businesses investing in other types of capital can defer recaptured CCA and capital gains if they acquire a replacement property of equal or greater value. For example, a company replacing a building occupied by its business can defer recaptured depreciation and capital gains tax if it acquires another building of equal or greater value. Similarly, a company can defer recapture of CCA and capital gains on capital equipment sold if other assets of the same type are purchased as a replacement – e.g. if the airliner with the 25% CCA is sold for more than the depreciated cost, the recaptured depreciation and capital gains can be deferred if the airline company purchases another aircraft. So, rental properties (including both rental housing and other types of rental real estate) are treated differently from other types of capital properties in this regard.¹¹

As the 2002 CMHC report concludes,

Failure to extend the former business property concept to rental properties leads to non-neutral decision-making, in that the rental property owner may defer the disposition of a rental property because a deferral is not available.

Consequently, the expected return to the rental investor is reduced, liquidity is decreased, risk is increased, and the investor requires a higher pre-tax price on the disposal of the rental property. **It is clear that the requirement to pay tax on the disposition of a rental property is a significant deterrent to expanding their investment base.**¹² (our emphasis)

With reference to the package of housing tax changes implemented in 1972, the authors of another report prepared for CMHC stated that “from an investment perspective, there is no question that the removal of these advantages have seriously reduced the attractiveness of investment in rental housing in Canada.¹³ It makes no sense that a hotel or motel or an airliner is eligible for a rollover, but not a rental building.

The key objective of reform of the rules for taxation on real estate dispositions is to increase liquidity and reinvestment in the rental sector. Currently, when an investor in a rental housing project (or any other type of rental real estate) sells the project, taxes are payable if the sale price exceeds the undepreciated capital cost of the project. The taxes would be based on a combination of recaptured CCA and capital gains. The taxes payable as a result of recaptured CCA and capital gains act as a deterrent to selling – the investor would prefer to keep the project (and avoid the taxes) rather than sell and reinvest in another project. In the extreme, owners may resort to demolishing an existing property to avoid the tax consequences of recapture – this would result in the destruction of older properties providing relatively affordable rental units.¹⁴ The discriminatory tax treatment inhibits the re-allocation of capital, thus raising its cost and increasing the rents needed to attract the

¹⁰ Canada Mortgage and Housing Corporation (CMHC). 2002. *Research Report: An Evaluation of Housing Taxation Measures*. Ottawa: Canada Mortgage and Housing Corporation. p 74.

¹¹ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.26

¹² Canada Mortgage and Housing Corporation (CMHC). 2002. *Research Report: An Evaluation of Housing Taxation Measures*. Ottawa: Canada Mortgage and Housing Corporation. p 75.

¹³ Canada Mortgage and housing Corporation, (1999). Clayton Research Associates Limited and Fish Marks Jenkins Real Estate Consulting. *Understanding Private Rental Housing Investment in Canada*. p. 39.

¹⁴ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.26.

required capital.

The restoration of tax-deferred reinvestment for rental properties would not eliminate, but only postpone the tax liability on recaptured depreciation (and capital gains) for owners of rental properties who invested the proceeds in another rental property. This would be beneficial to investment in new rental projects since it would encourage owners of older, heavily depreciated projects to upgrade their rental property portfolios by replacing older projects with newer ones – and allow them to use the greater equity for the investment. The taxes payable on recaptured depreciation and capital gains would be deferred as long as investors retained the newly-acquired rental projects – in the same way that these taxes are currently postponed as long as investors retain ownership of their current projects.¹⁵

In the US, the tax treatment of the sale of a rental property is quite different from the Canadian situation (discussed above). In the US, rental housing investors can defer capital gains tax and recaptured depreciation if the property is replaced by another property of greater or equal value.¹⁶

Equity Among Investors

While the objective of tightening loopholes available to the wealthy may be appropriate in some cases, changes in the tax rules have created “anti-loopholes” where rental owners are treated worse than other taxpayers; and in addition, as has been shown above, rental owners are not, for the most part, wealthy or high-income individuals. For both those reasons the tax system should be reformed to return fairness to the taxation of rental property.

Equity between Renters and Owners

Besides the issues of equity between rental housing investors and other income-earners, there is also the question of equity between renters and homeowners.

It is well known that the Canadian tax system provides favourable treatment for homeownership. Homes are treated as consumption goods rather than investment goods. The value that people enjoy in using a home is not recognized as being part of their income. Homeowners are able to invest in a home and enjoy the “fruit” of that investment without paying tax on it; whereas if a person invests in another asset and earns income they must pay tax on that before paying their rent. (We are not advocating the taxation of imputed rent as income; however, that is done in some European countries.) In addition, capital gains on the primary residence are exempt from income tax. This again favours the homeowner because of homeownership.

It is also well known that the average homeowner has both much more wealth and more income than the average tenant. CMHC¹⁷ reports that the average Canadian homeowner has a substantially higher income (\$71,946) than the average Canadian renter (\$38,797). That trend is consistent across all Canadian metropolitan areas. In addition, renters under the age of sixty-five have only about 13% of the wealth of homeowners, while renters over the age of sixty-five have only about 26% of the wealth of homeowners in the

¹⁵ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.26

¹⁶ Ibid

¹⁷ CMHC, *Canadian Housing Observer 2004*, Tables 20 & 21.

same age group¹⁸. Therefore, it runs against the principle of a progressive income tax system that homeowners have much greater tax benefits than tenants.

It is no answer to say that it is the rental property owners who pay the taxes rather than the tenants. In any other situation it would be readily recognized that if the producers of a product are relatively heavily taxed, that product will be increased in price accordingly and the quantity of it consumed will be diminished accordingly. That is exactly what happens with the heavy taxation of rental property, despite the fact that the government has a specific objective of promoting affordable housing. That objective is being severely compromised by the punitive income tax treatment of rental property.

Tax Changes or Grants?

Rental housing is part of a larger housing system, but tends to be the sector that accommodates most lower income households. Since there has been little new purpose-built private rental development for many years, this is a cause for concern – and questions about why.¹⁹

Clearly, the potential returns from development of new rental housing are not sufficiently attractive, given the returns available from alternative investments. New rental development is a risky investment, so investors need a return sufficient to compensate for the risks involved. The federal tax regime for rental housing is an obvious candidate for examination since, as is discussed below, there have been so many changes in the tax treatment of rental investment over the period since the early 1970s – the last period when there was substantial unsubsidized purpose-built rental production in Canada.²⁰

There are many precedents for using the tax system to promote particular types of investments, or to influence investors' decision-making – Labour Sponsored Venture Capital Funds, flow-through shares for resource exploration, and RRSP deductibility are only a few of the many examples of tax expenditure programs which seek to influence investor behaviour.²¹

Some argue against tax relief for rental housing alleging that such relief would be a tax expenditure which would be less efficient than direct subsidies to increase rental housing supply. We submit that such concerns should not apply to tax relief to bring equity to the taxation of rental housing compared to other investments.

When or if we reach the point that rental housing is not taxed more heavily than other sectors, then, and only then, will consideration of the efficiency concern have some validity. However, even at that point these are three substantial caveats. The first caveat has been treated above: that is the comparative treatment of ownership housing versus rental housing. The second and third caveats are treated here.

There is a tendency to overstate the beneficial results of direct subsidies. People often assume that if \$50,000 is spent to subsidize a unit (costing say \$120,000), then there is

¹⁸ Chawla, Raj K. and Wannell, Ted, "Housing costs of elderly families", Perspectives on Labour and Income, Vol. 5, no. 7 (Statistics Canada)

¹⁹ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.11

²⁰ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.11

²¹ Ibid

one more rental unit available than if the \$50,000 had not been spent. In fact, many "affordable" housing units are built in such locations and of such quality that they compete directly with the private sector. As such, they crowd out private development, through using the available land, through using the available mortgage financing and through taking the only tenants with effective demand.

Even if an additional new rental unit is built, the new unit may crowd out an existing unit by making rehabilitation not cost-effective, so that an existing unit is demolished. In his research on the rental supply subsidies in the United States, Murray found that in many market environments new subsidized production crowded out private supply one-for-one.²² It can easily be that the \$50,000 per unit subsidy expenditure may have produced no additional housing at all. Any increase in the private rental housing supply due to tax changes would be an improvement on those possible results of direct subsidy programs, even if the increase in private supply were only through continued repair and rehabilitation of the existing housing supply.

On the other hand, a reduction in taxes initially raises the after tax rate of return. That results in more investment in rental housing (i.e. more units or improvements to units), and the cost of the tax reduction on the pre-existing units is offset by the increase in tax revenue on the greater number of units or on the higher rent obtained on the improved units. The recommended changes to restore tax equity may well lead to an overall increase in tax revenue because of the tax revenue from the activities and businesses related to construction, redevelopment, real estate sales, etc., as all these activities will increase under the revised tax regime.

In addition, a tax change applicable to all investment property allows the markets to continue to work effectively. The rental housing markets vary across Canada: some few see rental developments now (but could use more); some are nearly at the point at which developments make sense; but for others rehabilitation is the economic approach. A general tax change promotes the changes that make economic sense. On the other hand, direct subsidies or subsidies delivered through the tax system (such as Low Income Housing Tax Credits) are inevitably distributed on a political basis. For example, the funding may be allocated across Canada based on current population. In economic terms that is extremely inefficient since the markets in some cities may justify more new rental housing, while others do not.

Direct subsidies or subsidies delivered through the tax system are also inefficient in that they require considerable know-how and time to apply for and process. Only large entities with past experience can succeed without a huge waste of time and resources. On the other hand general tax changes provide incentives to operators at all size levels who will respond efficiently with the changes that market conditions in each community warrant.

If the government will not address the issue of re-investment in rental property on a broad basis, then in the alternative the government should at least alleviate the situation for investors in small properties through pooling.

²² Michael P. Murray. 1999. "Subsidized and Unsubsidized Housing Stocks 1935 to 1987: Crowding out and Cointegration." *Journal of Real Estate Finance and Economics*, 18 - 1 107 -124. Other studies have found crowding out rates of between 50% and 75%.

Pooling

Related to the lack of the provision for tax deferred re-investment is the requirement to maintain separate classes for properties bought for over \$50,000. When that rule was imposed in 1972, \$50,000 represented a property of some value; today, \$50,000 is a negligible amount compared to the normal values of rental properties.

A documented rationale for the selection of \$50,000 as the threshold for the rental property separate class rule has not been found. However, \$50,000 appears to have been an amount selected to accomplish the objective of the government of the day – that is, to ensure that wealthy taxpayers could not unduly reduce their tax burden by acquiring a new rental property prior to the end of the year in which another property was sold.²³ (We have demonstrated above that rental property owners are not in fact disproportionately wealthy, but the perception would have driven the policy.)

The 2002 CMHC report concludes that because the \$50,000 threshold is not realistic in today's business environment, this provision is insufficiently flexible. Whereas many properties may have fallen under the threshold when the provision was enacted (thus to some extent targeting the measure to higher-income taxpayers), virtually no rental properties can be acquired for less than \$50,000 in today's market. Consequently, taxpayers in all income brackets are affected by the separate class rule. This lack of flexibility impairs attainment of the equity and affordability principles.²⁴

The key objective of eliminating the separate class rule, or dramatically raising the cut off level, is to increase liquidity and reinvestment in the rental sector. Currently, when an investor in a rental housing project (or any other type of rental real estate) sells the project, taxes are payable if the sale price exceeds the depreciated value of the project. The taxes would be based on a combination of recaptured depreciation and capital gains. The taxes payable as a result of recaptured depreciation and capital gains act as a deterrent to selling – the investor would prefer to keep the project (and avoid the taxes) rather than sell and reinvest in another project. In the extreme, owners may resort to demolishing an existing property to avoid the tax consequences of recapture – this would result in the destruction of older properties providing relatively affordable rental units.²⁵

The taxes payable are a significant disincentive for rental investors to sell their rental projects. It is a feature of the tax system which reduces liquidity in the industry since it hampers turnover of rental projects – developers who build and hold projects for an extended period are discouraged from selling them (even in a favourable sales climate such as the present) because of the significant taxes payable. Therefore, many investors simply retain their current portfolios of rental buildings rather than sell them and reinvest in other rental buildings.²⁶

Concluding Comments

In the determination to close loopholes and to extract the maximum possible revenue from the rental housing sector, a number of rules were put in place which treat the rental

²³ Canada Mortgage and Housing Corporation (CMHC). 2002. *Research Report: An Evaluation of Housing Taxation Measures*. Ottawa: Canada Mortgage and Housing Corporation. p. 86-87.

²⁴ Ibid

²⁵ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*. p.26.

housing sector inequitably as compared with other taxpayers. We seek the enactment of the following rules.

1. **Defer capital gains tax and recaptured CCA upon re-investment in rental housing** – such deferral is allowed for other types of capital investment if the investor purchases another similar investment. In this regard, rental real estate should not be treated differently from other types of capital investments.²⁷
 - 1A. If the government will not provide for the full deferral on reinvestment, then at least the government should **raise the limit for pooling** to \$1,000,000.
2. **Zero rate rental housing for the GST.** Groceries, another basic necessity, are zero-rated – i.e. GST is neither collected on the sale of groceries (like the case with rental housing) nor payable on the inputs required to produce groceries (unlike the case with rental housing).
 - 2A. **Fully rebate the GST on new rental housing projects** – after the GST reduction from 7% to 6% and the rebate for new construction, an investment in new rental housing attracts 3.8% GST, unlike commercial rental properties which effectively do not bear the GST. In this regard, rental housing is treated differently from other types of real estate investments. If the government will not zero-rate rental housing then the government should implement a full rebate targeted towards the development cost of new rental housing.²⁸
 - 2B. If the government will not provide broader GST relief, then a specific issue relates to **the GST assessment on self-supply**. When a developer constructs an apartment building, the developer will almost always register it as a condominium, even though the intention is to use the building as rental units. The market value of the units is often 25% higher if the units were sold individually as condo units instead of being held as rentals. Moreover, the value cannot be predicted accurately when construction is commenced. We request that the self-supply rules make it clear that if units are held and rented, then the value for the self-supply rules is the value of the units as held for the rental market. We request that the value be determined based on cost (including a reasonable mark-up for developer profit), because that will provide certainty in budgeting for the GST cost in rental development, and will not tax the excess condominium value that the owner will not realize.
3. **Allow small landlords to qualify as small businesses** – businesses which invest in and manage real estate are effectively barred from qualifying for the small business deduction. In this regard, they are treated differently from other types of businesses which require hands-on management. Instead of recognizing that they must actively manage their rental properties, small real estate businesses are treated the same as businesses which invest in stocks, bonds, and other types of passive investments.²⁹ That creates a distortion in the capital markets by prejudicing rental housing providers with 3 or 4 employees as compared with rental housing providers with 6 employees.

²⁶ Ibid

²⁷ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*.

²⁸ Ibid

²⁹ Lambert, Greg and Steve Pomeroy. 2002. *Options for Change in Federal Taxes to Encourage New Rental Construction*.

4. **Increase the CCA rate and extension of eligibility for CCA losses** – on the basis of existing inequities in the tax system, a case can also be made for increases in the CCA rate and extension of eligibility for CCA losses to other types of investors. Some investments (e.g. aircraft) are allowed much greater accelerated depreciation. Similarly, life insurance companies are allowed to claim CCA losses on rental investments against other income but this is not allowed for other non-PBC types of investors.³⁰

Except point 2B, all the points were made in 2002 by the Housing Supply Working Group, which was a joint effort of the Ontario government, the private sector and non-profit housing providers to seek out how to encourage new rental construction. Point 2B addresses an issue that has arisen since 2002.

³⁰ Ibid

Appendix 1 - The Foreign Experience

Tax policy has a critical impact on the relative attractiveness of rental investment. Policies are often of a more indirect nature, but capture rental investment within their net. Several countries have undertaken tax reforms with both positive and negative impacts on rental investment.

In the 1980's and 1990's, France and Germany implemented reforms of the tax system that have tended to make new private rental investment **more attractive**. Both permit losses on rental properties to be deducted against other sources of income, and have relatively high depreciation rates.

Since the 1972 Canadian tax reforms, the United States has consistently provided more favourable tax treatment to rental housing than Canada has.

Comments on the individual countries follow. We submit that their experience shows the effectiveness of tax policies as incentives for rental housing development.

Germany

Depreciation allowances have been a feature of German housing policy for many years, in both the rental and the ownership sectors. First introduced in the 1960's, depreciation allowances for landlords were based on straight-line calculations related to the anticipated life of the building. Originally the allowances were either 2% or 2 ½% depending on the age of the building.

To encourage the construction of new private rental buildings, depreciation rates were raised in the early 1980's to 5% for the first eight years, 2.5 per cent for the following six years and 1.25 per cent for the final 36 years. In 1989, depreciation rates for new construction were raised again to provide landlords with an additional incentive to invest in the sector.

In addition, losses from housing investments can be deducted from other sources of income³¹ and rental property is exempt from capital gains tax if held for more than two years.³²

Thanks in large part to these income tax provisions, as well as to a housing allowance program, Germany has an ample supply of purpose-built rental housing at all rent levels. In fact, in Germany the private rental stock makes up 43% of the total housing stock compared to 32% in Canada.³³

France

In France, individual investors own 87% of the entire private rental stock, although institutional investors own most of the newest stock (500,000 units). The total private rental stock is 25.0% of the total housing stock. Much of the privately owned stock is old, small and occupied by low-income households. There is some concern in France that when many of the individual owners die, their heirs will sell off the properties rather than continue to operate them.

³¹ Canada Mortgage and Housing Corporation (CMHC), Pomeroy, Steve, *Private Rental Policies and Programs: Review of the International Experience*. 1998. Ottawa. p. A-32

³² Canada Mortgage and Housing Corporation (CMHC), Pomeroy, Steve, *Private Rental Policies and Programs: Review of the International Experience*. 1998. Ottawa. p. A-30

³³ Canada Mortgage and Housing Corporation (CMHC), Pomeroy, Steve *Private Rental Policies and Programs: Review of the International Experience*. 1998. Ottawa. p. A-28

A view that the rental sector is generally unprofitable is widely shared by many investors and has led to serious declines in the construction of new purpose-built rental housing. In 1974, 54,000 new private dwellings were constructed; in 1984, only 5,000 units were built.

In reaction to this decline, the French government introduced new initiatives that stimulated the recovery in private purpose-built rental starts to 20,000 in 1990. However, many observers believe that the rental market is still not creating enough units to meet the need arising from young single-person households, divorced people, the working poor and transient professionals. Investors simply do not see rental housing as a profitable place to put their money, a perception that has been supported as valid by research studies. Incentives provided by the government are not as generous as incentives provided for other sectors of the economy. The result has been under-investment in rental housing.

In 1984, tax reductions were introduced for individuals investing in new private rentals. In 1987, the government took further steps to increase the attractiveness of private rental housing to investors. Before 1987, 15% of net rental income was tax free for a period of 10 years. The government raised the tax-free amount to 35% in 1987.³⁴

In France, the private rental stock makes up 25% of the total housing stock. However, that proportion is declining, and the newer stock is only a small fraction of the total.

United States

The division between rental housing and home ownership in the United States is remarkably similar to that in Canada. In both cases about two thirds of the housing stock is owner occupied and the remainder is rental units.

For the last quarter century, the focus of US government policy on rental housing has been on creating a positive environment for supply. Shelter allowances are also used to subsidize units, but only 12% of the total rental stock receives subsidization.³⁵

In the early 1980s preferential US federal tax treatment was introduced, accelerating the period of depreciation (from 30 to 15 years) and allowing the write off of "soft costs". This program was enormously successful in creating substantial new purpose-built rental housing, characterized by some analysts as overbuilding.³⁶ That program was muted in 1986 with reforms which extended the depreciation period to 27.5 years, and imposed restriction on some real estate tax shelters.

Rental housing is more readily available in the United States than in Canada, with vacancy rates in the range of 8% to 12% in many urban areas (versus around 1% to 5% in Canada). Relative to average incomes, average rents are also lower in the United States than in Canada, especially in US cities without rent control.

³⁴ Canada Mortgage and Housing Corporation (CMHC), Pomeroy, Steve *Private Rental Policies and Programs: Review of the International Experience*. 1998. Ottawa. p. A-38

³⁵ Canada Mortgage and Housing Corporation (CMHC), Pomeroy, Steve *Private Rental Policies and Programs: Review of the International Experience*. 1998. Ottawa. p. A-45

³⁶ Canada Mortgage and Housing Corporation (CMHC), Pomeroy, Steve *Private Rental Policies and Programs: Review of the International Experience*. 1998. Ottawa. p. A-52