Tax measures to address rental housing supply and affordability

In the November 2018 Fall Economic Statement, Finance Canada announced its intention to increase capital cost allowances for newly acquired capital assets to address Canada's competitiveness issues. This measure may be useful in the manufacturing and processing sectors, but the tax rules affecting investment in rental housing mean this measure has no effect on the supply and affordability of housing in Canada, which is a major national concern.

The Canadian Federation of Apartment Associations ("CFAA") presents the following proposals to help the government achieve its objectives of *improving housing affordability and addressing the housing needs of various vulnerable populations*, by increasing the supply of rental housing across Canada through income tax administrative – and related – measures.

Tax policy levers: Encouraging Investment in Rental Housing

Of the various stakeholders in the economy, namely homeowners, real estate developers, investors, business owners, and residential renters, it is residential renters who receive the least favorable tax treatment. While it is acknowledged that certain funding programs aim to increase the supply of housing for low-income renters; very few tax policies address renters at any income level, and the Income Tax Act ('ITA") contains rules and policies that run counter to encouraging investment in rental housing. However, renters in all income groups would greatly benefit from an increased supply of rental housing.

The key areas in need of improvement are the following:

1. *Take advantage of the move-up effect by reducing the GST/HST charged on new rental buildings;*
2. *Treat rental housing as an active business; and*
3. *Change the practice for determining whether major repairs are deductible as expenses.*

1. Take advantage of the "move-up effect" by reducing the GST/HST charged on new rental housing

An increased supply of rental housing at any price level would improve affordability at all price levels. That occurs through the "move up effect". When new rental projects become available, existing renters often move up, thereby making available the units they move out of. In turn, renters from older, economical units move into the units the existing tenants vacated. That dynamic makes affordable rental housing available quickly to those who need it, at a fraction of the cost of subsidizing the construction of what is called affordable housing.

Land prices and construction costs are elevated, especially in Greater Toronto and Greater Vancouver. Despite the ability to rent for new units at rents substantially above the average rents in those cities, many possible rental projects are less attractive than condo developments.

One low-cost way to nudge the market to build units for on-going rental is to eliminate the GST/HST on newly constructed rental housing. Indeed, that was a campaign promise of the Liberal party in the 2015 election. Several provinces have indicated their agreement with removing the HST on new purpose-built rental projects.

- **Through the move up effect, an increase in the supply of rental housing at any price point will make housing more available and affordable for those at all income levels .**

2. Treat Rental housing as an Active Business

On much of the current rental housing supply, taxes are elevated because rental housing and other real estate fall under the "specified investment property rules" with the result that small business corporations operating rental housing cannot access the small business deduction rules. However, the ownership and management of rental housing is a time consuming and very active management of property. It involves not only on-going property management, repairs and maintenance, banking, leasing, rent collection, but also significant labour; which many owners accomplish with 5 or fewer full-time employees.

The employee test is an arbitrary requirement to determine an activity level, which does not account for the scale of the enterprise. Income from rental housing is very much different from income from a stock portfolio or debt instruments, and should be recognized as an active business activity and therefore eligible for the small business deduction.

With advancements in computer software, on-line banking and the use of part-time employees or contractors, the number of employees needed to achieve the level of activity that was perceived necessary more than 30 years ago when these rules were introduced is no longer relevant. The number of employees in a business enterprise is a very poor measurement of the level of activity used to earn its income.

In addition, the rental loss restrictions, which prevent a taxpayer from creating a loss by claiming capital cost allowance, are an impediment to investment in rental housing.

- ➢ **A fairer tax regime that encourages development and ownership of rental housing will create an increase in the demand for rental housing as an asset. That will draw forth more new construction and thus increase rental supply.**

3. Change the practice for determining whether major repairs are deductible as expenses.

Many repairs and renovations are needed for buildings that may be anywhere from 15 to 50 years old. In addition, roofs, air conditioning systems, boilers etc. can be replaced by equipment manufactured at standards that far exceed what is being replaced. Under the current CRA practice, owners are at risk if they upgrade their buildings. For example, the replacement of a mid-efficiency furnace with a mid-efficiency furnace is clearly a repair which can be deducted against current income. However, installing a high-efficiency furnace may be deemed to be a capital expenditure, which can only be claimed as a capital cost allowance (CCA) at a 4% declining balance over the life of the investment. That tax treatment, or the risk of that tax treatment, can render the upgrade untenable in many situations.

The current CRA administrative practice considers each expenditure, taking into account the following considerations: is it an integral part of the building? Does the expenditure create a betterment of the property it is replacing? Does the expenditure create an enduring benefit? What is the amount of the expenditure in relation to the value of the whole property?

Instead, CRA should apply the considerations that the Tax Court has applied in recent decisions. The repair or maintenance expenditure should be a deductible expense if it substantially meets these tests:

- it does not result in any substantial increase in the rental revenue from the property
- it adds little to the overall value of the property
- it is an integral part of the whole property
- it upgrades the energy efficiency of the equipment to a stated R-factor or other energy efficiency or GHG reduction criterion.

- ➢ **An updated test for current deductibility for building system replacements would encourage upgrades to generate energy efficiency and reduce GHG emissions. Over time, that would create a larger, more sustainable supply of rental housing, advancing government policies on the environment and housing needs.**

Conclusion

The foregoing tax proposals would aid significantly in retaining and increasing the supply of rental housing, thereby improving housing affordability. The proposals would also promote the government’s objectives on energy conservation and GHG emission reductions. **CFAA wants to partner with the Government of Canada to advance the national goals of improving housing affordability and reducing Canada’s environmental footprint.**

CFAA Tax Proposals: Three Storylines to Illustrate Benefit to Canadians

1. Take advantage of the move-up effect by reducing the GST/HST charged on new rental buildings

"Susan and Mark are a married couple. To save money, they have been living in a modest rent apartment in a 1970s style apartment building. Susan just got a promotion at work and Mark just got a raise, so they've decided to move out of their unit and move into a much nicer apartment in a newly built rental building.

"Fatima and Jack are living in the basement of Fatima's parents' house because Jack has a disability and can only work part-time. They applied for social housing but will have to wait eight years for it. They just found an apartment they can afford which they like much better than the basement. It is the apartment Susan and Mark moved out of."

- **Moral of the story:** ***new rental supply at any price point allows people to move up, and that makes housing more available and affordable throughout the housing system, including for low income people.***

2. Treat Rental Companies as an Active Business

The following table illustrates Corporate Taxation Affecting Rental Income – Compared with the tax rates on the production of other necessities.

	ACTIVE INCOME ELIGIBLE FOR SBD* – *not applicable to any rental income*	GENERAL INCOME NOT ELIGIBLE FOR THE SBD* – *including rental companies with 6+ FT employees*	INVESTMENT INCOME (RENTAL INCOME) – *including rental companies with less than 6 FT employees*
	Applicable to companies of all sizes making or selling clothing, food, guns, tobacco, alcohol and most other items		N/A
Federal rate	9.0% (1)	28.0%	28.0%
Fed rate reduction		(13.0%)	
Additional investment income rate			10.67% (2)
Net fed rate	9.0%	15.0%	38.67%
Ontario rate	3.5% (3)	11.5%	11.5%
Combined fed/prov rate	**12.5% (4)**	**26.5%**	**50.17%**

- **Moral of the Story:** ***The rate differential tells the story. By treating rental companies as an active business, there is potential to create a business environment for rental companies that will incentivize them to contribute more greatly to increasing Canada's rental supply.***

NOTES

1-effective Jan 1/2019
2- effective Jan 1/2016 due to additional refundable tax payable on dividend distribution.
3-Ontario reduced rate for small businesses effective Jan 1/2018 from 4.5% to 3.5%
4-taxable active business income up to $600K
**Small Business Deduction (SBD)*

3. Reduce uncertainty regarding deductibility of major repairs as expenses

"Sam owns an 8 unit walk-up apartment building his grandfather built in the 1960s. In the 1990s, the building was upgraded with more insulation under the roof and a new mid-efficiency furnace and hot water boiler. Since the building mortgage is paid off, Sam earns about $40,000 a year from the building, and pays $20,000 in income tax, leaving him a net income of $20,000.

Now Sam needs to replace the furnace and hot water boiler again. Sam is concerned about the environment and checked into moving to a high-efficiency furnace and boiler. With the associated new venting, the furnace and boiler will cost $30,000.

Sam figures those costs are OK because he can claim the costs as expenses and save the taxes he pays on the building income, but Sam checks with his accountant before placing his orders. The accountant says the CRA guidelines may mean that Sam has to add the $30,000 cost to the value of the building, and claim CCA at 4%, or $1,200 per year. Thus Sam will still have to pay taxes of $19,400. He will have to inject $10,000 into the building, rather than taking out $20,000, a swing of $30,000.

Instead, Sam skips the upgrades, pays for the cheapest furnace and boiler he can find, for a total cost of $16,000. Those are expenses that are deductible and Sam ends up with net income of $24,000, so that he pays $12,000 in taxes. After the $16,000 for the work and the $12,000 in taxes, Sam is able to take $12,000 out, a swing of $8,000 from what he took out before the repairs.

*That is a lot better for Sam than injecting $10,000 into the building, but because of the **current uncertainty**, the building is not renewed, and the energy and GHG savings are not achieved.*

- **Moral of the story:** ***If the rules were clarified to provide certainty that energy retrofits can be claimed as repairs, then Sam would have lots of incentive to install the new high-efficiency furnace and boiler. That would result in income of $10,000 for the year ($40,000 of income less $30,000 for the new furnace and boiler). Sam would then pay tax of $5,000 that year, and take out $5,000. He is behind by $3,000 as compared with installing the cheap furnace, but the building will emit less GHG, consume less energy (and deliver more profit) for the future.***