# Economic Impact of Federal Tax Legislation on the Rental Housing Market in Canada

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The Canadian Federation of Apartment Associations (CFAA) is a federally chartered, nonprofit organisation representing 15 associations of owners and managers of residential rental property from coast to coast. Organised in 1995, the CFAA has grown to represent the owners and managers of more than 600,000 residential rentals across Canada.

The objectives of the CFAA are "*To represent its members on political and economic issues at the national level and to facilitate the exchange of information and materials amongst members while maintaining the highest professional and ethical standards and activities.*"

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# EXECUTIVE SUMMARY

## ECONOMIC IMPACT OF FEDERAL TAX LEGISLATION ON RENTAL HOUSING IN CANADA

Changes in the federal tax structure in Canada in the period since the early 1970s have discouraged the influx of private investment into rental housing. With a shortage of rental housing imminent, the Canadian Federation of Apartment Associations - Fédération Canadienne des Associations de Propriétaires Immobiliers in combination with its members and the Real Estate Foundation of B.C. commissioned Clayton Research Associates Ltd. to undertake an analysis of:

- The Federal tax changes made since the early 1970s and their implications for private rental housing investment and the rental housing market; and

- Ways to remedy the most adverse features of the current Federal tax system as they impact the rental housing market.

The principal findings of the analysis are outlined below.

**In an Effort to Close "Loop Holes", the Federal Tax System Has Significantly Reduced the Flow of Private Investment Funds into Rental Housing Over the Past 25 Years**

The income tax rules affecting rental housing investment have become progressively more punitive since 1972 when a major reform to the income tax structure in Canada took effect. Changes in the tax treatment of losses due to capital cost allowances (CCA), the amount of CCA deductible, allowable soft costs, and the deferral of taxes payable on recaptured depreciation upon reinvestment, and the application of a tax on capital gains at the time of sale have severely reduced the attractiveness of investing in rental housing. The application of the Goods and Services Tax (GST) to the full cost of new rental housing, as well as on-going operations, aggravated an already serious situation, which is compounded in the provinces which have entered the sales tax harmonization agreement with the Federal government.

The legislation originated from a concern with closing perceived "loop holes". There was little, if any, consideration of the adverse consequences on the flow of private capital into the rental housing, the production of new rental accommodation, or the cost of rental units to tenants.

**The Result: A Downward Trend in Private Sector Rental Housing Production and the Spending of Huge Sums by Governments to Counter This Trend**

The progressive deterioration in the Federal tax environment contributed to a downward trend in the private production of new rental housing. As a result, Governments, particularly the Federal Government, have expended large sums to support rental housing production across the country, particularly through the funding of social housing projects which require sizeable ongoing subsidies.

However, due to government cut backs and restructuring, additional subsidy funds are no longer available to stimulate the construction of additional rental housing. If a significant amount of new rental housing is to be built, it will have to be funded though investment from the private sector.

**The U.S. and MURB Experience Demonstrate That a More Benign Federal Tax Environment Produces Rental Housing**

In the United States, where the Federal tax regime as it relates to rental housing investment remains close to Canada's pre 1992 regime, the production of private sector rental housing has been much stronger than in Canada. In addition, the U.S, for the past decade, has also provided a Federal tax credit to investors building low-income rental accommodation. The U.S. has a much lower capital gains taxation rate and does not have the burden of a Federal sales tax on new rental housing production.

When the Federal Government in Canada temporarily reintroduced one of the pre 1972 tax reform provisions (the ability to deduct CCA losses against other income - the MURB provision) in the 1970s, thousands of new rental housing units were constructed. This demonstrated the powerful direct connection that tax provisions can have on rental housing investment flows from private investors.

**Canada Needs Tens of Thousands of Additional Rental Housing Units Annually and Plenty of Money to Refurbish Existing Rental Housing**

Canada needs to expand its stock of rental housing considerably in the coming years due to demographic requirements. Forecasts by government (CMHC) and private analysts show a need for approximately 50,000 additional units annually. In addition, hundreds of millions of dollars of investment are required to upgrade and refurbish the existing stock of rental housing. Almost all of these investment funds will have to be provided by the private sector.

**The Private Sector Response: Conventional Versus Non-Conventional Housing**

The private sector responds to opportunities to profit from providing additional rental housing in one of two ways:

- By providing additional conventional rental housing, e.g., purpose-built rental buildings which are counted in CMHC's monthly housing starts survey; or

- By providing additional non-conventional rental housing, e.g. through the creation of basement apartments, renting out condominium units.

When the development of conventional housing by bona fide developers and builders is viable, much of the requirement for additional rental housing is provided through construction of new rental projects. This has typically not been the case over the past couple of decades, in part due to the adverse Federal tax regime. Much of the additional supply by the private sector has been in the form of non-conventional housing.

For the Federal Government, non-conventional housing has a number of distinct disadvantages relative to conventional housing in terms of tax revenues and housing policy:

- The tax revenue on non-conventional housing is much less since it is likely that many investors owning houses with basement suites or rented-out condominiums do not declare, or underreport, their rental income for income tax purposes, and it is costly to audit this source of income;
- Much of the additional housing provided through basement suites is substandard and often illegal; and
- 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.

The Federal Government has a concern and a vested interest to support a significant increase in the production of conventional rental housing. In a similar vein, Federal government tax revenue and housing policy interests will be reinforced though the refurbishing and upgrading of the existing privately-owned conventional rental housing stock.

**The Availability of the Needed Private Sector Investment is Dependent on Changes in the Federal Tax Treatment of Rental Housing Investment**

The rental housing investment environment has been changing for the better in Canada. The dominant reason for this has been the sharp decline in mortgage interest rates. But more is needed if the required upsurge in private rental investment into both new and existing housing is to be forthcoming since rental investment generally still will not generate competitive rates of return.

One potential solution is for rents to rise sufficiently to produce the required returns for investors. However, renters increasingly are concentrated in the lower and modest income groups and many are simply unable to afford the higher rents. Thus, higher rents are a partial answer but more is needed.

A change in the federal tax regime as it applies to rental housing is essential. Potential changes in this regard include:

- Allowing investors to defer CCA recapture and capital gains on the proceeds from the sale of rental property when the proceeds are reinvested in another rental property within a reasonable time (the U.S. Federal tax system allows this);
- Allowing a 50 percent rebate on the construction of new rental projects and on major renovations to existing rental projects under the Federal GST, and the Harmonized Sales Tax in the provinces where the Federal and Provincial sales taxes have been merged. This treatment would treat private rental projects the same as social housing.
- Allowing all investors in rental housing (not just Principal Business Corporations) the opportunity to deduct CCA losses against other income; and

- Expand allowable ‘soft costs’ which can be deducted in the first year of operation of new rental properties.

**Changes in Federal Tax Treatment of Rental Housing Will Generate Positive Economic Repercussions**

The construction of additional conventional rental housing and the extensive upgrading of the existing stock will generate jobs in the construction and other industries dependent on construction activity including lenders, manufacturers, and retailers. In addition, ongoing jobs will be created to service and manage the additional rental housing.

The Federal Government will benefit directly through the additional construction activity by the influx of significant amounts of income and sales tax revenue even with changes to the Federal tax treatment of rental housing.

Without changes, the additional rental housing will not be built and more of the growth in renter demand will come from non-conventional sources, especially basement apartments. In this case, it is likely that a lot of the rental income generated will escape the Federal tax coffer because the income is not declared.

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# 1. INTRODUCTION

## 1.1 BACKGROUND

There have been numerous changes in Federal tax legislation, mostly income taxation but also sales taxation, since the early 1970s which have adversely affected private sector investment in rental housing in Canada.

There is a growing awareness that there is a shortage of rental housing emerging. Already vacancy rates have declined to acutely low levels in high-growth urban centres such as Calgary and Toronto. With the economic recovery, continued high immigration, and only limited social housing being built, declining rental vacancy rates are inevitable throughout much of the country. Changes to Federal tax legislation could be a powerful incentive to encouraging the construction of much needed rental housing at rents that prospective renters are able and willing to pay.

The various changes to Federal tax legislation as they relate to rental housing investment have also been discriminatory against rental housing. It can be argued that rental housing investors are now treated unfairly compared to some other types of business operations and investments, including investments in owner-occupied housing. The tax treatment of rental housing in the United States is more favourable than in Canada.

It seems appropriate to assess the Federal tax changes that have been made since the early 1970s and their implications for private rental housing investment flows and the rental housing market and to explore ways to remedy the most adverse features. The Canadian Federation of Apartment Associations - Fédération Canadienne des Associations de Propriétaires Immobiliers commissioned Clayton Research Associates Ltd. to undertake this assessment.

## 1.2 PURPOSE OF THE ANALYSIS

The specific tasks that Clayton Research has addressed are the following:

- Document the changes in the Federal tax regime since the early 1970s as it relates to investment in rental housing;
- Compare the current tax treatment of rental housing investment in Canada and the United States;
- Compare the current tax treatment of rental housing investment with other selected types of investments;
- Assess the impact of the changed Federal tax regime on the rental housing market;

- Assess the future outlook for the rental housing market with no change in the Federal tax regime; and
- Examine changes to the Federal tax regime which will significantly enhance private sector investment flows into rental housing.

## 1.3 SCOPE OF THE ANALYSIS

Most of the provisions of Federal tax legislation which have significant repercussions on private rental investment flows and the rental housing market are in the income taxation area. However, the replacement of the Federal sales tax with the Goods and Services Tax, and the subsequent harmonization of the Federal GST and Provincial sales taxes in several provinces have had adverse consequences for rental housing construction and operation as well.

## 1.4 APPROACH

The assessment presented here is based in large part on a review of both Canadian and U.S. literature. The extensive experience of Clayton Research personnel in assessing housing market impacts of Federal tax provisions and in conducting studies of rental markets, including rental project feasibility, repositioning studies and public policy reviews dating back to the late 1960s, is an important input as well.

## 1.5 REPORT STRUCTURE

This report contains four chapters in addition to this Introduction:

- Chapter Two explores the Federal tax treatment of rental housing investment (incorporating the first three bullets under **Purpose**);
- Chapter Three examines the impact of the changed Federal tax treatment on the rental housing market;
- Chapter Four considers the future outlook for the rental housing market under current Federal tax treatment of rental housing; and
- Chapter Five derives and explores the implications of changes to the Federal tax treatment of rental housing investment.

## 1.6 CAVEATS

The taxation provisions pertaining to rental housing in both Canada and the United States are often complex and dependent upon investors' personal circumstances. The descriptions in this report are intended to indicate the general features of the provisions only, and not their detailed applicability.

# 2. THE FEDERAL TAX REGIME AS IT RELATES TO RENTAL HOUSING INVESTMENT

This chapter describes the current Federal tax treatment of rental housing investment in Canada and how it has changed since the early 1970s. It also describes how the current tax treatment compares with the tax treatment of rental housing investment in the United States as well as with the tax treatment of certain other types of investment in Canada.

## 2.1 CURRENT FEDERAL INCOME TAX TREATMENT OF RENTAL HOUSING INVESTMENT

This section describes the current income tax treatment of rental housing investment. For income tax purposes, it does not matter whether the rental property is residential or non-residential (e.g., an office or industrial property which is rented out). Figures 2-1, 2-2, and 2-3 summarise the current tax treatment by type of investor (i.e., Principal Business Corporation vs. other) and investing profile (i.e., buying, ongoing ownership, selling rental property).

**Figure 2-1**
**Current Provisions of Canadian Federal Income Tax Regime Relating to Rental Housing Investment**
**Ongoing Ownership**

| | Type of Investor | |
|---|---|---|
| **Provisions** | **Principal Business Corporations (PBCs)** | **All Other** |
| **1. Capital Cost Allowance (CCA)** | | |
| **1.1 Rate** Calculated on a declining balance basis by applying the CCA rate to the undepreciated capital cost base (UCC) at the beginning of each year. | 4% in years 2+ | |
| **1.2 Pooling** A rental property with a capital cost in excess of $50,000 must be put in a separate CCA class. | Applies equally to both types of investors | |
| **1.3 Loss Restrictions** CCA claims cannot reduce rental income below zero unless the investor is a PBC. Disallowed CCA is added back into the UCC base. | PBC's can reduce rental income below zero. | Restriction applies |
| **2.0 At-risk rules** Investors in a limited partnership can only claim losses to the amount of the actual investment made. | n.a. | Rule applies |

Source: Clayton Research

**Figure 2-2**
**Current Provisions of Canadian Federal Income Tax Regime Relating to Rental Housing Investment**
**Purchase of a New or Existing Rental Property**

| Provisions | Type of Investor: Principal Business Corporations (PBCs) | Type of Investor: Other |
|---|---|---|
| **1. Capital Cost Allowance (CCA)** | | |
| **1.1 Rate**<br>Calculated on a declining balance basis by applying the CCA rate to the undepreciated capital cost base (UCC) at the beginning of each year. | 2% in year 1<br>4% in years 2+ | |
| **1.2 Pooling**<br>A rental property with a capital cost in excess of $50,000 must be put in a separate CCA class. | Applies equally to both types of investors | |
| **2. Soft Costs** | | |
| **2.1 Type of expense**<br>Certain costs incurred during the development of a project are not required to be depreciated over time, but are deductible from income as an upfront cost. | Landscaping, some site investigation costs, and financing fees.<br>Also includes:<br>promotion expenses, legal and accounting fees, mortgage fees, interest fees during construction, and property taxes. | Landscaping, some site investigation costs, and financing fees.<br>Does not include:<br>promotion expenses, legal and accounting fees, mortgage fees, interest fees during construction, and property taxes. |
| **2.2 Rules for deduction**<br>Soft costs must be deducted before any CCA is deducted. They can be deducted against income from other sources. | Applies to both investor types | |

Source: Clayton Research

**Figure 2-3**
**Current Provisions of Canadian Federal Tax Regime Relating to Rental Housing Investment**
**Sale or Demolition of Existing Rental Structure**

| Provisions | Type of Activity: Selling an Existing Rental Building | Type of Activity: Selling an Existing Rental Building and Buying Another Property | Type of Activity: Tearing Down Existing Rental Building | Type of Investor: Principal Business Corporations (PBCs) | Type of Investor: All Other |
|---|---|---|---|---|---|
| **1. Capital Cost Allowance (CCA)** | | | | | |
| **1.1 Recapture of CCA** If excessive CCA was deducted over the years based on the final sale price CCA is recaptured. | Applies to sales and demolition, and both investor types | | | | |
| **1.2 Terminal loss of CCA** If the sale price of the building (excluding land) is lower than the final UCC, the difference will be deducted from income of the owner in the year the property was disposed of. | Applies to sales and demolition | | One-half of terminal loss associated with demolition will be treated as business loss. Terminal loss must first be added to any capital gains from the sale of land, and/or applied to the UCC of any other buildings owned. | Applies to both investor types | |
| **2. Capital Gains** | | | | | |
| **2.1 Base** Applied at the time of selling an income-producing asset if there is an increase in value of the asset over its original cost. | 75% of gain taxed | n.a. | 75% of gain taxed | 100% of gain taxed | 75% of gain taxed |

Source: Clayton Research

### 2.1.1 Principal Business Corporation Vs. All Other Investors

Principal Business Corporations (PBCs) are life insurance companies and corporations whose principal business is the leasing, rental or sale, or the development for lease, rental or sale, of real property owned by them. Most investors that provide the bulk of Canada's rental housing fall in the "other" category. Individuals owning rental property investments cannot be PBCs.

### 2.1.2 Ongoing Ownership of Rental Property

Both types of investors owning rental property can generally deduct operating and mortgage interest expenses from the gross income generated by the property for income tax (see Figure 2-1). If expenses exceed rental income in a year, the rental losses are deductible against other income.

Investors can also deduct capital cost allowance (CCA) for the building portion of the property (i.e., excluding land) as an expense. CCA is permitted to allow for a decline in the value of the building as it is being used. Currently the annual CCA is 4% of the undepreciated capital cost base (UCC) for a building on a declining-balance basis. Figure 2-4 illustrates how CCA is calculated.

**Figure 2-4**
**Illustration of CCA Deduction**

| | |
|---|---|
| Purchase price of property in Year 1 | |
| Building | $250,000 |
| Land | 50,000 |
| | 300,000 |
| CCA in Year 1 is equal to 2% of $250.000 | 5,000 |
| Undepreciated Capital Cost Base (UCC) of property at beginning of Year 2 of ownership (Purchase price of building less CCA in Year 1) | 245,000 |
| CCA in Year 2 is equal to 4% of $245,000 | 9,800 |
| UCC at beginning of Year 3 is equal to $245,000-$9,800 | 235,200 |
| CCA in Year 3 is equal to 4% o $235,200 | 9,408 |
| UCC at beginning of Year 4 is equal to $235,200-$9,408 | 225,792 |
| (And so on) | |

Source: Clayton Research

For PBCs, losses resulting from CCA deductions can be deducted against other income. However, other investors can not deduct losses due to CCA against their other income.

### *2.1.3 Purchase of a New or Existing Rental Property*

When a rental property is first purchased, two tax features are applicable (see Figure 2-2). These relate to the purchase (or the development and retention) of a newly built rental property and to the purchase of an existing rental property.

Firstly, CCA deductions in the first year, regardless of the date the property was purchased, is limited to 2%, one-half the rate permitted in subsequent years.

Secondly, investors in new rental properties can deduct some so-called soft costs in the year of purchase. For non-PBC investors, soft costs are limited to outlays like fees for mortgages, legal, appraisal and accounting. PBC investors, in contrast, are allowed to deduct more soft costs including interest and property taxes during construction, architect's fees and building permit fees. The advantage of having outlays treated as soft costs is that they can be deducted in the year they are incurred. Otherwise, the costs are capitalised, added to the UCC and can deducted as CCA over a long period of time.

### *2.1.4 Sale of a Rental Property*

In Canada, the tax consequences associated with the sale of a rental property are the same regardless of whether the investor buys another property or not with the sales proceeds (see Figure 2-3).

Each rental property with an acquisition cost of $50,000 or more owned by an investor is required to be treated as a separate class under the income tax. What this means is if a building is sold at a price in excess of its UCC, any CCA deducted previously up to the difference between the sales price and the UCC

is recaptured and full income tax rates are applied. Any additional excess in sales price beyond the UCC plus all CCA taken is treated as capital gains for investors other than PBCs and three-quarters of this excess is taxed at full income tax rates. For PBCs, 100% of the excess is taxed at full income tax rates. Figure 2-5 illustrates how recaptured CCA and capital gains work where the sales price both triggers recaptured CCA and produces capital gains.

**Figure 2-5**
**Illustration of CCA Recapture and Capital Gain Taxation**
**Re: Sale of Rental Properties**

| | |
|---|---|
| Sale Price of Rental Property: | |
| Building | $1,000,000 |
| Land | 250,000 |
| Total | 1,250,000 |
| | |
| Undepreciated Capital Cost Base (UCC) at time of sale | 500,000 |
| Previous Cumulative CCA deductions | 300,000 |
| | |
| **Recaptured CCA** | **300,000** |
| | |
| Capital Gain: | |
| Land | |
| $250,000 less original purchase price of $150,000 | 100,000 |
| Building: | |
| Sales price less UCC and recaptured CCA | 200,000 |
| | |
| **Total Capital Gain** | **300,000** |

Source: Clayton Research

### *2.1.5 Demolition of a Rental Building*

Whether the demolition of an existing rental building (e.g., for the purpose of constructing new housing at a higher density) either by the owner or through the sale to a developer triggers income tax consequences, depends upon whether the value of the building component of the rental property is higher or lower than the UCC. If the disposable value is less than the UCC, the difference is called a terminal loss and one half of the terminal loss can be deductible from business income. If, in contrast, the disposal value is greater than the UCC, recapture of CCA will occur.

Terminal losses are deducted from the overall taxable income of the investor. There are two restrictions - if the disposal of land results in a capital gain, proceeds from the sale of the land must be used to reduce the terminal loss up to the amount of the capital gain, and if the investor owns any other buildings, the terminal loss is added to the UCC of the remaining buildings.

## 2.2 CURRENT FEDERAL GST TREATMENT OF RENTAL HOUSING INVESTMENT

### *2.2.1 Federal GST*

In six provinces, the 7% Goods and Services Tax (GST) of the Federal Government is applied to the purchase of a newly built rental property[1]. The tax is payable on the full value of new rental properties. The "value" for this purpose is either the purchase price for investors buying a property from the developer or the fair market value for a developer retaining the new property in his own portfolio. The Federal GST alone is $7,000 on a $100,000 rental unit. In addition, Provincial sales taxes (excluding Alberta) and provinces with Harmonized Sales Tax apply to the purchase of materials used in construction.

New housing purchased by homeowners is also subject to the GST. However, home purchasers benefit from a 2.5 percentage point rebate for houses priced under $350,000. Between $350,000 and $450,000, a reduced rebate applies. Non-profit housing also is treated more favourably by the GST, paying only 3.5 percent GST.

An existing rental property's operation costs, such as management fees, maintenance contracts, and supplies, are also subject to the GST. Whereas other businesses, including commercial property owners, are able to apply the GST they incur on inputs as a credit against GST collected, residential landlords do not have this relief because residential rents are not subject to GST.[2]

### *2.2.2 Harmonized Sales Tax*

In Quebec and three of the Atlantic Provinces, the Provincial sales taxes have been integrated with the Federal GST, and termed the harmonized sales tax (HST). The result is a much higher tax rate applied to the full value of new rental projects and ongoing operation of existing projects. In Nova Scotia, for example, the combined Federal and Provincial sales tax rate is 15 percent (equivalent to $15,000 on a $100,000 new rental unit).

## 2.3 CHANGES IN THE FEDERAL INCOME TAX TREATMENT OF RENTAL HOUSING INVESTMENT SINCE THE EARLY 1970S

The Federal tax treatment of rental housing properties, like all rental real estate, has changed considerably since the first major tax reform was introduced back in 1972. Prior to 1972, rental housing investment was treated much more favourably than the current treatment. Figure 2-6 highlights the most significant of the changes that have occurred by time period.

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[1] *All provinces, excluding Quebec, Nova Scotia, New Brunswick and Newfoundland.*

[2] *Lampert, G.* ***The Challenge of Encouraging investment in New Rental Housing in Ontario, p. 33.***

**Figure 2-6**
**Federal Income Tax Changes Since the Early 1970's**

| Provisions | Prior to tax reform in 1972 | Changes in the 1970s | Changes in the 1980s | Changes in the 1990s |
|---|---|---|---|---|
| **1. Capital Cost Allowance (CCA)** | | | | |
| **1.1 Rate** | | | | |
| Calculated on a declining balance basis by applying the CCA rate to the undepreciated capital cost base (UCC) at the beginning of the year. | Wood frame buildings: 10%<br>Other buildings: 5% | 1978 - all buildings: 5% | 1988 - all buildings: 4% | |
| **1.2 First year** | The full rate of CCA deduction can be applied from the first year of acquisition. | | 1981 - Half year rule: In the year an asset is acquired, CCA deductions are limited to one half the normal depreciation rate available.<br><br>1987-CCA may not be claimed until the year in which the asset is put into use. | 1990 - CCA is restricted to buildings available for rent (e.g. excludes vacant buildings). |
| **1.3 Loss Restrictions** | | | | |
| Investors are able to use any excess CCA deductions to reduce non-rentable taxable income to zero. | All investors are able to use any excess CCA deductions to reduce non-rental taxable income to zero. | 1972 - Individual rental investors are no longer able to reduce non-rental taxable income with CCA deductions from rental property.<br>Exceptions: PBC's and MURB's. | | |

**Figure 2-6 (continued)**
**Federal Income Tax Changes Since the Early 1970's**

| Provisions | Prior to tax reform in 1971 | Changes in the 1970s | Changes in the 1980s | Changes in the 1990s |
|---|---|---|---|---|
| **1.4 Pooling and Recapture of CCA** If excessive CCA was deducted over the years, based on the final sale price or Fair Market Value of the building, CCA is recaptured. | Taxpayer is able to treat a number of assets of a particular class as one unit for depreciation purposes. CCA recapture can be avoided if property of the same class is acquired in the same tax year as the year of disposition for an amount at least equal to the value of proceeds from sale | 1972 - All taxpayers must include any property with a capital cost of $50,000 or more and acquired after 1971 in a separate class for CCA purposes. CCA is recaptured at time of sale. | | |
| **1.5 Terminal loss of CCA** | The owner of rental property is able to deduct as a terminal loss the undepreciated capital cost (UCC) of the class which was not previously written-off when all property in a particular class is disposed of, and no new property of the same class is acquired. | 1976 - Terminal loss deductions must be made in the year in which the property is sold. | 1982 - If a building is demolished or otherwise disposed of, terminal loss can not be fully deducted. The loss is either added to the capital cost of another building owned by the taxpayer and depreciated, or one-half of the loss on demolition of the building is treated as a business loss. | |
| **2. Capital Gains** | | | | |
| **2.1 Base** Applied at the time of selling an income-produding asset if there is an increase in value of the asset over its original cost. | Not taxable | 1972 - 50% of gain taxed | 1988 - 66 2/3% of gain taxed | 1990 - 75% taxed |

**Figure 2-6 (continued)**
**Federal Income Tax Changes Since the Early 1970's**

| Provisions | Prior to tax reform in 1971 | Changes in the 1970s | Changes in the 1980s | Changes in the 1990s |
|---|---|---|---|---|
| **2.2 Capital Gains Deduction** | | | | |
| A taxpayer could shelter capital gains up to lifetime maximum amount set by the government. | | | 1985 - Introduction of Capital Gains Deduction for individuals, initially $20,000.00<br><br>1988 - Lifetime limit reduced to $100,000. Availability of individual capital gains exemption is reduced by the amount of 'cumulative net investment loss' (CNIL) claimed. | 1994 - $100,000 Capital Gains Deduction eliminated. |
| **3. Soft Costs** | | | | |
| **3.1 Allowable soft costs** | | | | |
| First time costs/expenditures incurred by the owner of a new rental property which are not related to the actual acquisition of the fixed assets. | Includes mortgage insurance and application fees, interest paid during construction, cash flow guarantees, landscaping, legal fees, property taxes and levies etc. | | 1981 - Soft costs are restricted to mortgage, legal, appraisal and accounting fees, landscaping costs, promotion and advertising, pre-opening costs and start-up costs. Exceptions: PBC's | |
| **3.2 Deduction period** | Deducted as paid, regardless of the period to which they relate. Costs can be deducted against income from other sources, and are subject to recapture. | 1979 - Certain soft costs (e.g. fees for cash flow guarantee) have to be deducted over the period to which they related. | 1981 - Costs related to real property or the acquisition of real property (e.g. interest and property taxes during construction) have to be capitalized in the purchase price instead of being deducted as they occur. Excptions: PBCs. | |

Source: Clayton Research

### 2.3.1 Ongoing Ownership of Rental Property

Prior to 1972 all rental housing investors could deduct capital cost allowance (CCA) losses against other income. This was changed with tax reform in 1972 for all investors with the exception of Principal Business Corporations (PBCs). Since 1972, except for PBC investors, losses due to CCA have not been allowed. Any unclaimed CCA because of this restriction is added to the undepreciated capital cost (UCC) base.

The deductibility of CCA losses was reinstated temporarily for new construction through 1974-1979 and in 1980-1981. The Multiple Unit Residential Building (MURB) provision of the Income Tax Act reinstated the favourable tax treatment of CCA for investors (individuals and companies which are not PBCs) which invested in certified MURB rental projects.

Prior to 1978, the applicable CCA rates were higher, especially for wood-frame buildings (10%). At the time much of the new rental housing being built outside specific major centres like Toronto were wood-frame buildings. For concrete buildings, the rate was 5%. In 1978, the rate for wood-frame buildings was reduced to 5%. Then in 1987, the rate for all rental buildings was reduced to 4%, which is the rate that currently applies.

In 1988, "at risk" rules were introduced for rental investors investing through limited partnerships. These rules limited the losses that could be claimed by limited partners to the amount of the actual contribution to the investment they had made.

### 2.3.2 Purchase of a New or Existing Rental Property

The major changes here are a reduction in the CCA rate in the year a rental property is acquired and changes in the soft costs eligible for deduction from income.

In 1981, CCA was limited to one-half of the full-year amount in the year a rental property was acquired. Previously, the full CCA rate was applicable.

Changes in the soft cost deductibility provisions in 1982 limited the rental losses against other income that could be claimed by limited partnership investors. However, other investors excluding PBCs, also had to face reduced soft costs deductions which reduced the amount of rental losses available for deduction against their other income.

### 2.3.3 Sale of a Rental Property

The tax consequences of a sale of a rental property, especially if the sales proceeds are used to purchase another rental property of equal or greater value, have changed considerably since prior to the year 1972.

Prior to 1972, investors in rental housing properties could defer CCA recapture upon the sale of a rental property by purchasing another rental property at an equal or greater price. This provision is referred to as ‘rollover’. In fact, at the death of an investor, any tax on the recaptured CCA was avoided all together. Rental housing investors, like all investors, also benefited from the non-taxation of capital gains.

This was changed with tax reform in 1972. With the requirement that each building valued at $50,000 or more had to have its own CCA class, recaptured CCA became taxable at income tax rates rather than capital gains tax rates in the year of the sale. The introduction of capital gains taxation in 1972 also contributed to increased taxes payable beginning in 1972 on the sale of a rental property assuming the sales price was greater than the combined UCC and cumulative CCA deductions.

Initially, under tax reform in 1972, 50% of a capital gain was taxed as income. This was increased to 66.67% in 1988, and 75% in 1990. This was done without benefit of a new Valuation Day, resulting in a capital gains tax increase of 25 percentage points which was retroactive for up to 17 years - probably the single most discouraging tax factor for rental housing investors since 1972. However, in 1985, a one-time exemption of $20,000 capital gains was permitted which increased to $50,000 in 1986 before being capped at $100,000 in 1987. All investors, not just investors in rental properties, benefited from this exemption. It was eliminated in 1994.

## 2.4 CHANGES IN THE FEDERAL SALES TAX TREATMENT OF RENTAL HOUSING SINCE THE EARLY 1970S

Prior to the introduction of the Goods and Services tax (GST) in 1991, the building materials used in the construction of new rental housing were subject to a Federal sales tax. Thus only a portion of the costs of building new rental properties were subject to this tax. With the replacement of the federal sales tax by the GST the total value of new rental properties is now taxed. Since the GST was introduced, the rate has been constant at 7%.

Most ongoing operation costs of rental properties such as management fees, and maintenance contracts, were not subject to a Federal sales tax.

The Federal government has been advocating that the provinces should merge their existing sales taxes with the Federal GST in a combined tax called the Harmonized Sales Tax (HST). Quebec expanded the base of its provincial sales tax some years ago. Three of the Atlantic provinces replaced their sales taxes with the HST in April, 1997.

## 2.5 CURRENT FEDERAL TAX TREATMENT OF RENTAL HOUSING INVESTMENT IN THE UNITED STATES

Since there is no Federal sales tax in the United States, only the income tax is considered here. The current income tax treatment of rental housing investment in the United States is more favourable than in Canada. In some ways, it bears a closer resemblance to the pre-1972 tax treatment than to the current treatment in Canada. Figures 2-7, 2-9, and 2-10 summarise key provisions of the current income tax in the U.S. as it relates to rental properties.

**Figure 2-7**
**Current Provisions of U.S. Federal Income Tax Regime Relating to Rental Housing Investment**
**Ongoing Ownership**

| Provisions | Type of Investor: Individual – Real Estate Professional | Individual – Small Landlords | Individual – Limited Partner and Passive Investor | Corporations – Regular and Closely Held Corporations | Corporations – Trusts, Personal Service Corporations |
|---|---|---|---|---|---|
| **1. Depreciation** | | | | | |
| **1.1 Rate** | | | | | |
| Calculated using the sraight-line depreciation method. | Pro-rated using mid-month convention in year 1 Depreciated over 27.5 years. | | | | |
| **1.2 Pooling** | | | | | |
| A rental property with a capital cost in excess of $50,000 must be put in a separate class. | Pooling restriction does not apply in the United States | | | | |
| **1.3 Loss Restrictions** | | | | | |
| Effective January 1, 1987, rental real estate activities are generally considered passive. Generally you can only deduct losses from income from other passive activities. (5) | Can deduct losses from income. Passive activity rules do not apply. | If rental losses are over $25,000 deductions for losses can only be deducted from passive income. | Cannot deduct rental losses from other income other than from passive income. | Can deduct losses from income. Passive activity rules do not apply. | Cannot deduct rental losses from other income other than from passive income. |

Source: Clayton Research

### *2.5.1 Real Estate Investor Types*

The categories of rental investors for the purpose of income tax in the U.S. include the following:

- Real estate professionals - individuals and closely held corporations in the real estate business who actively participate in rental real estate activities;
- Small landlords - a small taxpayer whose gross income from all sources (including spouses income) is less than $150,000 and who actively participates in rental activities;
- Passive investors - investors owning rental real estate for the primary purpose of earning income without taking an active daily role in the generation of the income; and
- Regular and closely held corporations, including public companies in the real estate business - treated the same as real estate professionals for tax purposes.

### *2.5.2 Ongoing Ownership of Rental Properties*

Investors in the United States are able to deduct depreciation (CCA in Canadian terminology) on rental properties excluding lands but on a different basis than in Canada (see Figure 2-7). Depreciation is based on a straight-line approach with buildings being completely depreciated over 27.5 years. Figure 2-8 shows how

the annual depreciation and CCA deductions compare over time. The cumulative deductions are larger in the first 6 years of ownership in Canada, but are progressively larger in the U.S. after Year 7.

**Figure 2-8**
**CCA and Depreciation Reduction**
**for a Rental Property Purchased July 1, Year 1**
**Canada and the United States**

*Assume building portion in initial purchase price = $500,000*

| | **Canada** | | **United States** | |
|---|---|---|---|---|
| | Declining Balance at 4% rate | | Straight line over 27.5 years | |
| Year | Annual CCA | Cumulative CCA | Annual Depreciation | Cumulative Depreciation |
| 1 | 10,000 | 10,000 | 8,335 | 8,335 |
| 2 | 19,600 | 29,600 | 18,180 | 26,515 |
| 3 | 18,816 | 48,416 | 18,180 | 44,695 |
| 4 | 18,063 | 66,479 | 18,180 | 62,875 |
| 5 | 17,341 | 83,820 | 18,180 | 81,055 |
| 6 | 16,647 | 100,467 | 18,180 | 99,235 |
| 7 | 15,981 | 116,449 | 18,180 | 117,415 |
| 8 | 15,342 | 131,791 | 18,180 | 135,595 |
| 9 | 14,728 | 146,519 | 18,180 | 153,775 |
| 10 | 14,139 | 160,658 | 18,180 | 171,955 |
| 11 | 13,574 | 174,232 | 18,185 | 190,140 |
| 12 | 13,031 | 187,263 | 18,180 | 208,320 |
| 13 | 12,509 | 199,772 | 18,185 | 226,505 |
| 14 | 12,009 | 211,781 | 18,180 | 244,685 |
| 15 | 11,529 | 223,310 | 18,185 | 262,870 |
| 16 | 11,068 | 234,378 | 18,180 | 281,050 |
| 17 | 10,625 | 245,003 | 18,185 | 299,235 |
| 18 | 10,200 | 255,202 | 18,180 | 317,415 |
| 19 | 9,792 | 264,994 | 18,185 | 335,600 |
| 20 | 9,400 | 274,395 | 18,180 | 353,780 |
| 21 | 9,024 | 283,419 | 18,185 | 371,965 |
| 22 | 8,663 | 292,082 | 18,180 | 390,145 |
| 23 | 8,317 | 300,399 | 18,185 | 408,330 |
| 24 | 7,984 | 308,383 | 18,180 | 426,510 |
| 25 | 7,665 | 316,048 | 18,185 | 444,695 |
| 26 | 7,358 | 323,406 | 18,180 | 462,875 |
| 27 | 7,064 | 330,469 | 18,185 | 481,060 |
| 28 | 6,781 | 337,251 | 18,180 | 499,240 |
| 29 | 6,510 | 343,761 | 760 | 500,000 |

Source: Clayton Research

Real estate professionals can deduct the full losses (including depreciation losses) from rental real estate acquired in 1994 or later but not for properties acquired prior to 1994. These latter losses must be carried over.

Small landlords with a gross income of less than $100,000 can deduct up to $25,000 of rental losses (also called passive losses) against other income. For small landlords with gross incomes between $100,000 and $150,000, the $25,000 deduction is reduced and is phased out at $150,000.

Passive investors are not allowed to deduct any losses (whether before or after depreciation deduction) against other income. These losses are not totally lost but are "suspended" and can be carried on a property-by-property basis to the next taxation year.

### *2.5.3 Purchase of a New or Existing Rental Property*

In the U.S., the depreciation allowed in the first year of ownership depends on the date the property is purchased (see Figure 2-9). Depreciation is based on the mid-month convention rather than mid-year as in Canada. Under the mid-month convention the year is broken down into 24 parts (2 per month) and the applicable depreciation deduction depends on the month of purchase. So if a property is purchased in early February, 21/24ths of the full-year depreciation is allowed.

**Figure 2-9**
**Current Provisions of U.S. Federal Income Tax Regime Relating to Rental Housing Investment**
**Purchase of New or Existing Rental Property**

| | Type of Investor | | | | |
|---|---|---|---|---|---|
| | Individual | | | Corporations | |
| **Provisions** | **Real Estate Professional** | **Small Landlords** | **Limited Partner and Passive Investor** | **Regular and Closely Held Corporations** | **Trusts, Personal Service Corporations** |
| **1. Depreciation** | | | | | |
| **1.1 Rate** Calculated using the sraight-line depreciation method. | Pro-rated using mid-month convention in year 1 Depreciated over 27.5 years. | | | | |
| **1.2 Pooling** A rental property with a capital cost in excess of $50,000 must be put in a separate class. | Does not apply in the United States | | | | |
| **2. Soft Costs** | | | | | |
| **2.1 Type of expenses** include: attorney fees, escrow fees, recording costs brokers and finders fees, appraisal costs, surveys, charges for title search and title insurance, costs of acquiring any outstanding leases, inspection fees and any expenses related to purchase other than those that physically affect the property. | Construction period interest and property tax (CPIT) expenses and purchase expenses must be added to basis and capitalized. | | | | |

Source: Clayton Research

All expenses related to the purchase, construction, or renovation of the property is added to the original cost of the property and depreciated over time.

The Federal Government in the U.S., under its income tax legislation, provides a Low-Income Tax Credit as an incentive for the private sector to produce lower-income housing. The credit offers investors a dollar-for-dollar credit against Federal income taxes for investing in new low-income rental housing. Developers apply to a state for a share of the state's credit. Developers then raise equity by selling ownership interests in the properties with the purchasers of the equity being eligible for the tax credit. Large non-real estate

corporations have found this credit to be an attractive vehicle. This provision is a tax expenditure rather than a direct expense to the Federal Government.

### *2.5.4 Sale of Existing Rental Property*

In the U.S., the tax consequences associated with the sale of a rental property are different depending upon whether another property of equal or greater value is purchased within a specified time after the sale (termed "like-kind exchange") (see Figure 2-10).

**Figure 2-10**
**Current Provisions of U.S. Federal Income Tax Regime Relating to Rental Housing Investment**
**Sale of Demolition of Existing Structure**

| | Type of Investor | | | | |
|---|---|---|---|---|---|
| | Individual | | | Corporations | |
| **Provisions** | **Real Estate Professional** | **Small Landlords** | **Limited Partner and Passive Investor** | **Regular and Closely Held Corporations** | **Trusts, Personal Service Corporations** |
| **1. Depreciation** | | | | | |
| **1.1 Recapture** | | | | | |
| When an asset is sold for more than the unrecovered cost, depreciation is recaptured. All or part of the gain is reported as ordinary income. | Applies to all types of investors | | | | |
| **1.2 Terminal loss** | | | | | |
| Cannot deduct any amount paid or incurred to demolish a structure, or any loss from the undepreciated basis of a demolished structure. | Applies to all types of investors | | | | |
| **2. Capital Gains** | | | | | |
| **2.1 Rate** | | | | | |
| Depends on the type of property sold, the holding period prior to sale, overall income level, when property was sold. | 10-28% | 10-28% | 10-28% | 10-28% | 10-28% |
| **2.2 Deferred capital gain** | | | | | |
| A capital gain on investment property can be put off to a future date if the sold property is replaced within a time limit by another property costing as much as or more than the property that was sold. (like-kind exchange) | Applies to all types of investors | | | | |

Source: Clayton Research

Where the investor sells a property and buys another property of equal or greater value within 180 days, any taxation owing on recaptured depreciation or capital gains is deferred.

Where the investor just sells a rental property, the difference between the adjusted sales price (sales price plus closing costs) and the adjusted basis (original cost plus closing costs at the time of purchase plus capital improvements less all depreciation claimed) is calculated. The difference, if positive, is the capital gain.

### *2.5.5 Demolition of a Rental Building*

Demolition expenses are added to the basis of the land where the demolished structure was located. They cannot be added to the undepreciated basis and depreciated over time.

## 2.6 COMPARISON OF TAX TREATMENT OF RENTAL HOUSING INVESTMENT IN CANADA AND THE UNITED STATES

### *2.6.1 Income Taxation*

The most significant similarities and differences between the income tax treatment of rental housing investment between Canada and the United States are the following:

- Both countries have restrictions on rental losses being applied against other income for investors not in the business of real estate. Generally, the restrictions in the U.S. are more onerous since all losses, not only losses due to depreciation (CCA), are not deductible (there is an exception for small investors);

- In the U.S., individual rental investors can be recognised as being Real Estate Professionals, and benefit from more lenient tax provisions regarding losses. In Canada, only corporations are given the Principal Business status;

- In the U.S., rental investors not in the real estate business can defer triggering taxation of recaptured depreciation (CCA) and capital gains when a property is sold by purchasing another property of equal or greater property. In Canada, the recaptured depreciation and any capital gain on any property sold is taxed in the year of the sale; and

- In the U.S., only a small portion of capital gains is subject to income taxation (up to 28 percent) compared to Canada (75 percent).

### *2.6.2 Sales Taxation*

In Canada the purchase of a new rental property and operating costs of existing buildings are subject to the 7% GST. There is no comparable tax in the United States.

## 2.7 TAXATION OF RENTAL HOUSING INVESTMENT COMPARED WITH OTHER TYPES OF INVESTMENT IN CANADA

Investors have a variety of investment vehicles in which to put their money. Presumably they allocate their funds amongst the various vehicles based on factors such as expectations about future returns (income and/or capital gains), their risk tolerance, and needs relating to liquidity and regular income flows. Differential tax treatment of various investment vehicles can distort investment decisions and the amount of investment in the various vehicles.

For rental investors not in the real estate business, the main tax differences with competitive investment vehicles are described below.

### *2.7.1 Principal Residence*

The primary tax incentive for an investment in a principal residence is that any capital gain at the time of disposition is not taxed. A secondary benefit is the ability for first time home buyers to apply pre-tax RRSP dollars up to $20,000 per person as a down payment on a home. Investors in rental housing, in contrast, are taxed on their capital gain but are allowed to deduct non-CCA losses, if any, against other income.

### *2.7.2 Registered Retirement Savings Plan (RRSP)*

Investors putting money into selected investment vehicles (primarily stocks, bonds and mutual funds) are able to transfer tax free funds up to $13,500 per year, depending on the level of earned income, and benefit from tax-free returns within an RRSP. These funds are ultimately taxed when they are received as income during retirement. The primary advantages are the ability to defer taxes payable for many years into the future and the likelihood of having a lower marginal tax rate applied to the income in the future.

### *2.7.3 Stocks*

Dividends received from Canadian companies are eligible for the dividend tax credit which results in a lesser tax payable than say for rental income or interest income.

### *2.7.4 Investments in Selected Active Businesses Including Small Business Corporations and Farms*

Active small business corporations, including hotels, motels and farms are eligible for a total lifetime capital gains deduction of $500,000. A small business corporation is a Canadian-controlled private corporation in which 90% or more of all assets are used in an active business or carried on primarily by the corporation. Unincorporated businesses are not eligible for this deduction, nor are apartment rental properties because ownership and operation of rental property is not considered an ‘active’ business unless there are 6 or more full time employees.

Active small businesses and farms can defer payment on a capital gain if they buy another property for the same or similar business. Rental properties are excluded from this provision.

Small business corporations also enjoy a lower rate of taxation than unincorporated businesses for the first $200,000 of ‘active business income’. Because income generated from rental properties is considered passive, owners of rental properties in Canada are not eligible for the lower small business tax rate even if the owner actively manages the property.

## 2.8 CHAPTER SUMMARY

The principal findings of the review of the Federal Tax treatment of rental housing investment in Canada and comparison with the tax treatment of rental housing in Canada are:

- The tax treatment of rental investment in Canada is much less favourable than in the United States and, indeed, other form of investments in Canada (including RRSPs and ownership in farms and small businesses such as hotels and motels); and

- The current tax treatment of rental housing in the U.S. more closely resembles the situation in Canada prior to tax reforms implemented in 1972.

# 3. IMPACT OF THE CHANGED FEDERAL TAX TREATMENT OF RENTAL APARTMENT INVESTMENT ON THE RENTAL MARKET

This chapter examines the implications of the changed Federal tax environment, largely the income tax, for the overall performance of the rental apartment market in Canada in the period since the early 1970s. The chapter relies to a considerable extent on previous studies and analyses dealing with impact issues.

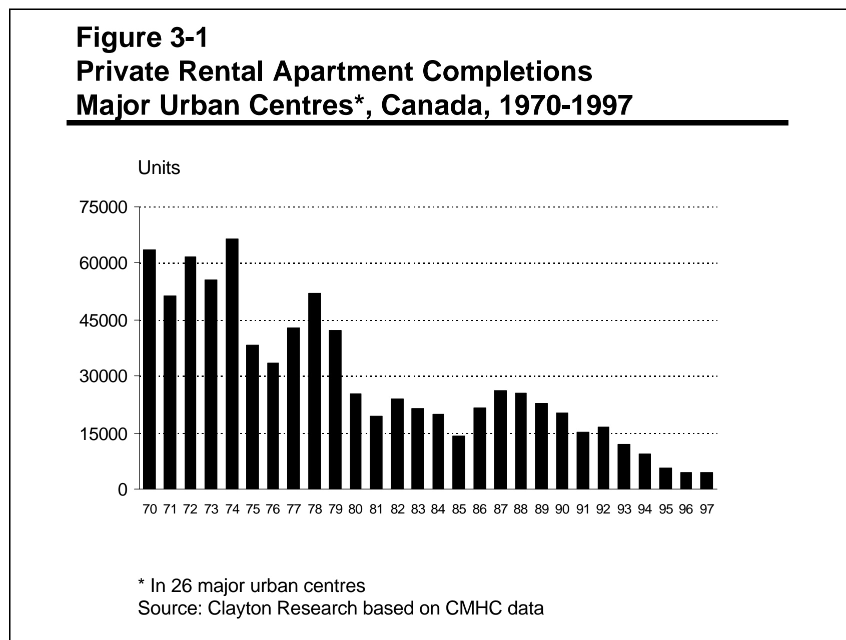
The chapter begins with a review of rental market performance in the period since 1970 with the emphasis being on the private side of the market. The Canadian experience is then compared to that in the United States. Several studies, which have examined the implications of the changed Federal tax environment in Canada in the period since the early 1980's, are then summarised. Finally, conclusions about the impact of the changed tax treatment of rental housing investment are presented.

## 3.1 RENTAL HOUSING MARKET SINCE 1970

### 3.1.1 Production of New Private Rental Housing in Canada

The quantum of new private sector rental housing built in Canada has been on a long-term decline in Canada since the early 1970s. Figure 3-1 shows the number of private rental housing completions built by year in 26 major Canadian urban centres in buildings with five or more units[3].

**Figure 3-1**
**Private Rental Apartment Completions**
**Major Urban Centres*, Canada, 1970-1997**




* In 26 major urban centres
Source: Clayton Research based on CMHC data

[3] *Comparable data are not available for all of Canada and for smaller structures. However, these larger centres account for the bulk of new rental housing built.*

The difference between the completion levels in recent years and the early 1970s is dramatic. Fewer than 5,000 private rental units were completed in each of 1996 and 1997. This is less than 10% of the volume of private completions annually in the 1970-1974 period.

Looking at the 1970-1997 period as a whole, there are three sub-periods of high or increasing private rental apartment production and three sub-periods of declining or low production.

- Early 1970-1974 - high production of private rental housing

  This was a time of strong economic growth and the demand for both ownership and rental housing were robust following the short-lived recession in 1970-1971. Completions, of course, lag housing starts. CMHC reported that rental starts began declining early in 1974, with the decline in rental apartment starts (both private and social) beginning earlier and being deeper than in the ownership sector.[4]

  A variety of factors in addition to the tax reform changes which became effective in 1972 caused the drop in starts in 1974, including a sharp rise in interest rates, a growing fear of rent controls, and uncertainties about construction and land costs.

- 1975-1979 - decline and rise in private rental housing production

  The Federal Government introduced two programs to stimulate the production of new rental housing. The Multiple Unit Residential Building (MURB) provision, which allowed investors in new rental housing to deduct CCA losses against other income, was introduced in the November, 1974 Federal Budget for rental projects started during the next 12 months. The provision was extended up to 1979. It was then introduced for about a year in the October, 1980 Budget. The Assisted Rental Program (ARP) was also introduced in late 1974 and remained in place through 1978. This program provided grants and, later, interest free loans to help make new rental projects viable until such time that market rents increased enough to do this.

  A large number of private rental starts resulted from these two programs. A total of 282,640 new units received MURB eligibility in the 1975-1978 period and 122,614 units were approved for ARP assistance[5] (since new private units could qualify for assistance under both programs, these numbers cannot be added). Additional stimulus for private rental housing in Alberta was provided by the Provincial Government in the late 1970s.

- 1980-1988 - low and then increased private rental housing production

  Despite the reactivation of the MURB provision in 1980, and its replacement by a new program, the Canada Rental Housing Supply Program, private rental apartment completions remained depressed until the latter half of the 1980s. The volume of completions picked up somewhat in the latter 1980s largely in Quebec and in Manitoba. Much of this increase was

[4] *CMHC, **Canadian Housing Statistics**, 1974, p. xii.*

[5] *Clayton Research Associates Ltd., **Tax Expenditures - Housing**, March, 1981, p. B-2 and Exhibit 3-6.*

the result of the one-time exemption introduced for capital gains which reached $100,000 in 1988. For many small investors, in particular, the rising real estate prices at the time combined with the favourable treatment of capital gains, made investment in new rental projects an appealing proposition.

- 1989-1997 - declining and then very low private rental housing production

  Private rental completions have fallen sharply since the late 1980s failing to exceed 5,000 units in either 1996 or 1997. Factors contributing to this depressed production include the recession and its after-effects, relatively high vacancy rates, and the emergence of affordable non-conventional sources of additional rental accommodation including basement apartment (also called secondary or ancillary) suites.

Part of the longer-term decline in private rental housing production is related to the demographically-induced drop in total new housing demand since the first half of the 1970s when the demand for new housing was at a post-war peak. However, there is more to the decline in rental production than this. Private rental completions as a proportion of total completions in 26 major urban centres across Canada dropped precipitously from more than 50% of all completions in 1970, the peak year, to just 5% in 1997 (see Figure 3-2).

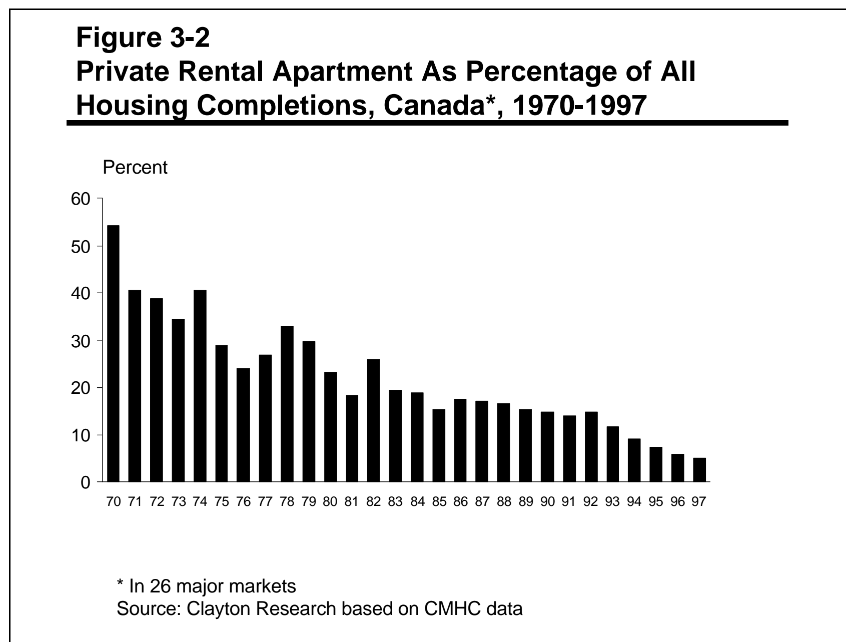



**Figure 3-2**
**Private Rental Apartment As Percentage of All Housing Completions, Canada*, 1970-1997**

* In 26 major markets
Source: Clayton Research based on CMHC data

### *3.1.2 Vacancy Rate*

In an unconstrained market (i.e., where there are no government impediments like rent controls) there should be an inverse relationship between the volume of new rental housing production and the vacancy rate. A low vacancy rate in a given urban centre puts upward pressure on rents which, in turn, induces developers and investors to built more new rental housing. The reverse holds when vacancy rates are high.

The remarkable strength in the demand for rental housing in the early 1970s is reflected in the drop in the private rental apartment vacancy rate in major urban centres to a low 1.2-1.3% in 1974-1976 despite record numbers of completions over the 1970-1974 period (see Figures 3-1 and 3-3). The subsequent rise in the overall vacancy rate in the latter 1970s was related to the higher private rental apartment production generated by the MURB provision and the ARP program.

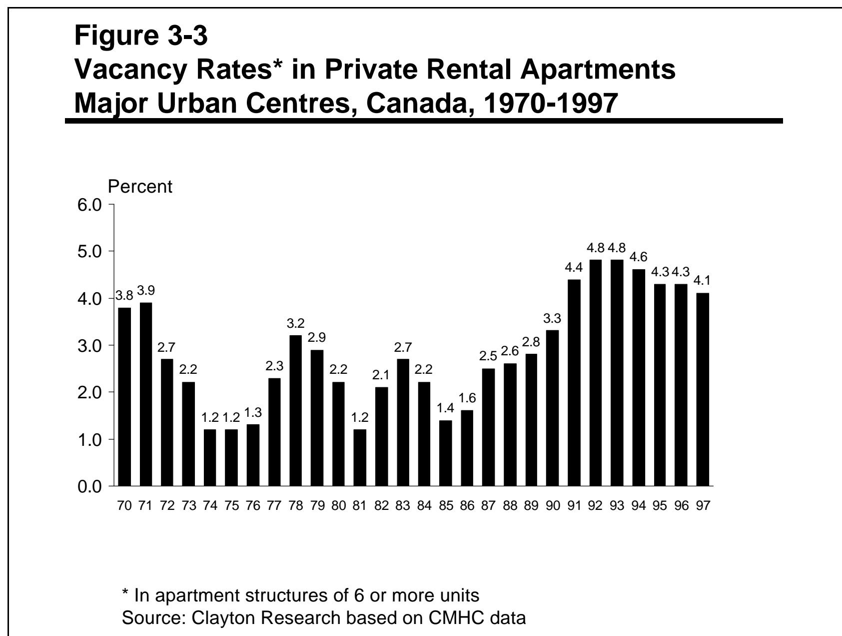



**Figure 3-3**
**Vacancy Rates* in Private Rental Apartments**
**Major Urban Centres, Canada, 1970-1997**

* In apartment structures of 6 or more units
Source: Clayton Research based on CMHC data

The overall vacancy rate declined to a low level in 1981, just before the 1982 recession adversely affected demand, and returned to near this low level in 1985 and 1986. The vacancy rate then climbed moderately in the latter 1980s in response to the higher number of private rental completions.

The 1990-1992 recession resulted in a drop in the demand for new rental housing as people coped with the worst economic downturn since the Great Depression in the 1930s. The overall vacancy rate accelerated from 2.8% in 1989 to 4.8% in 1992 and 1993. Since 1993, the overall vacancy rate dropped to 4.1% in 1997. CMHC estimates that the overall vacancy rate this year is 3.8% and will decline to 3.5 % next year.[6]

Focusing on the overall vacancy rate masks considerable differences in rental market conditions among major urban centres (see Figure 3-4). Six of the centres, including Toronto, Vancouver, Calgary, Regina, Saskatoon and Kitchener have tight rental markets with vacancy rates of 2% or less in 1997. Another four have vacancy rates below the overall average of 4.1% in 1997.

[6] *CMHC, **National Housing Outlook**, First Quarter, 1998, p. 38.*

**Figure 3-4**
**Vacancy Rate in Private Rental Apartments**
**Major Centres, Canada, October, 1997**

| Vacancy rates of 2% or less | Percent |
|---|---|
| Calgary | 0.5 |
| Toronto | 0.8 |
| Saskatoon | 0.9 |
| Vancouver | 1.5 |
| Regina | 1.5 |
| Kitchener | 1.9 |
| **Vacancy rates of 2.1%-4%** | |
| Oshawa | 2.3 |
| Hamilton | 3.1 |
| Victoria | 3.5 |
| Ottawa | 4.0 |
| **Vacancy rates over 4%** | |
| Windsor | 4.5 |
| Chicoutimi | 4.6 |
| Edmonton | 4.6 |
| St. Catharines | 4.8 |
| London | 4.9 |
| Winnipeg | 5.8 |
| Quebec City | 6.5 |
| Montreal | 6.6 |
| Sudbury | 6.9 |
| Thunder Bay | 7.3 |
| Sherbrooke | 8.1 |
| Halifax | 8.2 |
| St. John | 8.6 |
| Trois Rivieres | 8.8 |
| Hull | 8.9 |
| St. John's | 17.4 |

Source: Clayton Research based on CMHC data

Despite tight market conditions in six major urban centres, there is no sign of any pick up in new rental production in any of them (see Figure 3-5).

**Figure 3-5**
**Starts of Rental Housing in Six Major Urban Centres**
**Canada, Annual, 1992-1998**

| | Year | | | | | | Year to date | |
|---|---|---|---|---|---|---|---|---|
| Urban Centre | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | Aug. 1997 | Aug. 1998 |
| | | | | *Units* | | | | |
| Toronto | 6,859 | 3,636 | 2,143 | 1,597 | 482 | 250 | 205 | 145 |
| Kitchener | 656 | 315 | 68 | - | 13 | 5 | 5 | 217 |
| Regina | 87 | 87 | 26 | - | 3 | 3 | 3 | 2 |
| Saskatoon | 18 | 85 | 42 | 27 | 10 | 10 | 4 | 18 |
| Calgary | 94 | 247 | 61 | 26 | 17 | 128 | 14 | 58 |
| Vancouver | 1,901 | 1,435 | 1,181 | 669 | 715 | 1,319 | 901 | 401 |

*All rental starts, including private and social

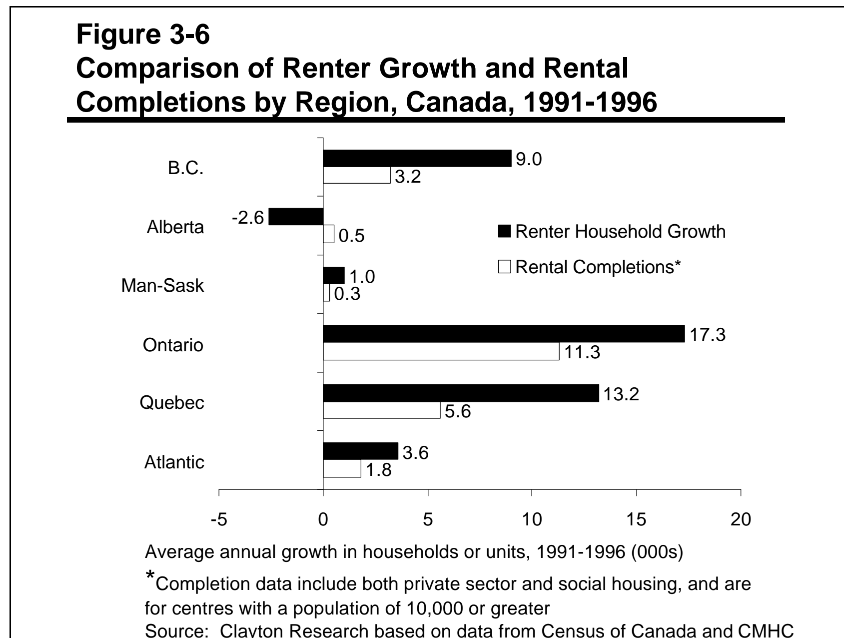
Source: Clayton Research based on data from CMHC

### 3.1.3 *Conventional vs. Non-Conventional Sources of Rental Housing*

Purpose-built rental projects, whether private or social housing, are not the only source of rental housing supply. Non-conventional sources include single-family houses and condominiums that are being rented by their owners as well as basement apartments (e.g., secondary suites). Many basement apartments, while generally offering affordable rents, often are low quality and illegal. New non-conventional units are not counted as rental housing production in CMHC's statistics and are not included in CMHC's rental survey of vacancies and rents.

Rental households have been increasing considerably across Canada in all regions except Alberta (Figure 3-6). Between 1991 and 1996, the occupied rental housing stock in Canada grew by roughly 42,000 units on average per year, accounting for 26% of all household growth. The completion of new conventional housing, both social and private sector, accounted for just over half of this expansion in the occupied rental housing stock, and most of this was social housing.

**Figure 3-6**
**Comparison of Renter Growth and Rental Completions by Region, Canada, 1991-1996**




*Completion data include both private sector and social housing, and are for centres with a population of 10,000 or greater
Source: Clayton Research based on data from Census of Canada and CMHC

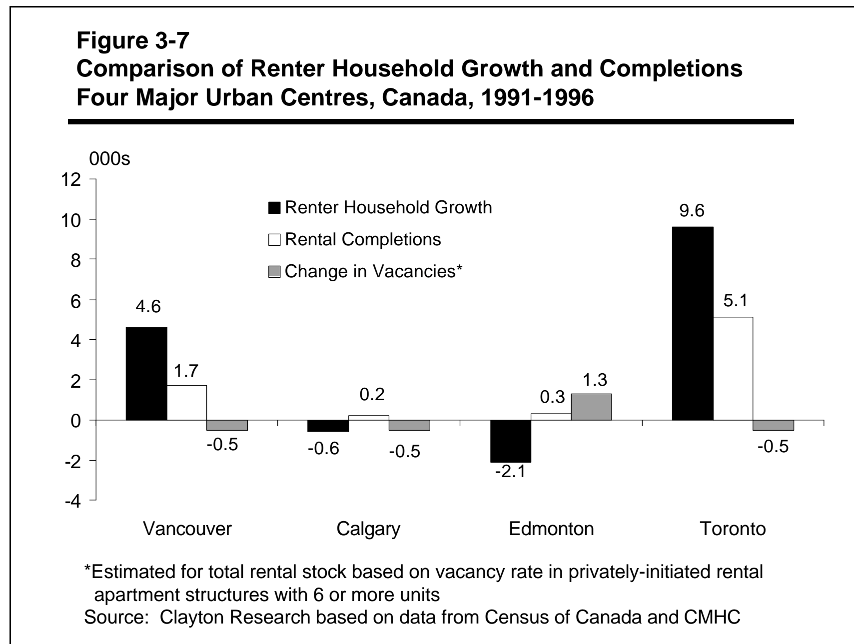
So where did the thousands of additional rental housing units come from? The occupancy of previously vacant rental units is not a factor - at least at the Canada-wide level. CMHC data indicates that the overall rental apartment vacancy rate in larger urban centres went up slightly between 1991 and 1996. The answer, therefore, undoubtedly lies in the creation of additional non-conventional units.

The experience in Alberta, however, has been quite different than in other parts of the country. Here the number of occupied rental units actually declined between 1991 and 1996.

In both Toronto and, especially Vancouver, the quantum of rental housing completions between 1991 and 1996 lagged renter household growth by a wide margin (Figure 3-7). This was mostly due to factors other than the occupancy of previously vacant rental housing units. The two main non-conventional sources of additional rental housing in these centres have been the net creation of additional rental units in existing

lower-density houses (e.g. basement/accessory suites) and the increased number of ownership types of housing units which have become rental-occupied, especially condominium apartments.

Figure 3-7
Comparison of Renter Household Growth and Completions
Four Major Urban Centres, Canada, 1991-1996




*Estimated for total rental stock based on vacancy rate in privately-initiated rental apartment structures with 6 or more units
Source: Clayton Research based on data from Census of Canada and CMHC

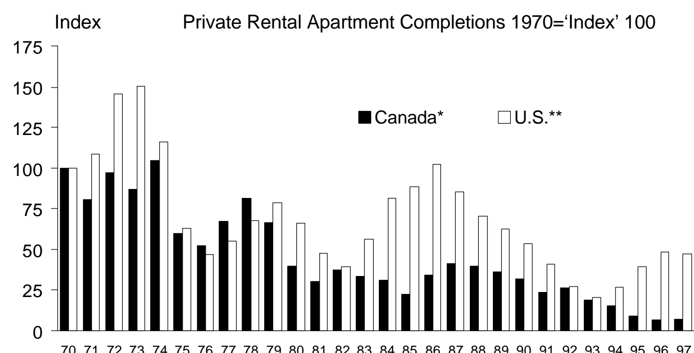
In Calgary and Edmonton, the rental supply situation, as for all of Alberta, has been quite different than in other large urban centres. The number of rental households declined between 1991 and 1996. This appears attributable to a number of factors which are not prevalent today: soft ownership markets in which builders enticed first-time buyers out of rental accommodation with attractive prices; the purchase by tenants of units in existing rental projects converted to condominiums; and, for Edmonton, a net outflow of population, including renters, to other areas. Since 1996, vacancies in private rental housing have declined sharply in both centres.

The corollary of a reduced production of conventional rental housing appears to be a greater share of renters are accommodated in non-conventional forms of housing including accessory suites.

## 3.2 COMPARISON OF PRIVATE RENTAL HOUSING PRODUCTION IN CANADA AND THE UNITED STATES

Given the many similarities between Canada and the United States, it is useful to compare the past trends in private rental housing production and to understand reasons for significant differences that prevail. Figure 3-8 shows annual private sector rental completions in the two countries for the 1970 to 1997 period. The completions data are indexed with 1970 equal to 100 (thus a value of 50 for a year means that completions in the year are half of what they were in 1970).

**Figure 3-8**
**Private Rental Apartment Completions**
**Canada and United States, 1970-1997**




Caution: data for Canada and U.S. not strictly comparable; they are provided here to compare **trends**, not actual levels
* In 26 major markets
** In all areas; only includes privately owned structures of 5 or more units
Source: Clayton Research based on CMHC and U.S. Department of Commerce data

What the data show is for every year, with the exception of 1976-1978 when the MURB and ARP programs in Canada were in full swing, U.S. private rental completions have been relatively higher than in Canada. This differential has been pronounced almost continually for the period since 1983, which is after the Federal Government in Canada disbanded its private sector assistance programs.

Another way of looking at the differences in the relative importance of private rental completions in the two countries is in terms of total completions. In the U.S., for example, private rental completions accounted for about 30% of all completions in the early 1970s; in 1996 and 1997, the comparable proportion was about 15%. In Canada, in contrast, the decline has been from about 40% in the early 1970s to just 5-7% in 1996-1997.

While it is not possible to quantify the contribution that various differences between the two countries (economic performance, demographics, preferences, the tax system, rent controls, governmental assistance for social housing, etc.), it seems evident that the difference in the Federal tax treatment of private rental housing investment has been a significant contributing factor. By making rental housing investment more attractive, the U.S. Federal tax structure enhances the after-tax returns from the ownership of such housing. The generally more favourable treatment of rental investment in the U.S. (e.g., higher CCA deductions, deferring recaptured depreciation and capital gains, etc.), has been reinforced by the Low-Income Rental Credit which has been in place since 1986.

## 3.3 LITERATURE REVIEW

There is a small but impressive body of literature dealing with the performance of the rental housing market in Canada over the period since the early 1970s. While the changed Federal tax system is not the only contributor to the long-term decline in private rental housing production relative to all new housing built, the literature is almost unanimous that the tax changes have played a significant role. This literature is highlighted below. The studies are presented chronologically.

### 3.3.1 Frank A. Clayton: Housing Implications of the White paper on Taxation, 1969

As part of its tax reform consultations leading up to new legislation which was implemented in 1972, the Federal Government released a **White Paper on Taxation.** Dr. Frank A. Clayton was on the staff of the Federal Minister Responsible for Housing at the time and prepared an assessment of the tax reform proposals in that paper for housing.

He drew attention to the proposed reforms affecting rental housing investing as having the most severe potential impact:

> "Probably the proposals of the White Paper, insofar as housing is concerned, which will generate most debate and, in fact, may have the most severe potential impact, are those relating to rental real estate, particularly the proposed restrictions on depreciation."[7]

He concluded that the tax reform proposals would be negative for the rental market, including higher rents for tenants:

> "If the strict interpretation of the depreciation modifications discussed above are followed, there can be little doubt that either new rental residential construction will be reduced (and indirectly rents increased), or if the volume is not reduced, higher rents to offset the smaller after-tax return."[8]

### 3.3.2 Lawrence D Jones: The State of the Rental Housing Market, 1983

Professor Jones of the University of British Columbia stated there was no question that the changes in the income tax treatment in the early 1970s was detrimental to expected profitability on rental investment. He also stated that the benefit from temporary programs like MURB (the MURB provision was intended to expire in a year but was renewed annually for several years) are diluted by the uncertainty with regards to longer term applicability. After all, rental housing investments require a longer- term perspective.

> "Expected profitability was undoubtedly impaired in the 1970's by changes in the tax law and uncertainty regarding what the tax law should be. Canadian tax policy was structured to encourage investment in rental housing prior to 1972.
>
> These benefits were removed for rental housing investments in 1972. The tax shelter provision was reintroduced in the November 1974 federal budget but only on a 'temporary' basis; the special MURB provisions were renewed annually through 1979 and reappeared for one year in 1981. However the positive impact of these provisions on expected profitability must have been significantly diluted by the uncertainty this transitory tax structure created in the minds of potential investors with regard to the longer run posture of tax provisions applicable to residential real estate."[9]

---

[7] *Clayton, Frank A.,* ***Housing Implications of the White Paper on Taxation,*** *1969, p. 9.*
[8] ***Ibid****, p.11.*
[9] *Jones, Lawrence D.,* ***The State of the Rental Housing Market,*** *1983, p. 19.*

Subsequently, the tax law changed so that the MURB tax benefit could not be transferred on sale to a new owner.

### *3.3.3 CMHC: Evaluation of Federal Rental Housing Programs, 1987*

CMHC's Program Evaluation Division prepared an evaluation of Federal rental housing programs in 1987. The report includes a chapter on the evolution of Federal involvement in rental housing, including the income tax provisions in effect prior to tax reform in 1972.

The study concluded that the net effect of the tax reform provisions related to rental housing was negative for the economics of investing in private rental housing. It also stated that the change in the treatment of CCA in combination with other factors, most notably inflation, which increased construction and financing costs faster than rents, caused a significant reduction in rental housing construction between 1971 and 1974.

> "The net effect of this package of tax changes on the economics of investment in rental real estate was, of course, negative (although it would be difficult to quantify the impact in isolation of other factors). Although the restrictions applied generally to all rental real estate, the negative effect was felt primarily in the area of rental residential accommodation (due to the fact that few individuals have ever invested in the non residential sector, i.e. office buildings, shopping centres, et cetera).
>
> The combination of a series of factors, most notably the rapidly rising rates of inflation which increased construction and financing costs at a more rapid rate than could be offset by higher rent levels and the removal of the CCA provision which had previously served as the major incentive to investors led to the significant decline in rental housing construction from 106,000 units in 1971 to 74,000 in 1974."[10]

The study also concluded that a significant increase in private rental housing coincided with the availability of the MURB and ARP assistance. While these programs were successful in stimulating rental construction, they also were costly. ARP was a program meant to initially close the gap between economic and market rents resulting in large part from high interest rates at the time. Now, of course, interest rates are much lower.

> "With the combination of the MURB tax incentive and the assistance available under the Assisted Rental Program, the level of public assistance was quite high. These incentives coincided with a significant increase in the supply of new privately-initiated rental housing, averaging over 86,000 per annum between 1976 and 1978 – well above the 70,361 level in 1975. In addition, vacancy rates increased gradually to 3.2% by 1978.
>
> The cost of the federal subsidy schemes implemented in the mid-1970's in order to stimulate rental construction and their success in spurring such investment led in part to the termination of ARP in 1978."[11]

[10] *CMHC,* ***Assessment Report: Evaluation of Federal Rental Housing Programs, (draft)*** *1987, p. 9.*

[11] ***Ibid****, p. 13.*

### *3.3.4 Willard A. Dunning: The Demographic Challenge to Rental Housing Policy, 1990*

Willard Dunning, an economist with CMHC, also concluded that the 1972 tax reform was negative for rental housing investment returns and, thus, real estate investment. He also offers an explanation for seemingly high amount of rental investment immediately after the 1972 tax reforms - sharply rising real estate prices stimulated investor interest in capital gains.

> "The 1972 changes reduced the attractiveness of rental housing investment, which meant that higher rents were required in order to attract investment. An adjustment process began: vacancy rates fell and rents began to increase. The adjustment process was truncated by the creation of the Multiple Unit Residential Building (MURB) and by increasing real estate prices, both of which encouraged investment, and by the imposition of rent controls."[12]

Dunning also examined the changes to the tax treatment of rental investment in the 1980s and concluded that these too reduced the after-tax rate of returns and, therefore, investment in rental housing.

> "Reforms of income tax rules during the 1980's were made in order to reduce tax sheltering and tax avoidance. This was intended to make the system more fair and to remove incentives for taxpayers to engage in activities and investments which are designed largely on the basis of tax considerations rather than on the basis of fundamental value.
>
> This chapter has argued investment in rental housing provides considerable opportunities for tax sheltering. Therefore, the profitability of rental housing investment has been negatively affected by measures intended to improve the fairness of the system.
>
> Key changes in the second half of the 1980's had the effect of reducing tax sheltering benefits of investing in rental housing and after-tax rates of return."[13]

### *3.3.5 Greg Lampert: The Challenge of Encouraging Investment in New Rental Housing in Ontario, 1995*

Greg Lampert, an economic consultant, prepared a discussion paper on rental housing investment in Ontario. He looked at the effects the changes in the Federal income taxes since the 1970s had on net operating income, and the negative impact on rental projects, as well as the GST, which replaced the Federal Sales Tax in 1991. He compares the impact of the GST using a proforma of a hypothetical real estate project and concluded that the income changes and the GST has had a significant negative impact on rental housing investment. He warns that the adverse consequences for rental housing are even greater under a harmonized sales tax.

> "There has been significant changes in the income tax treatment of rental investment since the early 1970s. Investment in rental housing no longer enjoys the substantial tax advantages that prevailed in the past. Investors now judge rental projects on their economic merits, not their tax benefits.

---

[12] *Dunning, Willard A.,* ***On the Agenda: the demographic challenge to rental housing policy in Canada,*** *(draft) 1990, Chapter 4.*
[13] ***Ibid,*** *(chapter 4).*

> The GST increased costs for rental construction substantially. Whereas previously, only building materials were subject to the Federal Sales Tax (at a preferential rate of 9 percent), now the full value of new rental buildings is subject to the 7 percent GST. This has increased costs significantly - about $3,800 on an $82,000 apartment unit. This contrasts with the treatment accorded new ownership housing which is eligible for a rebate of part of the GST. Non-profit housing also receives favourable treatment - only half the GST payable.
>
> Unless major changes are made, harmonization [of provincial sales tax] could impose even greater costs on new rental construction. The treatment of new rental housing by the GST and/or harmonized GST/PST should be examined to ensure that the taxes are not an impediment to new rental investment."[14]

### *3.3.6 Alex S. MacNevin, Effects of the Tax System on Rental Housing, 1996*

Alex MacNevin, a Halifax-based economist, analyses the effects of taxes for typical rental investments in Halifax in a research paper prepared for CMHC. The taxes considered include Federal and Provincial income and sales taxes and property taxes. He formulates a rental investment model which incorporates these taxes as well as other variables.

He concludes that taxes have significant effects on the rental market in Halifax. Increases in taxes (presumably through increases in tax rates or changes in the treatment of deductions like CCA) get reflected into higher rents.

> "The study concludes that taxes have significant effects on rental housing markets in Halifax. In order for rental housing investors to achieve market rates of return, increases in taxes must translate directly into increased rents for renters."[15]

Some of his specific conclusions are quite startling, including the cumulative impact of all taxes on rent levels and the implications of harmonization of the GST and the Provincial sales tax in Nova Scotia:

> "The marginal effective tax rate on the sector is about 61 percent - that is, 61 percent of the return from a new investment goes as taxes:
>
> Taxes, in total cause gross rents to be about 63 percent higher than they otherwise would be:
>
> The percentage contributions of the individual taxes to the total is: income taxes (37 percent); federal and provincial sales taxes (35 percent); municipal property taxes (28 percent): and
>
> The recent commitment to harmonizing the GST with the Nova Scotia sales tax will cause rents to rise about four percent and will have negligible effects on marginal effective tax rates."[16]

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[14] *Lampert, Greg,* ***Discussion Paper: The Challenge of Encouraging Investment in New Rental Housing in Ontario****, 1995, p. iii-iv.*
[15] *MacNevin, Alex S.,* ***Effects of the Tax System on Rental Housing: The Case in Halifax,*** *1996, p. i.*
[16] ***Ibid,*** *p. i.*

## 3.4 CHAPTER SUMMARY

The review of the performance of the Canadian rental housing market over the period since 1970, especially in comparison with that in the United States, shows that new rental housing production has been on a downward trend. This cannot be explained by changing market fundamentals, such as the ageing of the country's population, since the decline in new rental housing production is significantly larger than total new housing production. Similarly, the extent of the decline in new rental housing production is noteworthy since it has been more severe than in the United States where the Federal income tax treatment of rental investment is much more favourable than in Canada.

These differences strongly suggest that the changes in the Federal tax system (particularly the income tax, but the sales tax as well) in 1972 and subsequently have had a serious detrimental effect on the rental market because of the reduced production of private conventional rental housing. While the private sector has responded to the need for additional rental housing through non-conventional sources such as the creation of basement apartments in existing houses, much of this housing is of low-quality and illegal. It is also likely that many owners do not declare this income for income tax purposes.

This conclusion of serious detrimental effects is supported by various analytical studies that have been done on the implications of Federal tax changes on the rental market. These studies demonstrate that the worsening income tax treatment of rental investment in Canada during the period starting in 1972 has had quite negative implications for the rental market. These adverse consequences have been aggravated by the substitution of the Federal sales tax with the GST and in the harmonization of the GST and provincial sales taxes in several provinces. The literature also indicate that a return to more favourable tax treatment of rental housing investment will generate additional investment in this sector.

# 4. FUTURE OUTLOOK FOR RENTAL HOUSING MARKET UNDER CURRENT FEDERAL TAX TREATMENT

This chapter looks at the need for additional rental housing investment, both in new and existing accommodation, in the coming years and the likelihood of this needed investment being forthcoming in the volumes needed under the present Federal income and sales tax regimes. It also examines some of the negative repercussions on the rental market if investment is deficient.

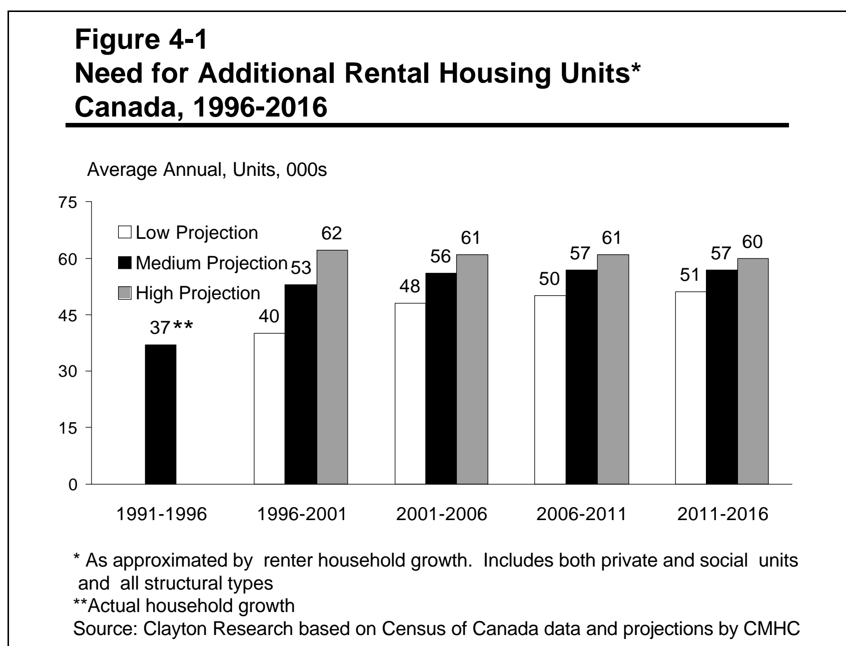
## 4.1 REQUIREMENT FOR NEW RENTAL HOUSING

### *4.1.1 CMHC Projections*

In 1997, CMHC released projections of household growth by tenure for the 1996-2016 period. Because of the uncertainties of forecasting the future with accuracy, three alternative national scenarios were formulated: low, medium and high. The medium scenario is used in the report as a reference scenario. Renter household growth is frequently used as a proxy for the need for additional rental housing.

Under all three scenarios the need for additional rental housing in Canada over the 1996-2001 period and beyond is higher than rental household growth in the 1991-1996 period (see Figure 4-1). Under the medium projection, an average of at least 53,000 additional units are required annually in each five-year period of the next 20 years. This represents a minimum of a 43 percent increase over the average annual rental household growth experienced during the 1991-1996 period.

**Figure 4-1**
**Need for Additional Rental Housing Units***
**Canada, 1996-2016**




* As approximated by renter household growth. Includes both private and social units and all structural types
**Actual household growth
Source: Clayton Research based on Census of Canada data and projections by CMHC

### 4.1.2 Baxter's Projections

David Baxter of The Urban Futures Institute in Vancouver has also recently prepared longer-term projections of future new housing demand in Canada.[17] His projections indicate a growth of about 47,300 rental households per year over the 1995-2003 period.

## 4.2 THE NEED FOR INCREASED VOLUMES OF CONVENTIONAL RENTAL HOUSING

Both these sets of future scenarios clearly demonstrate that the country as a whole needs more rental housing over the medium and long-term than the numbers of units created in the first half of the 1990s (renter household growth averaged 37,000 units per year). This housing potentially can be provided though conventional sources (i.e., in purpose-built rental buildings) or non-conventional sources (e.g., through the creation of basement apartments in existing houses, renting out condominium units).

It was already shown that much of the growth in renter households during the 1991-1996 period was accommodated in non-conventional rental housing (section 3.1.3). This occurred despite the fact that much of the conventional rental housing built during the period was social not private housing, especially in Ontario where the Provincial Government funded tens of thousands of non-profit and co-operative housing units.

It is much less likely that the future need for additional rental housing can be satisfied nearly as much by sources other than private conventional rental housing:

- The supply of new social housing funded by the Federal and Provincial Governments has essentially dried up as governments have terminated programs that generated new social housing. There is awareness on the part of government that social housing in new projects is an expensive proposition. The Auditor General in Ontario, for example, estimated that the average annual subsidy associated with the construction of provincially-funded social housing was about $12,000 per year per unit;

- The supply of investor-owned non-conventional units will likely grow less rapidly due to lesser expectations about capital gains. The prospect of sizeable capital gains is typically a driving force behind the purchase of houses or condominiums to rent; and

- The creation of additional basement apartments (secondary suites) is not expected to increase as much in the future as in the past. Many of the owners wanting to create such units have probably done so. In addition, more municipalities are attempting to regulate these apartment units by imposing standards and eliminating illegal units which will act to reduce the number of new units.

Moreover, the stock of conventional rental units is being depleted by conversions to condominium tenure. Conversions have been numerous in several urban centres, especially in Calgary and Edmonton, but also in

[17] *Baxter, David,* ***Demographics and the Future of Housing Demand in Canada: The Myth of the Vanishing Purchaser****, March, 1997.*

Vancouver and Ottawa. With the repeal of the Rental Housing Protection Act in Ontario, a greater number of conversions will ultimately result. In addition, demolitions will increase as the rental stock ages.

The bottom line is that a significant expansion in the volume of private sector investment will have to occur if the rental housing growth needs are to be met.

## 4.3 EXISTING STOCK REQUIRES HUGE INVESTMENT FOR UPGRADING

A report released by CMHC entitled **The State of Canada's Housing** draws attention to the growing problem of the ageing and reduced quality of the conventional rental housing stock in Canada.[18]

> "Evidence from studies in Ontario and Quebec has uncovered a series of problems related to the design and construction of high-rise and walk-up residential building. . . . Low-rise rental units, many of them older walk-up apartments, face some of the same difficulties."[19]

The report points out that the owners of the smaller rental properties in particular may not be making the needed spending for repairs and upgrading due to a lack of financial resources:

> "The condition of the stock is troublesome because there are indications that owners of smaller apartments, which provide the vast majority of rental accommodation, may lack the financial resources to undertake repairs. In some cases, apartment owners have indicated that tenants' low incomes act as an obstacle to renovation. Rising vacancy rates as well as the low incomes of many tenants can make it difficult to implement improvements, compounding problems associated with the present inadequate level of maintenance."[20]

## 4.4 SOURCES OF CONVENTIONAL RENTAL HOUSING INVESTMENT

There has been some renewed interest by institutional investors in rental housing over the past few years. Similarly, there are now a few publicly traded real estate companies which specialise in rental housing plus a couple of Real Estate Investment Trusts (REITs). However, the aggregate portfolios of these investors represent only a small portion of the total conventional rental housing stock across the country. While it is expected that investor interest will continue to grow, it would not be reasonable to expect that these investor vehicles will provide anywhere near the bulk of the investment required to meet the rental housing needs and to repair and upgrade the existing stock.

Private individual investors are needed in a big way if new rental housing is to be built in the numbers needed and the existing stock is to be rejuvenated.

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[18] *Carter, Tom,* ***The State of Canada's Housing****, 1994,*
[19] ***Ibid,*** *p. 11.*
[20] ***Ibid,*** *p. 11.*

## 4.5 MARKET IMPLICATIONS OF PRIVATE RENTAL INVESTMENT NOT BECOMING AVAILABLE IN THE NEEDED QUANTITY

The implications of not meeting the requirements for additional rental housing and for repairing and upgrading the existing stock of rental housing include:

- Tight rental markets with upward pressure on rents for all tenants including the growing number of low and modest income tenants;

- Further deterioration in the quality of the existing rental housing stock and increase in demolitions; and

- Further pressure to double-up and occupy lower quality and often illegal basement apartments.

It is unlikely that rent will rise sufficiently under the current Federal tax regime to produce the needed investment capital. As figures 4-2 and 4-3 show, renters are already bearing increased rent burden and are lagging behind homeowners in terms of their income. During the 1990's, the average renter has increased the share of their income devoted to rent from approximately 17.5 percent to approximately 20.5 percent. As well, a growing share of renters are concentrated in the lowest income group. These renters do not have the resources to pay higher rents.

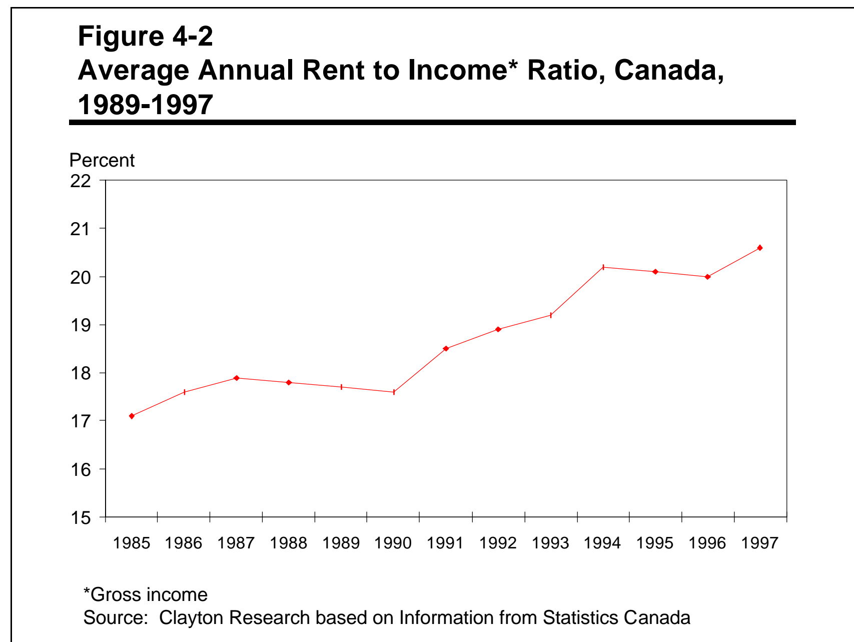
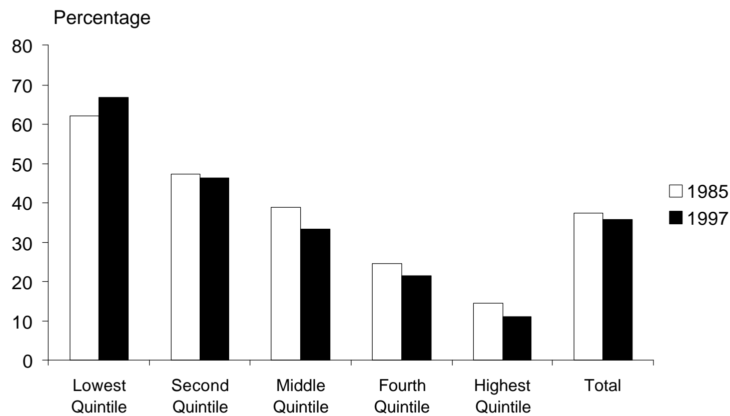



**Figure 4-2**
**Average Annual Rent to Income* Ratio, Canada, 1989-1997**

*Gross income
Source: Clayton Research based on Information from Statistics Canada

**Figure 4-3**
**Renters as a Proportion of All Households by Income Quintile, Canada, 1989 and 1997**




Source: Clayton Research based on information from Statistics Canada

## 4.6 CHAPTER SUMMARY

The country in the coming years has a need for the creation of a significant volume of additional rental housing and for the spending of large sums on refurbishing and upgrading the rental housing stock. Private investment is the only realistic source of the bulk of the needed funds. Their funds will not be forthcoming unless investors can see the prospect of competitive rates of return on rental housing. Without changes in the Federal tax system as it affects rental investment, the prospect of the required volumes of funds flowing into the rental housing market is next to nil.

# 5. CHANGES IN THE TAX TREATMENT OF RENTAL HOUSING INVESTMENT

This chapter starts by summarising the merits of the case for a change in the income and sales tax treatment of rental housing investment. It then explores and assesses specific proposals for change. Finally, it looks at some economic and tax revenue implications of increasing the numbers of new rental housing units built annually.

The focus is on investors who are not Principal Business Corporations (PBCs) since these are the investors most discriminated against by current tax provisions. However, several of the proposals also apply to PBCs.

## 5.1 THE CASE FOR A CHANGE IN THE TAX TREATMENT OF RENTAL HOUSING INVESTMENT

The analysis of the preceding chapters provide a compelling justification for changing the tax treatment of rental housing investment in order to encourage more investment in this sector:

- An upsurge in private sector investment is required to meet the needs for additional rental housing in Canada over the medium and longer term

  Canada has to have a substantial amount of new rental housing built if the needs of a growing and changing population are to be met. With the sharp curtailment of government funds flowing to the production of rental housing, the private sector is being relied on to meet most of this need. This investment will not be forthcoming in anything like the volumes needed without changes in the Federal treatment of rental housing.

- A vast amount of private investment is also required for repairing and upgrading the existing rental housing stock

  The rental housing stock in Canada has deteriorated and a growing number of units need significant repairs and upgrading to provide a quality living environment for their residents. Without a change in Federal tax treatment to encourage more private sector funds to flow into existing rental housing, the required funds will not be forthcoming and conditions in the existing stock will continue to deteriorate and the level of demolitions will increase.

- The changes to the income tax treatment of rental housing investment made since the early 1970s did not take into consideration adverse effects on the flow of investment funds and the rental market

  The rationale for the income tax changes, as they relate to the rental housing sector, that have been made since the early 1970s has been to close so-called “loop-holes”. In this regard, the changes can be said to be successful since they reduced investment flows into

rental housing significantly. Little attention was paid to the positive effects of the former investment flows in terms of the amount of new rental housing stimulated.

- Renters as a group do not have the financial resources to devote more of their income to pay higher rents

  Increasingly, renters are found within the lowest and modest income groups and many of these renters are having difficulty finding and paying for suitable shelter. Without a substantial increase in private investment flows, there will be a shortage of rental accommodation and higher rents, which will worsen the housing situation of renters, especially those with low and modest incomes.

- With changes in the rent control regime in Ontario arousing interest in rental investment, the time is ripe to translate this interest into action

  There is renewed interest in rental investment, both in new projects as well as buying existing projects to upgrade, in Ontario with the passing of the new **Tenant Protection Act**. Much of this interest is unlikely to become reality because the investments will not produce competitive returns without additional incentives such as changes in Federal tax legislation.

- There is precedent for using the tax system to achieving national social and economic goals

  The current Federal tax system provides incentives for private sector investment to achieve desired national goals. The capital gains tax exemption (up to $500,000) for investments such as family farms and small businesses including motels and hotels, and the Labour Venture Funds are examples.

- The tax regime applied to rental housing investment in the United States demonstrates that a more liberal tax treatment will stimulate significant private rental investment flows

  The Federal tax regime in the United States has, since the early 1970s, provided a more liberal tax treatment of rental investment than in Canada. For more than a decade, a tax credit has also been provided to stimulate the production of low-rent housing. There is no discriminatory national sales tax in the U.S. The result of this more favourable tax environment has been higher volumes of new rental construction with the positive ramifications this has for the rental marketplace.

- The GST discriminates against investment in new rental housing which worsens the unfavourable income tax treatment

  The entire 7% GST is applied to new private sector rental housing. Non-profit housing pays only half this rate of tax. As well, the purchasers of new homes are given a rebate for a portion of this tax. The current tax treatment of private rental housing is therefore discriminatory. This discriminatory treatment of new rental investment is aggravated by the

harmonization of Federal and Provincial sales taxes in the four provinces where this has happened.

## 5.2 POTENTIAL CHANGES TO THE CURRENT FEDERAL TAX TREATMENT OF RENTAL HOUSING

There are a number of ways that the current tax treatment of private rental housing investment could be changed to encourage greater investment flows. A number of these are discussed below.

- Allow investors to defer recaptured CCA and capital gains taxation on the sale of a rental property if funds are reinvested in other rental property

  U.S. investors are able to defer paying tax on recaptured depreciation and on capital gains from the sale of a rental property provided the proceeds are reinvested in rental property within a short while. Canadian investors were in a similar situation due to pooled CCA and the absence of a capital gains tax prior to the implementation of a tax reform in 1972.

  This provision encourages investors in rental housing to expand their portfolios over time and to specialise more in the rental housing sector. Many of the larger Canadian companies in the rental property business had roots in the period prior to 1972 when these tax provisions were in place

  Under this provision, taxes will be recovered when a building is sold and the funds are not reinvested in another building, or at the time of death of the owner when a 'deemed disposition' will occur.

- Treat private sector rental housing the same as non-profit housing under the GST and HST

  Newly-built social housing pays a rate of about 3.5 percent under the Federal GST. There is no rational basis for taxing rental housing if it is built by the private sector at the full GST rate and not rental housing built by government or non-profit groups.

  A 3.5 percent reduction in the costs of new private rental housing under the Federal GST is substantial, and will be even more dramatic under the HST (Harmonized Sales Tax) in the affected provinces (e.g., in Nova Scotia the HST is currently $15,000 on a $100,000 new building).

- Allow all investors (not just PBCs) to deduct losses due to CCA against other sources of income

  PBCs can deduct CCA losses from other income but other investors cannot. Extending this deduction for non-PBC investors would enhance the bottom line for these investors and would provide equal treatment with PBCs.

However, since few PBCs are currently investing in a big way in additional rental property, it is unlikely that this change in itself would be enough to stimulate significant additional investment in rental housing.

- Increase the maximum rate for annual CCA deductions for rental housing properties

  The current maximum CCA rate for rental housing is 4 percent calculated on a diminishing balance basis, down from a previous 10 percent for wood-frame and 5 percent for concrete buildings. Wood-frame construction is widely used in low-rise apartment buildings outside the Toronto area and in townhouse construction. The reduction of the maximum rate for wood-frame buildings from 10 percent to 4 percent, combined with the non-deductibility of CCA losses for non-PBC investors, has had a profound impact on an investor's after-tax return. A return to the pre-1978 maximum CCA rates combined with the deductibility of CCA losses could be expected to increase investor interest in rental properties quite considerably.

- Expand allowable "soft costs" which can be deducted in the first year of operation of new rental housing properties

  The deductibility of costs incurred up-front to build new or to upgrade existing rental properties still exists but the allowable costs have been sharply reduced. Allowing costs to be expensed rather than capitalised and depreciated over time has a robust effect on after-tax returns in the early years of investing. Since new rental properties typically generate negative cash flows in their early years, this added deduction can be quite appealing to investors.

There were abuses of soft costs by MURB syndicators. However, there are costs that formerly were deductible as soft costs, but are not now, that could be usefully re-categorised as soft to allow a larger deduction to investors in the early years of investing.

- Provide a tax credit, like in the United States, for investment in new rental properties or upgraded existing properties intended to accommodate low and modest income households

  With the Federal and Provincial Governments sharply reducing their funding for the construction of social housing targeted at low and modest income Canadians, there is a funding vacuum. Private investors are not likely to built much new housing for these income groups without incentives. Thus the Federal Government may wish to consider a U.S.-style tax credit program to induce investment in new housing targeted at low and modest income renters.

## 5.3 ECONOMIC IMPLICATIONS OF CHANGES IN TAX TREATMENT OF RENTAL HOUSING INVESTMENT

This section explores the economic implications of additional new rental units being built. The analytical framework is a partial analysis in the sense that it only considers economic impacts of the construction of

new rental housing without any consideration of costs that might be incurred[21]. For example, if the new rental construction is the direct result of the tax changes mentioned in the preceding section, the costs in terms of foregone or deferred Federal tax revenue should be taken into account. The analysis also assumes that the economic activity generated by the additional rental construction utilises resources that otherwise would have been idle.

The focus on gross tax revenues generated is justified since it provides a benchmark against which to judge the payback from undertaking specific tax initiatives which entail costs in terms of lost or deferred tax revenues.

The approach is to look at the economic impacts associated with a range of rental housing production scenarios (from 10,000 units per year to 40,000 units per year). The scenario with 20,000 is used as the reference scenario for the discussion below[22].

### *5.3.1 Employment Impacts from the Construction of New Rental Housing*

Figure 5-1 shows the employment created as a result of the construction of new rental housing. The estimates exclude annual employment created in the ongoing operation of the rental properties.

**Figure 5-1**
**Employment Impacts of Construction New Rental Housing Canada***

| Number of New Units Built | Employment Impact | | | |
|---|---|---|---|---|
| | Direct | Indirect | Induced | Total |
| *Units* | *Person years of Employment* | | | |
| 10,000 | 5,000 | 4,500 | 7,500 | 17,000 |
| 20,000 | 10,000 | 9,000 | 15,000 | 34,000 |
| 30,000 | 15,000 | 13,500 | 22,500 | 51,000 |
| 40,000 | 20,000 | 18,000 | 30,000 | 68,000 |
| *Employment Factor Per Unit: | 0.5 | 0.45 | 0.75 | 1.7 |

Source: Clayton Research based on employment factors derived from Statistics Canada's input-output tables

The estimates associated with the construction of 20,000 new rental units indicate that 10,000 person years of employment will be generated directly in the construction industry (direct employment). In addition, 9,000 person years of employment will be generated in the businesses which supply materials and services to the construction industry (indirect employment). Lastly, spending by workers in construction and in related industries (direct and indirect employment) is estimated to amount to 15,000 person years of employment. The grand total of employment impacts is, therefore, 34,000 person years.

[21] *While the preparation of the annual costs need to be calculated, this is beyond the scope of this study.*

[22] *The use of 20,000 is conservative. It assumes that the remainder of the new rental homes needed is provided through non-conventional or government sources and does not allow for demolitions.*

Since the recommended tax changes are to be permanent, the stimulation provided to new rental construction will be repeated in subsequent years, with the actual volume in any year dependent on overall economic and rental market conditions.

### 5.3.2 Employment Impacts from the Ongoing Operation of New Rental Housing

Jobs are also created from the ongoing operation of the new rental housing built ranging from property management and maintenance staffing to the services and supplies purchased.

The production of 20,000 rental units is expected to generate 600 jobs annually (see Figure 5-2). If this construction volume is maintained each year, then by year 15, a total of 300,000 units would be built resulting in annual person years of employment of 9,000.

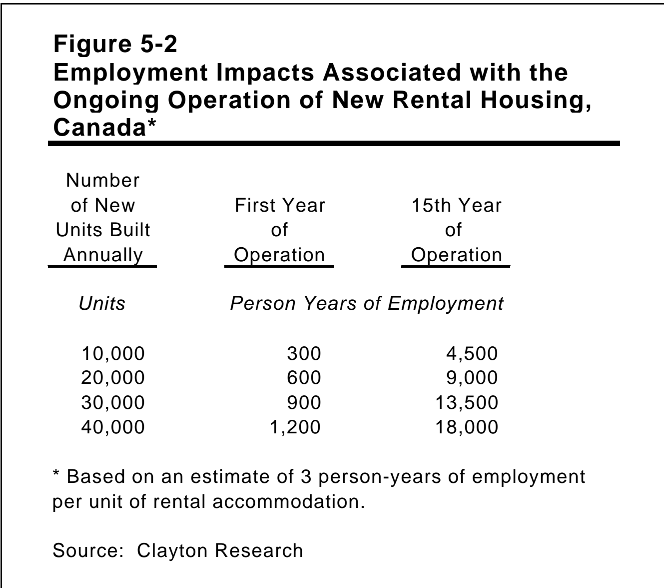


**Figure 5-2**
**Employment Impacts Associated with the Ongoing Operation of New Rental Housing, Canada***

| Number of New Units Built Annually | First Year of Operation | 15th Year of Operation |
|---|---|---|
| *Units* | *Person Years of Employment* | |
| 10,000 | 300 | 4,500 |
| 20,000 | 600 | 9,000 |
| 30,000 | 900 | 13,500 |
| 40,000 | 1,200 | 18,000 |

* Based on an estimate of 3 person-years of employment per unit of rental accommodation.

Source: Clayton Research

### 5.3.3 Taxation Revenues Generated by New Rental Housing

New rental housing produces tax revenues to all three levels of government during construction and then though their operation over time. A recent study authored by Alex MacNevin formulated a model and prepared estimates of the taxes raised by all levels of government for an illustrative new rental project in Halifax.[23] This study is used to generate some rough estimates of tax revenues generated from increases in rental housing production at the national level.

MacNevin assumes that a new rental project having a cost of $1million is developed, held for 15 years, and then sold. The streams of tax revenues for each level of government from this project are calculated and then converted to present value.

[23] *MacNevin, A.S.,* ***Effects of the Tax System on Rental Housing: the case in Halifax,*** *1996.*

MacNevin's analysis is extended to the country as a whole under the production scenarios that are being used here (see Figure 5-3). The $1 million investment outlay is converted to units using an average cost based on London, Ontario as a proxy rather than Halifax - the average price of a unit is higher in London.[24]

**Figure 5-3**
**Taxation Impacts of Building New Rental Housing and Holding for 15 Years, Canada**

| All Three Levels of Government | Income Taxes | Sales Taxes | Property Taxes | Total |
|---|---|---|---|---|
| *Units* | *Millions of Dollars* | | | |
| 10,000 | 168 | 162 | 125 | 454 |
| 20,000 | 335 | 323 | 250 | 908 |
| 30,000 | 503 | 485 | 375 | 1,363 |
| 40,000 | 670 | 647 | 500 | 1,817 |
| Federal Government Only | | | | |
| 10,000 | 107 | 87 | n.a. | 194 |
| 20,000 | 214 | 175 | n.a. | 389 |
| 30,000 | 321 | 262 | n.a. | 583 |
| 40,000 | 428 | 350 | n.a. | 778 |

Source: Clayton Research based on A.S. MacNevin, Effects of the Tax System on Rental Housing: The Case in Halifax, 1996.

For all levels of government (the tax rates for provincial and municipal taxes reflect rates in Nova Scotia and Halifax), the estimates indicate that the present value of tax revenues produced over 15 years from the construction, operation, and sale of 20,000 rental units are in the vicinity of $900 million.

The federal share of these total revenues in present value terms are estimated at about $389 million or about $19,450 per unit for the 20,000 rental units built. About 55% of the Federal revenues are income tax and 45% are sales tax.

These revenues relate to the construction, operation and eventual sale of 20,000 rental units built in a single year. Given that the tax changes are intended to be permanent, the Federal Government tax revenue stream will increase by a similar amount each year, i.e., $778 million for the first two year's construction (40,000 units), $1167 million for the first three year's construction (60,000 units), etc.

### *5.3.4 Comparing the Economic Benefits from New Conventional Construction versus More Basement Suites*

If more new conventional rental units are not forthcoming to meet the future requirements, it can be expected that a larger portion of the requirements will be accommodated through the creation of additional units in the existing housing stock (basement apartments or secondary suites). While there are no hard data available, it is reasonable to assume that there will be little added tax revenues to government flowing from

[24] *Lampert, G.,* ***The Challenge of Encouraging Investment in New Rental Housing in Ontario,*** *1995, Exhibit 2-1.*

the creation of such units. Their owners have a significant incentive to not report rental income from these suites since their existence is not public information, and many such suites are illegal.

Not only does the Federal Government, as well as the other levels of government, not gain much income tax revenue from these additional suites, their owners probably do not declare capital gains at the time of sale on the portion of the sales price attributed to the rental suite in the home.

## 5.4 CHAPTER SUMMARY

There is a very strong case for the Federal Government to implement changes in the tax structure to encourage the influx of significant amounts of private investment funds into rental housing. The stimulation of rental housing production will have a substantial positive economic effect including additional employment and tax revenues to all three levels of government.

# APPENDIX A

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