Options for Changes in Federal Taxes to Encourage New Rental Construction

Prepared For:

Research Subcommittee
Housing Supply Working Group
Ontario Ministry of Municipal Affairs and Housing

By:

Greg Lampert
and
Steve Pomeroy

March 2002

Executive Summary

This report has been prepared on behalf of the Research Subcommittee of the Housing Supply Working Group (HSWG) – a joint government-industry advisory group established to identify rental housing supply problems and solutions. The HSWG is co-chaired by the Ontario Ministry of Municipal Affairs and Housing and industry representatives.

In May 2001, the HSWG released an interim report, *Affordable Rental Housing Supply: The Dynamics of the Market and Recommendations for Encouraging New Supply*, which called for action to encourage much-needed new rental investment. Among other things, the report recommended examination of several potential changes in the federal tax treatment of rental housing which could assist in stimulating new rental investment.

This report is one of three companion reports intended to address issues raised in the HSWG's second report: *Creating a Positive Climate for Rental Housing Development Through Tax and Mortgage Insurance Reforms.* The three reports include:

1. **Options for Changes in Federal Taxes to Encourage New Rental Construction** –development of a framework for the identification and analysis of potential changes to the federal tax system that would strategically improve the climate for new rental investment in Ontario – this report;
2. **The Context for Private Rental Housing Production in the US** – identification of the most significant tax and housing-related program levers impacting new market rental development in the US, how they work, how they generate capital for new market rental housing, and the potential for using such mechanisms in Canada; and
3. **Promoting a Positive Mortgage Insurance Environment for New Rental Construction** – examination of Canada Mortgage and Housing Corporation's underwriting practices and mortgage insurance fees for rental housing, and identification of options for the Province to promote improved access to mortgage insurance for new rental housing projects.

Facilitating an adequate supply of new rental housing is important to both a healthy housing system and a healthy economy. At present, there is clearly insufficient investment in new rental production in many centres in Ontario – a situation which must be remedied. Changes in the tax treatment of rental investment over the past three decades certainly bear at least part of the responsibility for the lack of new rental investment in Ontario today. Estimates presented in this report indicate that changes in the federal tax regime for rental housing since 1980 have substantially reduced the attractiveness of investing in new rental housing.

This report responds to the recommendation in the HSWG report regarding the federal tax treatment of rental housing by examining the following potential changes:

- Revising the rate and method used to calculate capital cost allowance (CCA) on rental housing
- Allowing all investors in rental housing to utilize CCA losses in determining income for tax purposes – not just principal business corporations (PBCs)
- Allowing investors to deduct soft costs rather than capitalize them
- Allowing rental investors to defer capital gains tax and recaptured depreciation upon the sale of a rental project if the proceeds are reinvested in rental housing
- Allowing small landlords to qualify as small businesses for the purposes of obtaining the small business corporate tax rate
- Eliminating the capital tax on rental housing
- Full rebates of GST on new rental development, or zero-rating of rental housing.

For each potential tax change, the paper provides background and a description of the potential measure, an illustration of how the measure would impact on the economics of investment in new rental housing, and an assessment of the basis for introducing the change.

Any change in tax provisions will have a different impact depending on the characteristics of the investor. The report reviews the full range of potential rental investors and the extent to which each potential tax change would, or would not, affect a particular type of investor. For example, none of the potential income tax changes will have any direct impact on non-profit corporations, pension funds or Real Estate Investment Trusts (REITs); however, these potential investors would benefit from reductions in the GST on rental housing.

Principal business corporations (PBCs) are the types of investors most likely to consider developing new rental housing projects. Pension funds and REITs (the other major private investors in rental housing) generally prefer to acquire *existing* rental properties, which tend to be less risky since they have a stabilized income stream and known operating history. Individuals investing in rental housing are not considered to have the expertise necessary to plan and develop large rental projects – they typically purchase houses or condominiums or small existing apartment buildings.

While the analysis here, and in the companion report on the US, provides comparisons between Canada and the US tax treatment of rental housing, it should be noted that favourable tax treatment is an important factor stimulating rental investment in other countries, particularly Germany, New Zealand and Australia.

Assessment Framework

The report examines each of the potential tax changes in terms of:

- Effectiveness – would the measure improve the attractiveness of rental investment and result in increased new rental housing production?
- Fairness – is the measure justifiable in terms of equity with other similar types of investments?

- Practicality – would the measure be simple to implement, with the potential to target most of the benefits exclusively to investors in new rental housing projects?

Exhibit E-1 presents an overview of the assessment of each of the seven potential tax changes – based on the above three criteria. This exhibit also presents the potential tax changes in order of priority – based on an overall assessment of each according to the three criteria. It would be possible for the federal government to undertake each of the changes on a stand-alone basis and, for the purpose of assessment, is much simpler to present this way. However, this is not intended to imply that only one of the identified changes could, or should, be selected for implementation – clearly, a combination of tax changes would have a more significant impact on the economics of new rental development.

Exhibit E-1:

Assessment of Potential Tax Changes

	Effectiveness				Fairness	Practicality	
	Per Unit Change in After-Tax Cash Flow ($)*						
	Year 1	PV (25 yrs)	Change in Per Unit Initial Equity ($)	Effect in Generating New Rental Investment		Simple to Implement	Easily Restrict to New Rental Housing
Full rebate of GST on rental housing	182	2,597	2,553	Both lowers equity required and improves cash flow	Rental housing investors treated very differently from both other types of rental property, and other basic necessities (e.g. groceries)	Yes	Yes
Deferral of capital gains tax and recaptured CCA upon re-investment in rental housing	n/a	n/a	-	Difficult to quantify but provides important new source of investment capital	Rental property currently treated differently from other types of capital assets	Yes	Yes
Increase in CCA to 5%	213	2,079	-	Improves after-tax cash flow	Accelerated CCA allowed for some other types of investments	Yes	Yes
Restoration of soft cost deductibility ($5,000)	1,721	1,129	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Elimination of capital tax on rental housing	n/a	n/a	-	Improves after-tax cash flow	No evident unfairness	Yes	Yes
Allowing small landlords to qualify as small businesses	n/a	n/a	-	Limited number involved in new development	Investors in rental housing appear to be treated differently from other types of small businesses requiring hands-on management	Yes	No
Extension of eligibility for CCA losses	n/a	n/a	-	Yes (for non-PBCs)	Life insurance companies are allowed to use CCA losses against other income	Yes	Yes

* The change in after-tax cash flow (compared to the current tax treatment) for a Toronto rental project with development costs of $141,400 (excluding GST).

In the assessment of the effectiveness of each potential change, where possible, the exhibit presents estimates of the effect of each change (with the specific parameters assumed in this analysis) on an investor's after-tax cash flow – for a typical new rental project in Toronto. Estimates are presented for both the initial year and over time (on a

25-year present value basis). The longer-term present value assessment is considered more meaningful than the initial year snapshot, especially in the case of the potential changes where tax liability is deferred.

These estimates reflect the difference between the after-tax cash flows under current tax rules and those that would be in effect if the proposed tax changes were implemented – thus the prioritization takes into account the degree to which the potential tax changes improve the attractiveness of investment. The exhibit also assesses the impact on the initial level of equity required – of the potential tax changes only the full rebate of GST affects required equity.

For many potential tax changes, it is neither feasible nor practical to develop a detailed cost impact, as there are too many unknown variables that influence the result.

Effectiveness

Almost all of the potential tax changes are considered likely to have some effect in generating new rental production, although some have a larger and broader impact than others.

Full rebate of the GST has an immediate impact in lowering the level of investor equity required and has a follow through favourable impact (not shown in this exhibit) on the investor's return on equity. Full rebate of GST would also benefit *all* types of rental investors – not just those which pay income taxes. Restoring immediate deductibility of all (or some) soft costs would have the largest quantifiable impact on after-tax cash flow in the critical first year following project completion. In terms of after-tax cash flow over time, the full rebate of GST and raising the CCA rate to 5% have the largest impact of the three potential changes where impact quantification is feasible.

Some of the potential changes defy quantification. For example, allowing owners of existing rental properties to defer capital gains tax and CCA recapture if the proceeds are reinvested in a rental property of equal or greater value would not directly affect cash flow, but could have a very significant impact in providing the new capital investment necessary to fund new development. For this reason, this potential change is ranked as the second highest priority.

Based on the analysis here, fully rebating the GST on rental housing, deferral of capital gains tax and recaptured depreciation (upon reinvestment in rental housing), increasing the CCA rate, and restoration of soft cost deductibility would be the most effective measures in stimulating new rental investment. The other measures would have a positive impact and could be effective complementary measures, but alone are not considered likely to have as significant an impact.

Fairness

Several of the potential tax changes would rectify some degree of inequity in the current tax environment, compared with the tax treatment of other types of investments:

- **Deferral of capital gains tax and recaptured depreciation upon re-investment in rental housing** – such deferral is allowed for other types of capital investments if the investor purchases another similar investment. In this regard, rental real estate is treated differently from other types of capital investments.

- **Fully rebating rental projects for the GST** – an investment in new rental housing attracts 4.5% GST, unlike commercial rental properties which effectively do not bear the GST. In this regard, rental housing is treated differently from other types of real estate investments. An equity argument in favour of full rebates can also be made in comparison with the GST treatment of groceries – another basic necessity. Groceries are zero-rated – i.e. GST is neither collected on the sale of groceries (like the case with rental housing, where GST is not collected on rent) nor payable on the inputs required to produce groceries (unlike the case with rental housing). While a fairness argument can equally be made to zero-rate rental housing, such a change would have a very broad impact – across the total stock of rental housing, where GST is payable on operating costs. Accordingly, this analysis deals with a full rebate of GST on rental development costs – this would both limit the federal revenue losses and more effectively target the benefits towards improving the attractiveness of investment in new rental housing.

- **Allowing small landlords to qualify as small businesses** – businesses which invest in and manage real estate are effectively barred from qualifying for the small business deduction. In this regard, they are treated differently from other types of businesses which require hands-on management. Instead of recognizing that they must actively manage their rental properties, small real estate businesses are treated the same as businesses which invest in stocks, bonds and other types of passive investments.

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

Practicality

In the case of the CCA revisions, the report examines a number of broader options, in addition to increasing the rate to 5%. These other options include relaxing the half-year rule, and changing the method from a declining balance to straight-line depreciation (as used in the US). Since these represent fundamental change across the entire Canadian income tax system, they are not considered practical – only the increase in the CCA, which could be implemented without fundamental change to the tax system, is included in this assessment.

Similarly, zero-rating rental housing might be justified on the basis of fairness; however, this may not be practical due to the broad scale impact of such a change on federal revenues. Therefore, full rebate of the GST on the development cost of new rental housing is the potential measure considered here. It would provide most of the benefits of zero-rating (in terms of enhancing the attractiveness of investment in new rental housing), without the significant cost implications (or administrative changes) associated with zero-rating.

Other than these issues, none of the potential tax changes would appear particularly difficult to implement. They would require modest changes in tax policy and procedures, but such measures are routinely undertaken by the federal government.

Also, most of the measures could relatively easily be restricted to new rental housing so, if desired, the measures could be targeted exclusively to benefit new rental production. This would help to ensure that the impacts are well targeted and would limit the associated impact on federal tax revenues.

Current Rental Production

The primary objective of the potential tax changes would be to restore the attractiveness of rental investment and to stimulate new rental development. However, the changes cannot be exclusively focused on the resulting new increment of rental production – each measure, if implemented, would apply also to any other new rental development. Therefore, in assessing the impact of the potential tax measures on federal revenues (below), it is necessary to determine the total volume of new rental development likely to be built without these tax revisions, as well as the possible volume of incremental new rental units that might be stimulated by the potential tax changes.

CMHC is forecasting new purpose-built rental starts totalling roughly 13,500 in 2002. This includes projects developed by private for-profit (primarily PBCs, 10,000 units) and by not-for-profit corporations (3,500 units) which are subject to different tax treatment. In addition, a number of rental units are created within the condominium sector but purchased by individual investors seeking to rent them out. These individual investors may qualify for some of the tax changes discussed above. It is estimated that 25% of condominium units across Canada could be built in response to demand by these small investors, producing an estimated 8,000 additional new rental units in 2002 – so total new rental production in 2002 is forecast at 21,500 units.

Since the magnitude of the stimulative impact which would result from adoption of the potential tax changes is unknown, three illustrative potential levels of additional incremental rental starts are identified – increases of 5,000 and 10,000 units, over and above the base forecast production of 21,500 units.

Cost-Benefit of Potential Tax Measures on Federal Tax Revenues

The report identifies five main sources of federal revenues that are impacted directly by new rental construction: personal and corporate income taxes, GST, Canada Pension Plan (CPP) contributions and Employment Insurance (EI) contributions. Although CPP contributions flow into a separate account (the CPP reserve fund), all five sources are included here. It is estimated that the construction of 21,500 new rental units generates roughly $510-$656 million in revenues to the federal government from these sources. In addition, rental production would have a beneficial impact on other parts of the federal treasury (e.g. profits generated from CMHC insurance, duties on imported construction materials, reduced EI claim payments from construction workers, etc.), but these are not quantified in this analysis.

Exhibit E-2 presents an overview of the estimated revenues from currently forecast rental construction, as well as the net impact on federal revenues from incremental rental production which might result from adoption of the three potential tax changes with federal revenue impacts that can be readily quantified – CCA increase to 5%, immediate deductibility of soft costs, and fully rebating the GST. In the exhibit, each measure is presented on a stand-alone basis and a low-high range estimate of federal revenue impacts is presented.

Exhibit E-2:
Net Impact of Potential Tax Changes on Federal Revenues
($Millions)

	5% CCA		$5,000 Soft Cost		Full Rebate GST	
	Low	High	Low	High	Low	High
Base Benefits from Current Forecast Production						
Total Current Revenue	510	656	510	656	510	656
Total Foregone with Tax Change	18	24	7	7	87	116
Net Revenue with Tax Change	492	632	503	649	423	540
Additional Revenue from Incremental Units Only						
5,000 Additional Units	114	146	116	150	99	126
10,000 Additional Units	227	292	230	298	197	251
Total Revenues from Rental Production (with Tax Changes)						
Current Production	492	632	503	649	423	540
- Plus 5,000 Incremental Units	606	779	619	799	522	666
- Plus 10,000 Incremental Units	719	924	733	947	619	791

Highlights of Exhibit E-2 include:

- With the anticipated annual starts of 21,500 units (including private rental, investor-owned but rented individual condominium units, and non-profit units), total federal revenues from new rental construction are estimated to range from $510-$656 million.

- The effect of implementing the three potential tax changes which have been quantified, applied against this base forecast, results in a reduction in federal revenues of:

  – $7 million for allowing immediate deductibility of $5,000 in soft costs;
  – $18-$24 million for raising CCA to 5%; and
  – $87-$116 million for a full rebate of GST on rental development costs.

- Depending on the number of incremental rental units stimulated by adoption of the potential tax changes, the revenue benefits to the federal government could be substantial. For each of the potential tax changes, the exhibit presents estimates of the incremental federal revenues which would flow from incremental rental production of 5,000 and 10,000 units.

- An increment of 5,000 rental starts would generate additional net federal revenues of $114-$150 million for the CCA or the soft cost changes – well above the modest revenue losses from current forecast production from either of these changes. The revenue gain is lower for the GST change ($99-$126 million).

- Additional incremental starts (spurred by the tax changes) of 10,000 units would double this additional federal revenue.

- Assuming that adoption of any of the potential tax changes results in additional rental starts of 5,000 units or more, the net impact on federal revenues is positive – i.e. the additional revenue from the higher level of production more than offsets the revenue foregone from the 21,500 base level of rental production as a result of the tax changes. The additional federal revenues from 5,000 incremental units would total $99-$150 million (depending on the tax change involved) – the additional federal revenues are greater than foregone revenues in all of the scenarios (assuming at least 5,000 incremental rental units).

- The total federal revenues from rental production would grow significantly if the tax changes stimulate additional rental production. From a base level of $510-$656 million from currently forecast rental production, even the (relatively expensive) GST change would result in increased federal revenues: $522-$666 million (5,000 incremental units); $619-$791 million (10,000 incremental units).

Although not shown on the exhibit, production of roughly 6,000 incremental units fully covers the revenue losses incurred by extending *all three* of these changes across the base forecast of 21,500 units. Any new development beyond this level would generate a net revenue gain for the federal treasury.

In sum, the potential tax changes examined here would result in higher rental production, while the foregone federal revenues would be at least partially offset by additional revenues from the increased volume of rental construction. At the same time, as a direct consequence, the higher volume of rental production would lead to healthier housing markets. The new rental supply would help to relieve current very tight rental markets which, in turn, would reduce upward pressure on rents and effectively moderate the degree to which rising rents (caused in part by lack of supply coupled with new demand from population and household growth) exacerbate affordability problems.

To receive a copy of the complete report, please contact:

Market Housing Branch
Ministry of Municipal Affairs and Housing
14^{th} Floor, 777 Bay Street
Toronto, ON M5G 2E5

Tel: 416 585-6001
Fax: 416 585-7607
E-mail: eric.adams@mah.gov.on.ca