Canadian Federation of Apartment Associations

Fédération Canadienne Des Associations De Propriétaires Immobiliers

Rental Housing in the 2012 Federal Budget

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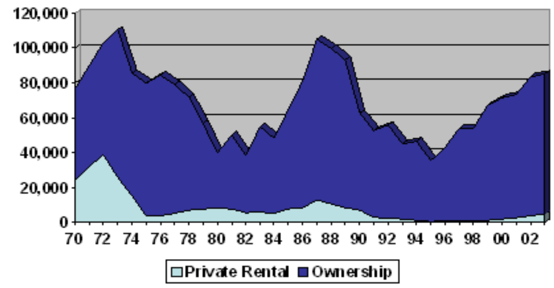
Rental Housing - Canada’s Neglected Industry
And why that neglect is bad for Canadians

Canadian public policy discriminates against the rental housing industry[1]. This is bad for Canadians for a number of reasons, namely:

Housing Starts by Intended Market
Ontario, 1970 to 2003



Source: FRPO based on CMHC and Ontario Ministry of Municipal Affairs and housing start data.

- **Declining rental housing industry:** during the 1960s and 1970s, rental housing represented 30% of all housing starts. Now that proportion is down to 6%[2].
- **Less government revenue:** Canada is losing out on tax revenue from the ongoing operation of rental projects.
- **Higher government costs:** The lack of rental housing construction in Canada creates additional pressure for government funded housing development. So instead of benefitting from additional tax revenues from private rental housing, governments are driven to pay for new housing supply.
- **More unemployment:** Excess levels of home ownership reduce labour mobility and raise the unemployment rate, as well as creating other negative effects in the labour market.
- **Ageing rental stock:** The average rental building in Canada is now over 40 years old, and getting older every year (while in contrast, owner-occupied housing is being renewed).
- **Less housing choice:** Canadians no longer enjoy the range of housing choices they should. The regulatory and tax climate in Canada also does not allow for a vigorous supply response to housing shortages.

Recommendations

The government of Canada needs to end its discrimination against the rental housing industry, to allow the industry to create new rental buildings, and more housing opportunities for Canadians, while generating more tax revenue. The following changes would be an important start toward turning around the situation:

- **1. Allow rollovers:** Allow the proceeds of a building sale to be “rolled over” into new rental properties, as is allowed in the U.S.
- **2. Increase the CCA rate:** Higher capital cost allowances, particularly in early years, as was allowed in Germany in the 1990s, when Germany had a healthy rental housing sector which was seeing new development.
- **3. Restore soft cost deductibility:** Restore more soft cost deductibility to promote new rental construction, as applied in Canada before 1983.

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[1] Government Subsidies to Homeowners versus Renters in Ontario and Canada, Frank A. Clayton, August 30, 2010, available at http://cfaa-fcapi.org/pd2/CFAA_FRPO_Govt_Sub.pdf .

[2] The chart shows figures for Ontario. The Canada wide figures are very similar.

The Canadian Federation of Apartment Associations represents the owners and managers of close to one million rental suites across Canada through 17 local and provincial apartment associations. We are the sole national voice of the for-profit rental housing industry in Canada.

Less government revenue

The need for the reforms we propose arises largely from the divergence in the current tax treatment of homeowners from the tax treatment of renters.

Item	Tax treatment for owner-occupiers	Tax treatment for renters
Capital gains	Tax free	Taxed
Operating profit	Tax free because it is not addressed[3]	Taxed
Maintenance & repairs	Usually done by owners, paying no tax	Usually done by paid people paying tax on their income
Property taxes	Lower than on rental property (in Ontario and NB)	Higher than on owner-occupied homes (in Ontario and NB)
Home renovation tax credits	$3B was allocated for tax credits for owner-occupiers	$0 credits to improve rental property

Canada's governments lose out from rental decline because the taxes on rental housing are much higher than the taxes on owner-occupied homes. In contrast, continued inflation and the exemption of owner-occupied housing from capital gains taxation has provided increased tax advantages to owner-occupiers.

Higher government costs

Due to the revisions of the Income Tax Act over the last four decades, the tax treatment of residential rental properties is much less positive than it was. This has led the rate of rental housing development to decline dramatically in Canada, relative to the population and population growth. The rate of purpose-built rental development in Canada has fallen far behind the rate in the United States.

That decline in rental housing development has led to calls for direct government investment to build rental housing in the form of social and non-profit housing. Such housing is even more likely than private ownership housing to tie residents to their current housing, and thus prevent them from following job opportunities. That has negative implications for the households served, and for economic growth generally.

In addition, governments lack the fiscal capacity which would be needed to supply housing along with governments' core functions.

More unemployment and other labour market effects

As first identified by economist Andrew J. Oswald, an increase in home ownership results in an increase in the rate of unemployment. As Oswald wrote in 1999,

> In the period from 1950 to 1960, most European nations had low owner-occupation rates and low unemployment rates. The

[3] The operating profit on rental housing is equivalent to the impute income owner-occupiers enjoy free of tax.

> United States then had relatively high owner-occupation of 60%. At that time the US had the highest unemployment rate in the industrialized world.
>
> [Since then] unemployment rates have risen most quickly in the nations with the fastest growth in home ownership.
>
> … [N]ations where many people rent have less joblessness than nations where home-ownership is the norm. … The link between housing and jobs appears to hold across space within a country as well as across different countries.[4]

Numerous other economists have confirmed the Oswald effect. The cause of the increase in unemployment appears to be primarily the immobility that home ownership creates for home owners in the labour force. Simply put, it costs much more to move when you are a home owner than when you are a renter.

Besides higher unemployment, Oswald suggests that there are other negative effects of higher rates of homeownership. Homeowners tend to commute much longer distances to work than renters. That increases traffic congestion and raises the costs of moving people and goods across cities, and in and out of cities. In addition, "in an economy in which people are immobile, workers do jobs for which they are not ideally suited. This inefficiency is harmful to everyone: it raises costs of production and lowers real incomes in a country. … Jobs get destroyed –- or more precisely priced out of existence — by such inefficiencies."[5]

Housing choice

The current tax position means that Canada's housing markets are not providing the housing opportunities in the rental sector needed by households with low and moderate incomes, and by people who move between cities.

Rental ownership is ideal for someone moving to a city with which they are unfamiliar. The new resident can move somewhere convenient to their employment. Then as the first year unfolds, they can learn where to access the schools, churches, and city amenities which suit them; how the city's traffic works; and decide where they want to live for the long term. After a one year lease they can move to an new area and try it out. Before committing to homeownership with its substantial in and out costs, the new resident can decide if they want to stay in the new city and in what area.

Rental housing allows people more mobility and choice than they have with home ownership.

- Compared to selling or buying a home, moving from or to a rental home is easy and economical.
- Renters can readily move to change jobs, for advancement or to adjust for a changing economy.
- Young people can easily establish new households at less cost than buying a house.

Rental housing costs less than owner occupied homes because:

- Rental housing takes advantage of economies of scale and the expertise that professional managers bring to building maintenance.
- Rental housing often uses less land to house a given number of people, which means less land cost and more economical land servicing.

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[4] Andrew J. Oswald, "The Housing Market and Europe's Unemployment: A Non-Technical Paper, available at http://www2.warwick.ac.uk/fac/soc/economics/staff/academic/oswald/homesnt.pdf, p. 3 (August 11, 2011).

[5] ibid, p. 4.

- Rental housing avoids real estate fees and other transaction costs.
- Rental housing avoids the risk of carrying two mortgages, which will happen if the sale of a house falls through when another has been bought.
- Occupancy costs are even and predictable since major repair costs (e.g. a new roof) are borne by the landlord, and recovered through the rent over time.
- Rental housing is available to people with no down payment, and often to people with weak credit histories.

As well, low-income Canadians are often not well served by home ownership. Home ownership comes with up-front costs which they can ill afford. Home ownership tends to penalize people who move more often then once every five years, whereas low-income people need to be able to follow job opportunities. That mobility is reduced by the obligations and risks of home ownership.

RECOMMENDATIONS

A solution to all of these various problems is to re-engage the private sector in building and operating additional purpose-built rental housing. Private sector re-engagement will require a reduction in the effective tax rates on rental housing. However, in the medium and long term, such reductions should not require government revenue reductions, since rental housing pays income tax and capital gains tax, whereas owner-occupied housing does not. Such reforms will also reduce the need for direct government expenditures, currently aimed at addressing the short-falls in private sector development.

1. Allow Rollovers

Owners of business property benefit from a rollover, which means that if, for example, a print shop sells its building and buys a larger building, the tax system recognizes that the owner has reinvested the proceeds of sale in a replacement asset, and the owner does not have any money to pay tax on the gain on the first property. The tax on the gain will be paid, but only when the gain is realized when the proceeds are not reinvested in a similar asset (at which time the business person has the funds to pay the tax). Currently the rollover provisions are not applicable to rental property. They should be.

Allowing a rollover (i.e. a tax deferral) on rental property sale and reinvestment would:

1. Reduce the cost of rental housing, and improve affordability and housing supply
2. Promote efficient capital allocation across the economy
3. Promote more compact, environmentally sound urban redevelopment
4. Help small investors, middle-income families and seniors
5. Facilitate relocation by owner-managers and reduce absentee ownership
6. Remove the discrimination between tenants and property owned by businesses.[6]

The rollover cost is reasonable

The government revenues that would be deferred by the rollover proposal in the first year after implementation are approximately $450 million. In the years that follow the first year, the direct deferral amount should decrease given that taxes payable (deferred from the first and subsequent years) would appear as added taxes payable thereafter. Besides that, the increase in transactions would generate increases in economic activity and thus higher

[6] For more details, see "Tax Deferral on reinvestment – Facts and Recommendations", CFAA, September 2008 available at http://www.cfaa-fcapi.org/pdf/CFAA_Tax_deferral_facts_0809.pdf.

taxes on that activity. Over time, the deferral "cost" would decrease toward zero, while the economic benefits would quickly make the overall impact on government revenue positive.

2. Increase the Capital Cost Allowance (CCA)

As is well known, buildings tend to wear out over time. Consequently, besides the out-of-pocket expenses of operating a building, the deterioration of the building is also an expense. Accountants call that expense depreciation. For tax purposes, the expense is recognized by allowing owners to deduct a capital cost allowance (CCA) from their net income.

When the CCA rate is low that raises a landlord's net income, which increases his or her taxes, and makes the business less attractive. On the other hand, when the CCA rate is high that reduces a landlord's net income, which decreases his or her taxes, and makes the business more attractive.

Until the late 1970's, the CCA rate on wood-frame construction in Canada was 10%, as compared with 5% for concrete construction. Then the wood frame rate was reduced to 5%. In 1988 the CCA rate was reduced from 5% to 4% for all buildings acquired after 1988. Both reductions made investment in rental housing less attractive.

Here is a comparison between the CCA allowed under the current Canadian system and the system used in Germany in the 1990s, when Germany had a healthy rental housing sector which was seeing new development.

Proportion of building costs written off (if maximum claimed)			
Years from construction or purchase	Current Canadian CCA system	1990s German system	CFAA proposal (6% CCA rate)
5	17%	33%	24%
10	32%	58%	44%
15	45%	64%	59%
20	55%	70%	70%
25	63%	77%	78%
30	70%	85%	84%

CFAA's recommendation is for the general CCA rate on residential rental properties to be raised to 6%, or failing that, for the rate for concrete construction to be raised to 5% and the rate for wood-frame construction to be raised to 6%[7].

3. Restore the deductibility of soft costs to directly incentivize rental construction

In the late 1970s and early 1980s the deductibility of soft costs was dramatically reduced in Canada. That had a chilling effect on rental construction. Soft cost deductibility should be restored, both for those whose business is rental real estate, and for people for whom it is not their primary business (who are often an efficient source of financing for rental housing.)

[7] In 2005 Fisher, Smith, Stern and Webb found that, with a 2% inflation rate, the depreciation rate on residential rental property required to equal the average actual depreciation is 5.25%: "Analysis of Economic Depreciation for Multi-Family Property", JRER Vol. 27, No. 4. At less than 5.25% the CCA rate does not reflect the landlord's costs. A higher rate would be needed to provide actual stimulus for rental housing construction.