

Increasing Rental Inventory through Fair Tax Treatment

A healthy rental market is important to business operations as the rental inventory provides housing for employees at all levels of the employment spectrum, and most importantly, for entry level employees. Employers are increasingly finding the issue of rental availability to be a hurdle to the task of recruitment and retention. In some areas, the extremely low vacancy rates may affect the ability of business to grow. For example Saskatchewan and British Columbia, currently two western provinces with strong economic performance, have average vacancy rates of 1.2 percent and 1.0 percent respectively, with rates lower than that in most of their major cities.

Tax changes introduced over the last 25 years have disadvantaged the treatment of investment in real property, and rental housing in particular. The tax changes have created inequitable taxation on these investments when compared to other forms of investment. The result has been decreased activity in the rental housing market, such as less property turnover and revitalization, and less purpose-built rental property construction. This has been reflected in an erosion of the availability of rental units, which according to the Canada Mortgage and Housing Corporation, fell from an average Canadian vacancy rate of 4.5 per cent in 1994 to 2.2 per cent by the fall of 2008. (CMHC classifies rental buildings as those with three or more units for rent. It does not apply to duplexes, secondary suites in residential premises, or to strata units for rent.)

In the 1990s, investments in real property were eliminated from the lifetime capital gains exemption. The rationale for the tax move was to direct investment dollars to more “productive” investments. The capital gains tax formula on the sale of rental property is applied immediately upon the disposition of the asset, whereas capital gains on other assets, such as “former property” or “former business property” are eligible for tax deferral when a replacement property is purchased within a specific time frame. Rental property, curiously, is specifically excluded from the definition of “business property”.

In addition to the capital gains tax, property owners must also pay tax at their full tax rate on the recaptured amount of capital cost allowance depreciated over the period of their ownership tenure. Together, these two tax measures result in a significant lock-in effect where owners of real property hold on to the assets rather than re-invest in more productive properties. The tax measures also act as a disincentive to maintain or revitalize the overall quality of both commercial and residential assets as doing so would result in higher capital gains tax payment upon eventual disposition.

The Canadian Real Estate Association, through the services of Dr. Thomas Wilson, a leading authority on taxation and the University of Toronto’s Institute for Policy Analysis, has determined the cost to government to introduce a deferral on capital gains for real property. The approximate cost in the first year is estimated to be \$415 million to the federal government and \$208 million in total to provincial and territorial governments. They assert that the cost would actually decrease in subsequent years as the deferrals of gains would come into play and that increased business activity from newly freed capital would more than compensate through increased tax revenue.

All taxes induce people to behave in certain ways. It is clear that the changes in tax policy of the last 25 years applying to investment in real property, and specifically rental property, have resulted in a lock-in effect, less activity in the rental housing industry,

and an overall decrease in rental accommodation availability. Yet as noted at the outset, a healthy rental market is important to business operations since rental inventory provides housing for all levels of the employment spectrum.

Recommendation

That the federal government enact deferral of capital gains tax on the sale of real property, including rental property, when the proceeds of sales are reinvested within a twelve-month period into other real property investments, and defer the recapturing of the value of depreciated capital cost allowances on real rental property.