

## PROPOSED FEDERAL TAX CHANGES

In June 2005, Council adopted the Homeless Action Plan. To encourage the private sector to build more rental housing, recommendation #26 of the Homeless Action Plan recommends federal tax changes. The recommendations are consistent with the Federation of Canadian Municipalities' (FCM) "Moving Forward: Refining the FCM Recommendations for a National Affordable Housing Strategy" (October 2004).

What follows is a summary of proposed changes that can be used as a quick reference followed by a longer discussion that provides additional background information on each of the recommended Federal tax changes.

### **1. Allow rental investors to qualify for small business deductions**

Most types of small businesses pay lower taxes on the first \$200,000 of their income. However, this is not available to rental properties unless they have more than 6 full-time employees. Canadian rental properties are typically owned by investors with only a small portfolio of one or two properties and do not have sufficient employees to be eligible.

### **2. Allow capital gains tax to be deferred by restoring Capital Cost Allowance roll over**

Prior to 1972 when investors sold a rental property, they could defer paying taxes on the depreciated building value if they rolled over that value into a newly acquired rental building. This encouraged owners of older buildings to upgrade their rental property portfolio by replacing older buildings with newer ones. This provision, or rollover, of capital cost allowances (reflects the depreciated value) should be restored.

### **3. Reduce GST payments on rental housing**

Residential rental properties are treated differently from commercial rental projects regarding GST and this is inequitable. Landlords of commercial rental projects pay GST on the Goods and Services to operate their buildings, but are able to fully offset those payments with the GST on rent payments of their tenants. This offset is not available to landlords of residential rental projects because their tenants do not pay GST on rents.

The FCM recommends two possible approaches:

- Allowing the landlord to claim GST credits by re-classifying rental housing (rental housing would become a "zero rated good"); or
- Provide rebates to fully offset GST expenses.

### **4. Enable creation of an Equity Investment Fund for Rental Housing**

Tax credits are used in other countries to attract investment in housing and should be permitted in Canada. This could be done quickly by using an existing Canadian vehicle (a labour-sponsored investment fund, or ISIF) if affordable housing mortgages were added as a qualifying investment.

## MORE DETAILED DESCRIPTION OF EACH OF THE RECOMMENDED CHANGES

### 1. Allow rental investors to qualify for small business deductions

Most types of small businesses pay lower taxes on the first \$200,000 of their 'active business income' ("the small business deduction"). The small business deduction does not apply to rental apartment properties because ownership and operation of rental property is not considered an 'active business' unless it has more than 6 full-time employees. Income generated from rental properties is considered passive income and therefore owners of these properties are not eligible for the small business tax rate, even if the owner actively manages the property. Canadian rental properties are typically owned by investors with only a small portfolio of one or two properties and rarely do they have the required minimum six full-time employees and as a result, they are not eligible for the small business corporate tax available to most small businesses. By allowing rental investors to qualify for the small business deduction (under the provision that they are in fact active investors), it would encourage more investment in rental housing.

### 2. Restore Capital Cost Allowance (CCA) rollover to encourage capital reinvestment in new properties

When a rental property is sold, the investor must pay tax on the difference between the sales price and the depreciated value of the property (the original cost of the building, less the Capital Cost Allowance deductions). 'Recaptured depreciation' (the difference between the depreciated value and the original cost) is taxed at full Income Tax rates. Capital Gains taxes apply to the increase in value above the original cost.

Before 1972, there were two main incentives to encourage investment in rental housing. Wood frame rental buildings were allowed a 10% per year depreciation rate and any "paper losses" created could be written off against other, non-rental income thus resulting in a generous tax shelter. In addition, rental investors could "roll over" an investment in a rental property. In other words, if an investor sold his or her rental property but purchased another rental project in the same year s/he could avoid paying recaptured depreciation by transferring the excess CCA to reduce the depreciable value of the newly acquired project. Said another way, they were able to defer paying income taxes on recaptured depreciation on buildings sold by rolling over the recaptured amount with the CCA from other buildings.

Since 1972, investors have not had that benefit and have therefore been reluctant to sell and re-invest as a result of the huge tax penalty payable on sale. At that time, the Federal government also imposed a 50% tax on Capital Gains (raised to 75% in 1988), as well as a decrease in depreciation rates to 5%, and later to 4%. These tax reforms served to discourage investment in rental properties.

Allowing pooling (or "rollover" as it is sometimes called) would not eliminate tax liability; it would simply postpone the tax penalty on recaptured depreciation and capital gains for owners of rental buildings who invest the proceeds into another rental property.

The FCM also notes that this would create investment in new rental properties since it would encourage owners of older, fully depreciated, projects to upgrade their

rental portfolios by replacing their older projects with newer ones (as long as the investor retained the new rental properties). The impact of this recommendation on the Federal treasury is minimal - it would simply defer taxes in favour of reinvestment in rental housing which in turn would generate additional tax revenues.

### **3. Provide rebates to offset the Goods and Services Tax on rental housing -**

Commercial rental projects do not bear the cost of GST - as with most businesses, landlords of commercial properties receive full input credits for all GST paid. These 'input' credits are then deducted from GST collected from their commercial tenants. Because residential landlords do not collect GST on rents, they are stranded with the GST they pay without the offsetting input tax credits that are available to non-residential rental operators. The 2000 Federal budget included some GST relief for rental (reducing it to 5.4%). However this does not fully overcome the inequitable treatment of the residential rental development sector. The FCM recommends that rental housing either be re-classified as a "zero rated good" (i.e., no taxes are collected on the final sales of these goods, but sellers can claim input tax credits on their purchases), or that rebates be provided to fully offset the GST expense incurred by the rental landlords.

FCM acknowledges that this recommendation may impose significant tax expenditures on the federal treasury and suggest that in order to address this, the Federal government consider applying the zero rating status only to new properties developed following the proposed change.

### **4. Create investment pools for affordable housing**

In the US, the Low Income Housing Tax Credit has been the main tax provision supporting the development of affordable housing. The credit attracts equity investment and has resulted in the creation of almost 100,000 units annually. A Labour Sponsored Investment Fund (LSIF) is an existing Canadian fund that could be amended to include affordable housing. Under existing legislation, LSIF offers small individual investors a combined Federal/Provincial one-time tax credit of 30% of an investment, up to \$5,000 each year. While the tax benefit on the initial investment is what is most attractive to investors, they also benefit from any return generated by the venture fund.

An LSIF structured to support affordable housing would be marketed as a more conservative investment and would generate equivalent tax savings but provide a more conservative ongoing yield than venture funds. The LISF could be used to provide construction financing, and long term mortgage financing on affordable housing projects, and assistance in the acquisition of existing properties in partnership with non-profit sponsors. To initiate a LSIF specifically for affordable housing would require a regulatory amendment to add affordable housing mortgages as a qualifying investment.

In addition to these recommendations, the FCM also supports amending the Income Tax Act to provide equal treatment of donations of land for the purpose of affordable rental housing and homeless shelters as that provided in the case where land is

donated for an environmental trust. The Capital Gains tax rate for land donated to an environmental trust is 50% of that allowed for a donation for affordable housing.

In conclusion, it should be noted that similar proposals have been brought forward by the development industry by the Canadian Home Builders Association and the Ontario Housing Supply Working Group (2003), as well as the Toronto Board of Trade (2003).<sup>1</sup>

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<sup>1</sup> The Toronto Board of Trade's "Affordable, Available, Achievable: Practical Solutions to Affordable Housing Challenges" (2003) also recommends increasing the CCA rate to five percent for new rental housing; and, expanding the "soft costs" which can be deducted in the first year of operation of new rental properties.