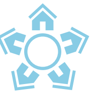
Encouraging Construction and Retention of Purpose-Built Rental Housing in Canada

Analysis of Federal Tax Policy Options



Acknowledgements

Focus Consulting
Focus on what you Can do
Not what you cannot

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Prepared for:
Canadian Home Builders' Association
And
The Greater Toronto Area Housing Action Lab

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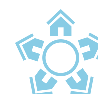


Table Of Contents

Preface 4

Introduction 5

The GST/HST Treatment of Purpose-Built Rental Housing 6

Rationale for Zero-Rating of Purpose-Built Rental Housing 6
Alternative to Zero-Rating 7
Impact of Zero-Rating of Purpose-Built Rental Housing on the Economics of Rental Investment 8
Findings about Zero-Rating New Rental Housing 11

Deferring Capital Gains Tax and Recaptured CCA on the Sale of Rental Housing if Reinvesting in Rental Housing 12

Rationale for Deferring Capital Gains Tax and Recaptured CCA 12
Illustration of the Corporate Taxes Payable on the Sale of a Rental Housing Project 13
Illustration of the Positive Effect on the Economics of Rental Investment of Deferring Capital Gains Tax and Recaptured CCA 15
Deferring Capital Gains Tax and Recaptured CCA Would Encourage New Purpose-Built Rental Housing Development 17
Findings about Deferring Capital Gains Tax and Recaptured CCA 19

Introducing a Rental Retention Vendor Tax Credit 20

Findings about a Rental Retention Tax Credit 23

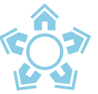
Self-Supply Rules for New Rental Developments 24

Lending Value or Cost Approach – Best Ways to Determine Value for GST/HST on New Rental Developments 27

GST/HST Treatment of Secondary Housing Units 28

Findings about "Self-Supply" Rules for Laneway Houses 30

Conclusion 32



Preface

This report was prepared in 2015 by two of Canada's most experienced and productive housing policy analysts for CHBA and the Greater Toronto Housing Action Lab.

Their previous work has ranged across the full spectrum of topics in this field, whether rental production, home ownership assistance, social housing renewal, or housing market dynamics.

In this report, they have examined in considerable depth -- and in consultation with several rental housing entrepreneurs -- a limited number of potential federal tax policy changes to stimulate investment in new developments of this type. They have focused on changes with greatest potential appeal to investors, but at lowest cost in foregone federal tax revenues.

Most tax policy changes they have considered arguably establish a "level playing field" with other types of investments. The authors do not envisage a return to the federal taxation regime of the 1970s by any means.

CHBA and the GTA Housing Action Lab had a simple motive in commissioning this report. It was to contribute to and expand the public policy discussion of one of Canada's most pressing issues. That is: how best to increase access to market–rate rental housing by households with adequate incomes and relatively bright long-term employment prospects. This report was intended to support the formulation of CHBA and GTA Housing Action Lab positions in the future.

This report's findings and conclusions have, at least for the present, been overtaken by events. The authors of the March 21, 2016 federal Budget chose to take a different route. They rejected changes to Canada's tax laws in favour of an administered program of rental construction financing managed by Canada Mortgage and Housing Corporation.

It is quite likely that once this alternative strategy has been pursued further, there will remain a need to consider the limitations and anomalies of federal tax treatment highlighted here. If so, this report will be a useful reference document for policy-making.

We welcome comments on its contents.

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August, 2016

Introduction

This report examines four potential changes in the federal tax treatment of purpose-built rental housing:

- Zero-rating purpose-built rental housing for the purposes of the Goods and Services Tax (GST) or Harmonized Sales Tax (HST) or, alternatively, rebating the GST/HST collected on the development cost of purpose-built rental housing;
- Deferring capital gains tax and recaptured depreciation due upon the sale of an existing purpose-built rental housing project, providing that the proceeds are reinvested in the development of new purpose-built rental housing;
- Introducing a vendor tax credit structured to provide benefits to those private sector owners having assets with moderate rents who sell to non-profit housing corporations; and
- Rationalizing the 'self-supply' rules regarding the application of GST/HST to new purpose-built rental housing developments and new detached secondary suites.

The first two items (zero-rating and deferral) would lead to a significant change in how purpose-built rental housing is treated by the federal tax system. These are discussed in detail below – first, in terms of the rationale for the change and, second, how each of the changes would affect the economics of investment in purpose-built rental housing.

The third item would complement proposed changes to provisions for sale of existing rental properties by offering another choice to current owners: sale to non-profit corporations with a proven track record in managing affordable rental housing.

The fourth item relates to the need for a reinterpretation of how new purpose-built rental housing is treated for the purposes of the GST/HST. The 'self-supply' rules which currently apply are confusing and awkward for the Canadian Revenue Agency (CRA) to implement. Of course, such a reinterpretation of the 'self-supply' rules would be unnecessary if the first potential change cited above (zero-rating of new purpose-built rental housing for the purposes of the GST/HST) is implemented since GST/HST would not be collected on such projects.

The GST/HST Treatment of Purpose-Built Rental Housing

Rationale for Zero-Rating of Purpose-Built Rental Housing

The GST/HST is intended to be a tax on final consumption – to be borne by consumers, not by business. The intent is to make the economy more competitive by lowering the costs of operating businesses. Most businesses charge GST/HST on their products and services and remit these funds to the government, after deducting the GST/HST they pay on their inputs – i.e. they do not bear any of the GST/HST they pay on their inputs of goods and services.

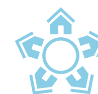
In the case of commercial rental developments such as office buildings and shopping centres, the developers must pay GST/HST on the development and operating costs of the buildings but they deduct these 'input tax credits' from the GST/HST they collect on the rents paid by tenants prior to remitting the net GST/HST to the government.

The commercial tenants, of course, also deduct the GST/HST paid to their landlords from GST/HST they collect on their sales – the principle is that businesses collect the GST/HST, but do not bear any of these taxes – they are passed on to the ultimate consumer.

Residential rental development is treated very differently.
GST/HST is not charged on residential rents – a policy decision at the time the GST was introduced, based mainly on the fact that low-income households comprise a large proportion of tenants, and charging GST on their rents would have substantially increased their shelter costs. In a similar vein, a policy decision was also made not to charge GST on groceries, because they are a basic necessity.

Like all businesses, residential rental landlords must pay GST/HST on the goods and services they purchase in developing and operating their properties. However, since there is no GST/HST collected on residential rents, residential rental landlords are 'stranded' with their input credits since they have no stream of GST/HST receipts from which these credits can be deducted.

Rental housing is one of the few types of businesses in Canada that are 'GST/HST exempt' – other types of businesses treated similarly are health and dental services, financial services, day-care services and educational services. These all pay GST/HST on their inputs, but do not collect GST/HST on their services – so they also are 'stranded' with their GST/HST input tax credits, since they have no GST/HST stream from which these can be deducted. However, unlike rental housing, these are not typically capital-intensive businesses so their losses from being stranded with the GST/HST they pay on inputs are relatively small compared to rental housing developments.



The effect of the current GST/HST treatment of rental housing is higher development and operating costs than would be the case if they were treated like most other businesses in Canada:

- **Development costs** – purpose-built residential rental housing in Ontario typically qualifies for the GST/HST New Residential Property Rebate. This rebate reduces the effective rate of HST on new residential developments in Ontario from the 13% general rate of HST to 5.2%.[1]
- **Operating costs** – the full 13% HST applies to all of the purchased inputs involved in the operation and management of a residential rental property in Ontario – i.e. other than property taxes and the wages and salaries of employees, HST would apply to virtually all other inputs required in the operation of the building.

Of course, these higher (tax-included) costs result in an increase in the amount of rent revenue required to make a new residential rental development an attractive investment – for the rental market as a whole, the result is higher rents and reduced supply. Ironically, therefore, low-income renters, the targeted beneficiaries of the decision to exempt rents from the GST when it was introduced, ultimately pay higher rents and suffer from reduced choice due to the GST/HST built into the cost structure of new rental housing.

Zero-rating of rental housing is one option to redress this situation. Groceries are an example of zero-rated businesses – no GST/HST is collected on the final sale, but sellers can claim input tax credits on their purchases. Thus, all GST/HST paid at the intermediate stages is stripped away and no tax is buried in the grocers' costs (unlike the case with GST/HST-exempt businesses such as rental housing, health and dental services, etc.). So, while GST/HST does not apply to either groceries or residential rents, unlike residential rental landlords, the providers of groceries (e.g. farmers) do not bear the GST/HST – they receive refundable input tax credits for any GST/HST paid on inputs.

Alternative to Zero-Rating

Very rough estimates indicate that zero-rating of residential rental developments would result in federal revenue losses in the order of $400-$500 million annually. Roughly one-quarter of this revenue loss would be from the non-taxation of the development costs of new rental housing, the remaining roughly three-quarters would be from the non-taxation of the operating costs of the vast stock of existing rental housing.

Zero-rating would, therefore, entail a substantial revenue reduction for the government. And, since most of the benefit would initially accrue to existing landlords (through elimination of GST/HST on operating costs), only a relatively small share of the cost to government would be effectively targeted at encouraging new rental housing development in the short-term.[2]

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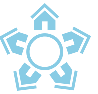
[1] Other than Ontario, none of the harmonized provinces have rebates for the provincial share of HST on new residential rental developments. The federal rebate is 36% of the 5% federal share of the HST (36% of 5% = 1.8%) for projects with unit values of $350,000 or less; the rebate phases out for projects with unit values up to $450,000; there is no GST rebate for projects with unit values of $450,000+. The Ontario rebate is 75% of the 8% Ontario share of the HST (75% of 8% = 6%) to a maximum of $24,000 per unit (the rebate which applies to a $400,000 unit). Therefore, the total federal plus Ontario rebate is 7.8% – so the HST payable on new residential rental developments in Ontario is 5.2% (13% - 7.8% = 5.2%). In the other harmonized provinces, only the federal rebate applies to the total HST payable on new rental housing developments.

[2] In the long-term, according to economic theory, as the impacts of zero-rating work their way through the rental stock, there would be an improvement in the returns to rental housing, which would raise the equilibrium level of rental housing assets demanded, and thus may stimulate an increase the supply of rental housing, which would ultimately lead to moderating pressure on rents.



An alternative, better-targeted, measure would be to refund all of the GST/HST payable on the development costs of new residential rental project, while leaving the GST/HST to apply on operating costs (for both the new projects and the vast stock of existing rental housing). This would lead to an immediate reduction of 5.2% of the development cost of new purpose-built rental housing in Ontario – assuming that Ontario also refunded the provincial share of HST. Such a reduction in GST/HST would lead to a substantial improvement in the economics of developing new purpose-built rental housing.[3]

Impact of Zero-Rating of Purpose-Built Rental Housing on the Economics of Rental Investment

Exhibit 1 presents an illustrative pro forma for a hypothetical new private purpose-built rental housing project which has been developed for this analysis. The pro forma is based on a real potential purpose-built rental housing project, however, the information has been significantly simplified in order to concentrate attention on the key factors involved in the analysis.

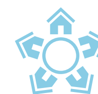
The mechanics of the pro forma shown in Exhibit 1 are discussed here before moving to a discussion of Exhibit 2 which illustrates the impacts of zero-rating the project for GST/HST.

The hypothetical project is assumed to be located in the fringe outside of the downtown area in the City of Toronto. It has 150 units with an average size of 750 square feet and market rents averaging $1,875 per month.[4] For simplicity, the pro forma is presented on a 'per unit' basis.

Exhibit 1:
Illustrative Pro Forma
Toronto Rental Housing Project
($ per unit)

	Base Case		
Development Costs and Financing			
Land	35,000		
Construction	240,000		
Development Charges	21,992		
Total Cost	296,992		
HST	15,444		
Project Costs	312,436		
Financing			
Equity	78,109		
Mortgage Financing	234,327		
Mortgage Insurance Premium	5,272		
Total Mortgage	239,599		
Revenues, Costs and Cash Flow			
	Year 1	***Year 5***	***Year 10***
Revenues	23,300	25,221	27,846
Maintenance & Operations	5,800	6,278	6,932
Property Taxes	1,600	1,732	1,912
Total Operating Costs	7,400	8,010	8,844
NOI	15,900	17,211	19,002
Mortgage Payments	15,124	15,124	15,124
Cash Flow	776	2,087	3,878
Cash-on-Cash Return	***1.0%***	***2.7%***	***5.0%***
Cap Rate	***5.1%***	***5.5%***	***6.1%***

[3] If the zero-rating applied to the provincial share of HST in the other harmonized provinces (which do not have a rebate of the provincial share of HST), the beneficial effect on rental development in those provinces would be significantly greater.
[4] This is for a new Toronto project; rents would be slightly lower in the other regions, Mississauga, York, etc.



Key elements in the pro forma for the project include:

- **Development costs**
  land cost depends on the location of the project – this is assumed to be $35,000 per unit. Construction costs for the project are assumed to be $240,000 per unit – this includes both hard and soft costs, plus financing costs during development and the rent-up phase. Development charges (another type of soft cost, but separately identified here) for 2-bedroom apartment units in the City of Toronto (as of October 2015) are $21,992 per unit.

  The total cost (land and construction costs, plus development charges) is $296,992 per unit. As discussed, the effective rate of HST for new purpose-built rental housing in Ontario is 5.2% (for units valued at $350,000 or less, with all rebates applied) – this yields HST of $15,444 and a total project cost of $312,436 per unit.

- **Financing**
  for simplicity, it is assumed that the investor has equity equivalent to 25% of the value of the project – $78,109. This leaves 75% of the project ($234,327) to be financed with a mortgage.

  For the purposes here, it is assumed that the project cost is equivalent to the lending value for the project (unlikely, since lending value is typically lower). Mortgage insurance is not required for a mortgage with a 75% loan to value ratio, however, lenders generally prefer CMHC insurance and will reflect the added security with a lower interest rate. CMHC's mortgage insurance premiums vary depending on the loan-to-value ratio – for a 75% mortgage, the premium is 2.25% of the mortgage amount ($5,272 based on mortgage financing of $234,327) and is added to the mortgage and paid off over the 25 year amortization period.

- First year operations – this simplified pro forma assumes that the project is fully rented up at the beginning of the first full year of operations. Revenues (at $1,875 per month) plus parking and adjusting for roughly a 1.5% vacancy factor are assumed to be $23,300. Total operating costs, including maintenance and operations, plus property taxes, are assumed to be $7,400.

- **Net operating income (NOI)**
  the difference between revenues and operating costs, but before allowing for mortgage payments, is $15,900. This is a key number as it is the basis for the valuation of the project – NOI divided by the total project cost yields the capitalization (cap) rate – 5.1% for this illustrative example.

- **Mortgage payments and cash flow**
  assuming a 4% mortgage amortized over 25 years, the annual mortgage payments (principal and interest) would be $15,124 per unit. Deducting this from NOI, yields cash flow from the project of $776 in the first year – essentially breakeven.

- **Cash-on-cash return and Cap Rate**
  these are critical factors in an investor's decision about the attractiveness of a rental project. While different investors will look at the levels of these factors differently in terms of assessing whether to invest, the key for this analysis is how these change as a result of a change in the treatment of the project by the GST/HST.

In addition to the first year costs, Exhibit 1 also presents a projection of the revenues and costs for year 5 and year 10 (assuming 2% inflation in all revenues and costs). Over time, with inflation (assumed to be 2%), there is a progressive increase in NOI, cash-on-cash return and the cap rate.

Exhibit 2: Effect of Changes in HST on Economics of Rental Investment

($ per unit)

	Base Case	Zero Rating	No HST on Development Costs
Development Costs			
Land	35,000	35,000	35,000
Construction	240,000	240,000	240,000
Development Charges	21,992	21,992	21,992
Total	296,992	296,992	296,992
HST	15,444	0 ←	0 ←
Project Costs	312,436	296,992	296,992
Financing			
Equity	78,109	78,109	78,109
Mortgage Financing	234,327	218,883	218,883
Mortgage Insurance Premium	5,272	4,925	4,925
Total Mortgage	239,599	223,808	223,808
First Year Revenues, Costs and Cash Flow			
Revenues	23,300	23,300	23,300
Maintenance & Operations	5,800	5,266 ←	5,800
Property Taxes	1,600	1,600	1,600
Total Operating Costs	7,400	6,866	7,400
NOI	15,900	16,434	15,900
Mortgage Payments	15,124	14,127	14,127
Cash Flow	776	2,307	1,773
Cash-on-Cash Return	***1.0%***	***3.0%***	***2.3%***
Cap Rate	***5.1%***	***5.5%***	***5.4%***

Exhibit 2 above presents an illustration of the effect that zero-rating new purpose-built rental housing would have on the illustrative project in two ways:

- **Lower project costs**
  because no HST would be charged on the development costs, the total project costs would be lower – by $15,444. Assuming the down payment remained the same, the size of the mortgage (and mortgage payments) would be reduced.
- **Lower maintenance and operating costs**
  currently, HST is built into these costs since it would apply to all products and contractors involved in operating the project – except staff. For the purposes here, it is assumed that roughly 85% of maintenance and operating costs are subject to the HST. Removal of HST would lead to savings of roughly $540 per year – and a commensurate increase in NOI.

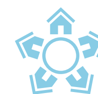
The combination of lower mortgage payments and higher NOI resulting from zero-rating the project has a positive effect on both the cap rate and the cash-on-cash return. This would significantly improve the attractiveness of the rental project from an investment perspective.

Exhibit 2 also presents an illustration of the alternative of not charging HST on the development costs but retaining HST on on-going operating costs. This has the same effect on development costs and the size of the mortgage (and mortgage payments) as zero-rating, but has no impact on operating costs or NOI. As can be seen in the Exhibit, this has a similar (though somewhat smaller) effect on the cash-on-cash return and the cap rate compared to zero-rating. Thus, while not as positive in terms of increasing the attractiveness of the rental project from an investment viewpoint – it would still have a significant beneficial effect.

Findings about Zero-Rating New Rental Housing

Zero-rating of new rental housing projects for the GST/HST is defensible from the standpoint of treating rental housing similarly to how other necessities (e.g. groceries) are treated by the GST/HST. It is also sensible in terms of promotion of much-needed purpose-built rental housing. Modeling indicates that zero-rating of new rental housing would have a significant impact on the attractiveness of new purpose-built rental housing from an investment standpoint.

While zero-rating would bring the GST/HST treatment of rental housing in line with groceries, it would be relatively costly to the government. The alternative of refunding the GST/HST paid on development costs would bring the GST/HST treatment of rental housing more in line with other GST/HST-exempt businesses, such as medical and dental services, which (unlike rental housing) do not incur large capital costs. Modeling indicates that this approach would have a somewhat smaller, though still significant, beneficial effect on a rental housing project from an investment standpoint.



Deferring Capital Gains Tax and Recaptured CCA on the Sale of Rental Housing if Reinvesting in Rental Housing

In determining income taxes payable on the income from a rental property (including residential rental properties) the owners can deduct depreciation on their buildings – called capital cost allowance (CCA).

This is intended to account for deterioration in the building over time. In Canada, the annual CCA allowed for residential rental properties is 4% of the undepreciated balance of the capital cost of the building itself (CCA does not apply to the land component).

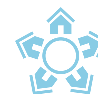
Rationale for Deferring Capital Gains Tax and Recaptured CCA

The annual CCA deductions for a residential rental building add up over time. Assuming the full 4% CCA is deducted every year, after 20 years, the undepreciated balance of a building is less than half of its original capital cost – after 30 years, the undepreciated value of the building is only about 30% of its original value. In reality, of course, the property typically has not depreciated in value at all – in fact, with inflation and rising rents (which apply in buoyant markets like Toronto), the current value of a residential rental property built 20-30 years ago would be significantly greater than not only its depreciated value, but its original cost as well.

This creates a large tax liability for owners of rental properties when they decide to sell. To the extent that the value of a residential rental property is greater when it is sold than when it was built, the owner will face tax on the recaptured CCA (all of the CCA charged over the years) as well as the capital gains. The taxes on recaptured CCA (which attracts the full income tax rate) and capital gains can be very large for rental properties which have been owned for a lengthy period and have been substantially depreciated. This large tax liability often discourages these owners from selling their building and reinvesting the proceeds elsewhere.

Prior to the major reform of the income tax system which occurred in the early 1970s, the owners of rental buildings could defer the income taxes payable on the sale of a rental building if the proceeds were reinvested in another rental building.[5] The liability for recaptured CCA was not forgiven – the recaptured CCA from the building which had been sold was transferred to the new rental building which, as a result, had a depreciated value for tax purposes which was less than the actual value of the new building.

5 There was no capital gains tax prior to tax reform, so income taxes would have been payable only on recaptured CCA.



This was no longer allowed after tax reform – one of many changes which resulted in a less attractive investment environment than previously applied to purpose-built rental housing.

If rental housing investors were allowed to defer capital gains tax and recaptured CCA on the sale of a rental building by transferring the tax liability to a newly-acquired building, it would remove a disincentive and impediment for many owners to sell their existing buildings. If, however, the measure was contingent on the owners buying or developing a new purpose-built rental project, it is likely that some could be encouraged to do so – thus increasing the supply of much-needed new purpose-built rental housing.

There is a ready market for existing stable residential rental projects from long-term investors such as real estate investment trusts (REITs) and pension funds. Such long-term investors typically prefer to purchase existing rental projects rather than develop new projects because existing projects generally have stabilized rents and vacancy rates. Also, the institutional investors and REITs typically purchase larger assets (200 plus units) to achieve economies of scale and justify transaction expenses. Thus, there would be a ready market for existing larger rental projects freed up by any measure to encourage existing owners to sell their projects.[6] Another benefit from such sales is that new long-term owners such as REITs and pension funds often undertake extensive upgrades to their new acquisitions – thus addressing deferred maintenance and extending their likely lifespan. It is noted that this may not preserve any existing affordability for assets with rents at or below the market average (typically the case more for small-medium size properties)[7].

Unlike the case with rental property investors, businesses investing in other types of capital property can defer recaptured CCA and capital gains taxes if they acquire a replacement property for the same or similar use as the original property and for gaining and producing income from the same or similar business. Investors in hotels, for example, can defer capital gains tax and recaptured CCA on the sale of an existing hotel, if they reinvest in another hotel. So, rental properties (including both rental housing and commercial real estate) are treated differently from other types of capital in this regard. Also, it is worth noting that, in the U.S., rental housing investors can defer capital gains tax and recaptured depreciation if the property is replaced by another similar rental property. So adopting this approach would address an existing inequity in the Canadian tax system.

Illustration of the Corporate Taxes Payable on the Sale of a Rental Housing Project

Exhibit 3 below presents an illustration of the calculation of the tax liability of a long-time rental property investor that sells a rental housing project – based on a hypothetical 100 unit building completed in 1989 for a total cost of $6 million ($60,000 per unit), which is sold in 2015 for $12.5 million ($125,000 per unit).[8] It is assumed that the building underwent a renovation in 2005 which cost $10,000 per unit.

6 Rental property owners that sell their properties to a REIT can structure the transaction such that capital gains tax and recaptured depreciation are effectively deferred. In these cases, the vendor receives units of the REIT and the deferred taxes are payable upon disposition of these units. While minimizing the taxes payable on the disposition of the project, the funds would be tied up in the REIT and would not be available to reinvest in a new rental project.

7 See later proposal for a rental vendor tax credit to address this issue.

8 For simplicity here, it is assumed that the $12.5 million figure represents the net proceeds from the sale after the payment of all selling costs.

Exhibit 3:
Sale of an Existing Rental Project
($ per Unit)

	Land	Building	Total
Initial Cost (1989)	10,000	50,000	60,000
Renovation (2005)		10,000	10,000
Total Cost Base	10,000	60,000	70,000
CCA (1989-2015)	-	36,400	36,400
Undepreciated Capital Cost (2015)	10,000	23,600	33,600
Sale Price (2015)	25,000	100,000	125,000
Capital Gain	15,000	40,000	55,000
Recaptured CCA	-	36,400	36,400
Calculation of Corporate Tax			
Taxable Capital Gain (50%)	7,500	20,000	27,500
Recaptured CCA (100%)	-	36,400	36,400
Taxable Income From Sale			63,900
Corporate Tax Rate			46.17%
Taxes Payable			29,500

Key elements in Exhibit 3 include:

- **Initial cost (1989)**
  the breakdown of the initial cost into land ($10,000 per unit) and construction costs ($50,000) is important to the analysis because land is not a depreciable asset – so CCA applies only to the construction cost ($50,000 per unit).
- **Renovation (2005)** – the renovation in 2005 adds a further amount to be depreciated over the period following the completion of the work.
- **CCA (1989-2015)** – CCA can be claimed on the original capital cost of the building ($50,000) at the rate of 4% annually applied to the depreciated balance[9] – so the amount of CCA declines over time as the undepreciated capital cost base declines. CCA can also be claimed on the renovation costs. Over the 1989-2015 period, the cumulated CCA deductions total $36,400.
- **Sale price (2015)**
  the project is assumed to be sold for $125,000 per unit ($12.5 million) in 2015. This is $55,000 per unit more than the original cost of the project plus the renovation – both the building and the land have appreciated in value.
- **Capital gain and recaptured CCA**
  the capital gain on the building and the land is $55,000 ($125,000 – [$60,000 + $10,000]). Recaptured CCA is the total amount of CCA deductions over the period ($36,400).

9 The 'half year' rule restricts CCA to half the normal rate in the first year, so CCA in the first year is 2%.

- **Corporate taxes payable**
  only 50% of capital gains are subject to tax ($27,500); 100% of recaptured CCA is subject to tax. Thus, the taxable income from the sale of the building is $63,900. CRA designates rental housing to be a 'passive' investment and it is therefore taxed at a higher rate than 'active' investments (46.17% combined federal and provincial corporate tax rate in Ontario).[10] Therefore, the corporate taxes payable on the sale of the building are $29,500 per unit – $2.9 million for the 100-unit building.

After paying the taxes on the sale of the building, and assuming no outstanding debt on the property, the previous owner would have $95,500 per unit left to reinvest in some other venture ($9.5 million for the project as a whole). If investors were allowed to defer capital gains and recaptured CCA, providing they reinvested the proceeds in another rental housing project, the funds available for investment would be the full $125,000 per unit proceeds from the sale ($12.5 million for the project as a whole). Having such a large amount of cash available would create a strong appetite for reinvestment, and may not exist without the incentive of deferral.

Illustration of the Positive Effect on the Economics of Rental Investment of Deferring Capital Gains Tax and Recaptured CCA

Exhibit 4 utilizes the pro forma analysis for the illustrative new rental housing project discussed in Exhibits 1-2 (in relation to zero-rating of rental housing for the purposes of the GST/HST earlier in the report) to demonstrate the beneficial effects of deferring capital gains and recaptured CCA on an investor's decision whether to reinvest the proceeds of the sale in a new rental housing project.

The analysis in Exhibit 4 is exactly the same as in Exhibit 1 except that rather than assume an equity investment of 25% of the cost of the project, there are two scenarios regarding the equity in the new rental housing project – again, for simplicity, these are presented in 'per unit' terms for the first full year following completion of the project: Reinvestment with deferral of capital gains tax and recaptured CCA – equity is assumed to be $125,000 – the full amount of proceeds from the sale of an existing rental project (i.e. assuming that capital gains tax and recaptured CCA have been deferred).

Reinvestment after paying corporate taxes on the sale – equity is assumed to be $95,500 – the amount of proceeds remaining after payment of corporate taxes on the capital gains and recaptured CCA from the existing rental project.

10 The combined federal/Ontario general corporate income tax rate on active income is 26.5% (the small business tax rate is lower). While the income tax rate for passive income is much higher (46.17%), 26.67% of this would be refundable to the corporation when it pays dividends to its shareholders. This refund does not apply if the proceeds of the sale are reinvested in another property – which is the case under consideration here.

Exhibit 4:
Effect of Deferral on Economics of Reinvestment Of the Sale Proceeds
Toronto Rental Housing Project
($ per unit)

	Reinvestment With Deferral	Reinvestment After Taxes
Development Costs and Financing		
Land	35,000	35,000
Construction	240,000	240,000
Development Charges	21,992	21,992
Total Cost	296,992	296,992
HST	15,444	15,444
Project Costs	312,436	312,436
Financing		
Equity	125,000 ←	95,500 ←
Mortgage Financing	187,436	216,936
Mortgage Insurance Premium	4,217	4,881
Total Mortgage	191,653	221,817
Revenues, Costs and Cash Flow		
Revenues	23,300	23,300
Maintenance & Operations	5,800	5,800
Property Taxes	1,600	1,600
Total Operating Costs	7,400	7,400
NOI	15,900	15,900
Mortgage Payments	12,098	14,002
Cash Flow	3,802 ←	1,898 ←
Cash-on-Cash Return	***3.0%*** ←	***2.0%*** ←
Cap Rate	***5.1%***	***5.1%***

Development costs, revenues and operating costs (and therefore NOI) are not affected by the difference in equity contribution – the only other item affected is the size of the mortgage – the total mortgage (including the mortgage insurance premium) is $191,700 in the deferral scenario – significantly less than the $222,000 in the after-tax scenario.

This, of course, reduces mortgage payments. The mortgage payments in the deferral scenario are almost $2,000 less than in the after-tax scenario in the first year. This flows to the bottom line – cash flow under the deferral scenario is $3,800, versus $1,900 in the after-tax scenario. And much better than the base case in exhibit 1 ($776)

Cash-on-cash returns under the deferral scenario are 3% in the first year compared to 2% in the after-tax scenario (and 1% in base case). Of course, the 3% return for the deferral scenario is on a much larger denominator (due to the deferral of taxes) than in the after-tax scenario.[11]

11 With the reinvestment of tax-sheltered proceeds, the equity investment increases. Although cash flow is larger, it does not appear as a large percentage increase (3% vs. 1% in base case) because the denominator equity is a larger amount ($125,000 vs. $78,000 in base case ex 1). To the extent that the extra investment facilitated by deferral (extra $29,500) is "found money" the investors effective cash on cash return is close to 5.1% in year one and approaches 9% by year 10 – a far more attractive return and incentive to invest in rental housing.

Once the benefit of liquidated equity is considered together with the benefit of retaining tax funds for reinvestment, the owner of a rental housing project would be significantly more inclined to sell the existing rental project and reinvest the proceeds in a new rental project if deferring capital gains and recaptured CCA was an option. The substantial taxes payable on the sale of an existing property are a significant disincentive for rental investors to sell their rental projects.

Deferring Capital Gains Tax and Recaptured CCA Would Encourage New Purpose-Built Rental Housing Development

The owners of existing rental projects know the business – they know the risks associated with the development of new projects. In many cases, they may have developed the projects in the first place – and might be encouraged to develop new purpose-built rental projects, if the economics are attractive. Many would have land holdings which might be suitable for the development of rental housing. However, as discussed above, if they attempt to redeploy capital from their existing rental portfolio to developing a new project, they will suffer substantial tax consequences – a significant disincentive to sell their older projects and build new ones.

If taxation of capital gains and recaptured CCA could be deferred when a building is sold providing the funds were reinvested in another rental project, it seems likely that some of the larger more sophisticated investors could be encouraged to develop new purpose-built rental housing projects.

It is important to emphasize that the proposal here relates to the deferral – not forgiveness – of the tax liabilities. These would effectively be transferred to a new rental project. The cost base for the new project from which capital gains tax would ultimately be charged would be reduced, and the recaptured CCA would reduce the size of the depreciable balance on the new project. The tax liability would remain and, in fact, the transfer of the recaptured CCA would reduce the CCA which the owner would be able to deduct from the income flow from the new project.

Exhibit 5 illustrates how the tax liability resulting from the deferral of capital gains and recaptured CCA from the sale of the existing rental project (Exhibit 3) would be transferred to the new rental housing project in Exhibit 4. Key elements of Exhibit 5 include:

- **Initial cost**
  the total cost of the new rental housing project including HST is $312,436 per unit (from Exhibit 4). The land cost is $59,956 and the building cost is $252,480.
- **Deferred capital gains**
  for tax purposes with deferral, these land and building costs are reduced by the amounts of the deferred capital gains – $15,000 for the land and $40,000 for the building (from Exhibit 3). The total adjusted per unit cost for the land and building are reduced to $44,956 (from $59,956) for the land, and $212,480 (from $252,480) for the building.
- **Recaptured CCA**
  the cost base for the building is further reduced by the $36,400 (from Exhibit 3) in recaptured CCA in order to determine the undepreciated balance for the project of $176,080 per unit (building part only, since land is not depreciable). Thus, with deferral, the undepreciated balance on which CCA deductions are based is reduced significantly from the $252,480 balance, which would apply in the absence of deferral.

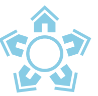
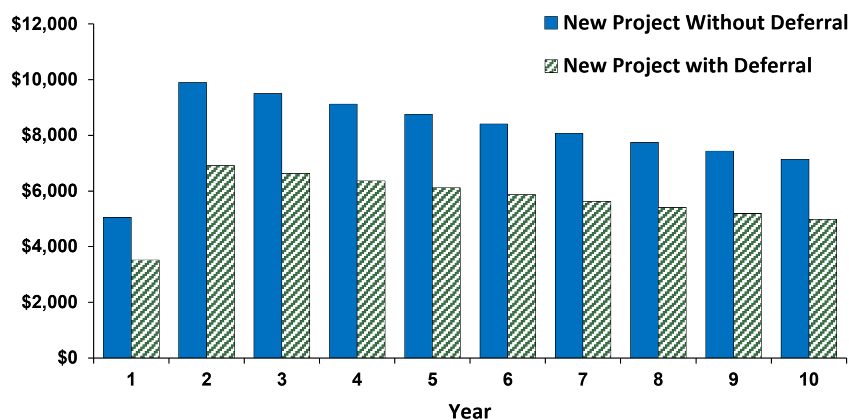


Exhibit 5:
Deferral of Capital Gains and Recaptured CCA To New Rental Housing Project
($ per Unit)

	Land	Building	Total
Initial Cost	56,992	240,000	296,992
HST	2,964	12,480	15,444
Total	59,956	252,480	312,436
Deferral of Capital Gains	15,000	40,000	55,000
Adjusted Cost	44,956	212,480	257,436
Recaptured CCA		36,400	
Undepreciated Balance		176,080	

Exhibit 6 below presents estimates of the size of potential CCA deductions on the new rental housing project in Exhibit 4 under the deferral and non-deferral scenarios. Deferral of capital gains and recaptured CCA result in a significant reduction in the available CCA deductions on the new project because the adjusted cost base for the project is much lower. Therefore, due to less CCA available for deduction, the income taxes collected from the operation of the new project would be greater in the deferral scenario than in the after-tax scenario – thus (from the government's perspective) recouping to some extent the taxes deferred from the sale of the existing project.

Exhibit 6:
CCA Deductions
Illustrative Toronto Rental Housing Project



Findings about Deferring Capital Gains Tax and Recaptured CCA

It is likely that deferring capital gains tax and recaptured CCA on the sale of rental housing projects, contingent on reinvestment in a new purpose-built rental housing project would be effective in encouraging some current owners to sell, and reinvest in new projects. From the perspective of the rental housing market, this would have two-fold benefits: additional supply of new purpose-built rental housing projects, and likely an upgrade to the existing rental projects by their new owners.

It seems reasonable to allow such a provision since other types of capital investments are allowed to defer capital gains tax and recaptured CCA upon sale if the proceeds are reinvested. And, it is worth noting that such deferral is allowed for rental housing in the United States.

Introducing a Rental Retention Vendor Tax Credit

In discussing the option to permit deferral in cases where proceeds are reinvested, it is noted that institutional and pension funds typically seek to acquire larger properties – they are less active in the purchase of small assets (under 100 units).

Within the purpose built rental section monitored by CMHC (total 1.7 million units in structures with 3 or more units) only 12% have more than 200 units and a further 30% are between 50-199 units.

Assuming half of this category are more than 100 units, only one quarter (27%) of the total purpose built rental stock are in the larger portfolios favoured by institutional investors. Most, more than two-thirds, of the purpose built rental universe are owned by small investors, including many "mom and pop" owners that own just one building which they purchased as an income property and retirement plan.

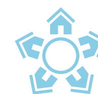
These small owners face the same large tax liabilities (relative to property value) on resale, as those examined in exhibits 3-5 above, but they may not have the expertise or desire to undertake new rental development. Unlike larger properties where there is strong investor demand from institutional sources, there may not be an active investor market seeking to purchase the smaller assets, and current owners may not have the resources and capacity to undertake new development. So the deferral option may not result in new rental development.

And as noted earlier, when properties are purchased, new owners often update and raise rents, causing erosion of the existing relatively more affordable stock.

In many cities these assets are an important source of modest rent opportunities. Many have rents close to or even below the average market rent, which CMHC uses as the benchmark to define affordability. In the face of intensification and redevelopment (mainly condo) these may be at risk. Review of Census and National Housing Survey data reveals a dramatic erosion of lower rent stock from 2001 to 2011. The number of rental units at rents below $600 per month (roughly affordable at minimum wage) declined by over 800,000 units over that decade. Part of this was due to demolition, but most due to inflating rent levels in remaining units.

From a public policy perspective it is important to preserve and keep in adequate physical condition existing affordable stock. Preservation can be more cost effective than constructing new homes and usually provides more affordable rents compared to new properties.

An effective way to preserve existing assets could be to transfer ownership to the not-for-profit sector. Canada has a long history of community based non-profit housing organizations providing affordable housing. Because their mission is to provide affordable



housing, rents are generally kept at lower break-even levels. So where existing rents are currently moderate (i.e. at or below the CMHC average market level) it is desirable to try and preserve this existing affordability.

The concept of a vendor tax credit involves the same tax liability issue discussed in the previous section (deferral of tax liabilities). Small investors are often discouraged from selling the asset due to large tax liabilities, but at same time, many lack the financial resources to maintain the units in sound condition. Instead of deferring the tax liability by promising to reinvest in new rental, which such small owners may lack the skill or desire to undertake, a vendor tax credit would be structured as an incentive to those owners that have assets with moderate rents (e.g. below the local CMHC average market rent) that also wish to cash out of their long-term investment. The proposal is that they would receive a tax credit if they transfer to a non-profit owner, who would be expected to preserve the current affordability.

The value of the tax credit would be calculated on the basis of the owned tax liability, thus reducing taxes due on sale (capital gain and CCA recapture). This would be conditional on offering the property at a discounted price that reflects the value of the tax credit, with a small portion retained by the vendor as an incentive, such that their net proceeds are higher post-tax than would otherwise be the case if they simply sold on the open market.

Earlier Exhibit 3 identified the potential tax liability on a hypothetical property held from 1989 to 2015. The total tax liability per unit was $29,500. A credit could be structured to reduce or eliminate this tax cost in exchange for selling to a non-profit that commits to retain rents at or below average market levels. This would then enable a non-profit to purchase at a discounted value, supportable at current rents. Existing tenants may already be low-moderate income; as units vacate these can be allocated to targeted low-moderate income tenants served by the non-profit).

Exhibit 7 below presents an example of how this might work. This replicates the base case used in exhibit 3. For the purpose of this illustration, it is assumed that the vendor tax credit is set at 50% of the tax payable. This would provide a sizeable incentive to the vendor, and leave the government with a share of the tax payable. It assumes that the credit is applied immediately in year of sale, against the tax liability triggered at sale. Key elements in Exhibit 7 include:

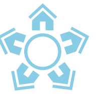
- **Initial cost (1989)**
  As in exhibit 3, the initial cost is 60,000 including land. The same renovation in 2005 is retained at 10,000 for the purpose of the capital cost base for depreciation and tax purposes.
- **CCA (1989-2015)**
  CCA can be claimed on the original capital cost of the building ($50,000) at the rate of 4% annually applied to the depreciated balance – so the amount of CCA declines over time as the undepreciated capital cost base declines. CCA can also be claimed on the renovation costs. Over the 1989-2015 period, the cumulated CCA deductions total $36,400.
- **Sale price (2015)**
  the project is assumed to be sold for $125,000 per unit ($12.5 million) in 2015. This is $55,000 per unit more than the original cost of the project plus the renovation – both the building and the land have appreciated in value.

- **Capital gain and recaptured CCA**
  the capital gain on the building and the land is $55,000 ($125,000 – [$60,000 + $10,000]). Recaptured CCA is the total amount of CCA deductions over the period ($36,400).
- **Corporate taxes payable**
  as in Exhibit 3, taxes payable include capital gains at the 50% inclusion rate as well as tax on100% of recaptured CCA and are taxed at the 46.17% combined federal and provincial corporate tax rate in Ontario. Again as in ex 3, the corporate taxes payable on the sale of the building are $29,500 per unit – $2.9 million for the 100-unit building.

Rental retention vendor tax credit – assuming the vendor tax credit is set at 50% of tax payable, it is worth $14,750 per unit (total of 1.475 million) to be credited against tax payable. This enhances the vendor return of 15% over what would otherwise have been generated from the sale.

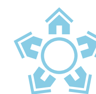
Exhibit: 7
Rental Retention Vendor Tax Credit
($ per Unit)

	Current sale	Sale with Vendor credit
Initial Cost (1989)	60,000	60,000
Renovation (2005)	10,000	10,000
Sale Price (2015)	125,000	125,000
Capital Gain	55,000	55,000
Calculation of Corporate Tax		
Taxable Capital Gain (50%)	27,500	27,500
Recaptured CCA (100%)	36,400	36,400
Taxable Income From Sale	63,900	63,900
Corporate Tax Rate	46.17%	46.17%
Taxes Payable	29,500	29,500
Net proceeds to vendor	95,500	95,500
Value of vendor Tax credit (50% of gain)		14,750
Total proceeds		110,250
Increase in vendor proceeds		15%



Findings about a Rental Retention Tax Credit

Based on the extent to which interest is expressed in pursuing this kind of technique, CHBA may commission additional analysis of its financial and other implications for the federal government. Consideration would also be given to cost-effectiveness in retaining accommodation affordable by households needing or wanting this type of dwelling. So the credit might be restricted to properties in which rents are currently at or below the average market level (or perhaps within 110% of this threshold).



Self-Supply Rules for New Rental Developments[12]

As discussed earlier in the section on zero-rating of rental housing, GST/HST is payable on new purpose-built rental housing developments.

For newly-built rental projects which are sold to third parties, GST/HST is applied to the sale price of the project and purchasers receive a rebate of part of the GST/HST – the rebate is 36% of the GST (provided that the average value of the units is less than $350,000) and, in Ontario, there is a rebate of part of the provincial share of the HST. In other harmonized provinces, there is no rebate of the provincial share of HST.

Developers of purpose-built rental projects who develop projects for their own portfolios (rather than to sell to a third party) are subject to the GST/HST under a very different procedure. Under the 'self-supply rule', GST/HST is payable on the fair market value of the rental project – i.e. the price the project would attract if it were sold to a third party. Since there is no actual transaction – and, therefore, no actual price – the value needs to be determined by some other method.

According to industry sources, the CRA has used various methods to attempt to determine the value of purpose-built rental housing projects for the purpose of the self-supply rules for the GST/HST. One of the methods purportedly used by the CRA is the valuation of the rental project as a condominium, which is clearly inappropriate. In many cases, the methods used by the CRA have not been considered fair by developers – and, because the sums involved can be substantial, this has led to litigation.

Options for determining the value of self-supplied purpose-built rental housing for the purposes of the GST/HST include:

- **Valuation as a condominium**
  The value of individual units if sold as condominiums.

  This has superficial attraction because there are many more condominiums being built than rental housing projects, so there are other projects on which to base a valuation of the new rental housing. Also, many developers of purpose-built rental housing structure their projects as condominiums in order to keep their future options open – i.e. to allow them to sell the units individually at some point in the future.

  Another reason that developers often structure their projects as condominiums is to take advantage of the fact that condominium units sometimes have more favourable property tax treatment than rental housing projects.

12 Zero-rating of rental housing for the purposes of the GST/HST as recommended earlier in this report would, of course, render the concerns about the self-supply rules redundant in the non-harmonized provinces. In provinces with harmonized sales taxes, the self-supply rules would still apply to the provincial share of HST, unless the provinces adopted the same zero-rating provision for rental housing.

Nonetheless, valuing purpose-built rental housing projects as condominiums under the self-supply rule is clearly inappropriate. Condominium projects typically include many more amenities than rental housing and the prices include the costs of expensive marketing campaigns. The value of condominium projects is substantially different from the value of purpose-built rental housing projects, mainly due to the value being based on capitalized rental income. For new higher end developments, valuations are closer – which is why some developers have returned to rental development, albeit in higher end niche.

- **Direct comparison approach**
  the value of the project based on the sales price of comparable rental projects in the same market area.

  To be accurate, this would require that the other projects be very similar to the subject project – in terms of age, unit sizes, amenities, location, etc. In most cases, such direct comparisons are not available for newly-completed rental projects.

  This is not considered to be a realistic method of determining the value of a new rental project since there would usually be great difficulty finding truly comparable projects. Court decisions regarding valuation of rental projects for the GST/HST have apparently reached the same conclusion.

- **Income approach**
  The value of the project based on the estimated income from the project (estimated rent revenues less estimated costs, with an allowance for vacancies) combined with the estimated capitalization (cap) rate which applies in the market area.

  This approach requires numerous judgements and assumptions regarding achievable rents, actual costs, vacancies and the appropriate cap rate – a process which will inevitably be subject to disputes between the owner and the CRA. Determination of value through the income approach requires a great deal of market knowledge which is not typically available to the CRA, but could be retained through consultant appraisers.

- **Lending value**
  This is a variation of the income approach.

  In determining the amount of the mortgage they would be prepared to advance on a rental housing project, lenders typically value the project based on the income which the project would generate – using assumptions regarding achievable rents, costs, vacancies, and the appropriate cap rates. Often CMHC will be involved in determining the appropriate value since many developers seek the highest possible loan amount – which would require CMHC mortgage insurance. In determining lending value, lenders (and CMHC) engage experienced appraisers who have the requisite knowledge and expertise to provide a reliable estimate of the value of the project.

  Use of the project's lending value is considered to be an accurate and fair means of determining the value of a rental project for the purposes of the GST/HST. A key advantage of using lending value as the base for the GST/HST is that the value is determined by an independent third party which is not involved in either paying or collecting the GST/HST.

Cost approach

The costs involved in building the project – i.e. the value of the land, plus all of the goods and services involved in developing the project.
The cost approach is based on factors which are typically known (with certainty) at the completion of the project. The only likely contentious issue might be in the case of land, which has been owned for some period by the developer/owner of the project; however, this could be resolved by engaging a knowledgeable appraiser who could provide an estimate of land value. The cost approach is considered to be an accurate and fair means of determining the value of a purpose-built rental project for the purposes of levying the GST/HST.

Another advantage of the cost approach is that it would bring the self-supply rules for rental housing projects in line with the GST/HST rules which apply to owner-builders – people who 'self-supply' in building their own homes either by acting as their own general contractor, or by building much of their home themselves. Owner-builders are required to pay GST/HST only on their costs – there is no attempt to estimate the value of their labour, the 'profit' they would make if they sell their home, or the final value of their home.

Cost-plus approach

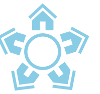
This is similar to the cost approach except that it includes an additional amount to reflect the developer's estimated profit plus financing costs and any of the developer's employed labour (on which GST/HST would not be payable).

Determination of a 'reasonable profit' is inherently subjective. Reasonable profit would depend very much on the owner's circumstances – for example, some rental project owners may have available land which otherwise may not be developed for some lengthy period, so they may be content to build a rental project which is not immediately profitable but may yield acceptable returns in the long-term. Or, the owner may be a condominium developer who, in a downtime in the condo market, decides to keep his team together by using the workers on a rental project even though the short-term returns are minimal.

Also, given the vagaries of the rental market, expected profits may not be borne out when the project is completed due to changes in market conditions, etc.

The cost-plus approach is not considered to be an accurate or fair means of determining the value of a purpose-built rental project for the purposes of levying the GST/HST since there is no reliable way to determine a reasonable estimate of the actual amount of profit.

Establishing some fixed percentage of cost as a notional estimate of profit would essentially be an arbitrary guess of actual profit levels which would vary widely from one part of Canada to another, and from one developer to another.



Lending Value or Cost Approach – Best Ways to Determine Value for GST/HST on New Rental Developments

Two of the options are considered to be acceptable means of determining the value of a purpose-built rental housing project for the purposes of levying the GST/HST:

- Lending value; and,
- Cost approach.

Neither of these options are subject to judgements on the part of either the developer or the CRA. Lending value is based on a third party estimate, and the cost approach is based on known costs involved in developing the project. Since circumstances differ (e.g. some developers may not seek mortgages on their new projects), it would appear best to allow them a choice of valuation options – either the lending value or the cost approach. Allowing such a choice would add flexibility to the process of determining the base for the GST/HST that would reflect differences in project financing which current (and future) developers may utilize as new financing options and sources of funds come to the market.

GST/HST Treatment of Secondary Housing Units

The GST/HST treatment of different forms of newly created secondary housing units is extremely confusing.

The amount of GST/HST owing on a newly created secondary suite depends on whether the suite is detached or attached to the main residence and whether it was purchased as part of a package along with the main residence – and, in some cases, who is the intended occupant.

Exhibit 8 illustrates how much HST would be payable on a newly created secondary suite under four different scenarios (assuming a 13% HST):

- Suite contained in or attached to principal residence;
- Suite separate from principal residence – with an unrelated occupant;
- Suite separate from principal residence – with a related occupant; and,
- Owner purchases separate suite as part of a package with principal residence.

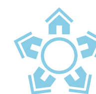
Two alternative construction costs ($100,000 and $250,000) are shown in the Exhibit. The HST payable on newly created suites with a $100,000 construction cost is discussed first:[13]

- **Suite contained in or attached to the principal residence (Scenario 1)** – this is the most common situation where a new unit is created within the walls of an existing home or attached to the home – the HST rate of 13% would apply to the construction cost of $100,000 so the HST payable would be $13,000.

Exhibit 8:
HST Treatment of Newly Built Secondary Suites
Ontario

	Owner Organizes or Builds Secondary Suite			Owner Purchases Separate Suite as Part of Package With Principal Residence
	Suite Contained in or Attached to Principal Residence	Suite Separate from Principal Residence		
$100,000 Construction Cost Medium Value Land		Occupant Unrelated	Occupant Related	
	Scenario 1	*Scenario 2*	*Scenario 3*	*Scenario 4*
Construction Cost	$100,000	$100,000	$100,000	N/A
Land Value etc	N/A	$50,000	N/A	N/A
Tax Base for HST	$100,000	$150,000	$100,000	$150,000
HST at 13%	$13,000	$19,500	$13,000	$19,500
Rebate	N/A	$11,700	$7,800	$11,700
Net HST	$13,000	$7,800	$5,200	$7,800
$250,000 Construction Cost High Value Land				
Construction Cost	$250,000	$250,000	$250,000	N/A
Land Value etc	N/A	$200,000	N/A	N/A
Tax Base for HST	$250,000	$450,000	$250,000	$450,000
HST at 13%	$32,500	$58,500	$32,500	$58,500
Rebate	N/A	$24,000	$19,500	$24,000
Net HST	$32,500	$34,500	$13,000	$34,500

13 For the purposes here, it is assumed that the owner does not undertake any of the work himself. The situation where the owner does some or all of the work is discussed later.



- **Suite separate from principal residence –** a detached dwelling created on the same parcel of land as an existing principal residence, but not attached to the principal residence, has been labeled a 'laneway house'.[14] The GST/HST treatment of laneway houses depends on who occupies the newly-created unit:

  - **If the occupant is unrelated to the owner of the principal residence** (Scenario 2), the CRA considers the new laneway house to be a new self-supplied rental unit on which GST/HST is applied to the 'fair market value' of the new dwelling – i.e. the value of the dwelling, plus the land on which it sits "and the land immediately surrounding the laneway house that is reasonably necessary for its use and enjoyment as a place of residence".[15]

    For the purposes here, it is assumed that the fair market value of the newly-created unit including the land is $150,000 – so the land on which the unit is sitting is worth $50,000. At the HST rate of 13%, the HST would be $19,500. However, the new unit would qualify for the New Residential Rental Property Rebate (32% of the 5% GST) and, assuming the unit is in Ontario, the provincial rebate (75% of the 8% provincial share) – the total rebate would be $11,700, so the actual HST payable would be $7,800.

    As discussed earlier, in most harmonized provinces, there is no rebate for the provincial share of HST for new rental dwellings. In these cases, the full HST (less the small GST rebate of 32% of the 5% GST) would apply. So, if the HST rate was 13%, the HST payable would be $19,500 ($150,000 x 13%), less the GST rebate [32% of ($150,000 x 5%) = $2,700], or $16,800.

  - **If the occupant is related to the owner of the principal residence (Scenario 3),** the CRA makes an exception to the above rule under which the new laneway house is considered to be a new self-supplied rental unit – and, therefore, does not require the 'fair market value' test, so no GST/HST is payable on the land occupied by the laneway house.

    Since the new laneway house is occupied by a relative of the owner, the owner is eligible for the New Housing Rebate (which, though the same in effect, is distinct from the New Residential Rental Property Rebate). The GST/HST is payable on the cost of building the new unit, less the rebate of the GST (and the provincial share of HST in Ontario). So, in Ontario, the HST on the construction cost of the new unit would be $13,000 (13% of $100,000), less the New Housing Rebate of $7,800. Effectively, the HST payable would be $5,200.

- Owner purchases a separate suite as part of a package with the principal residence – if the new laneway house is part of a package which includes a principal residence and the laneway house, the two units are treated separately for the purposes of the GST/HST. The laneway house is considered to be a new rental unit and, under the self-supply rules, both the construction cost and a share of the overall land cost is included in the base from which the GST/HST is determined.

  In this case, the laneway house will attract the same GST/HST treatment as the situation where an unrelated person occupies a newly-built laneway house: the GST/HST applies to the construction and land cost (13% of $150,000 = $19,500) but the New Residential Rental Property Rebate applies ($11,700) so, assuming the dwelling is in Ontario, the HST payable is $7,800. If the dwelling is in another harmonized province (i.e. where there is no rebate of the provincial share of HST), the HST payable would be considerably higher.

14 Much of the discussion here is based on information provided in the GST/HST Info Sheet: The GST/HST Implications of the Construction of Secondary Housing Units (Laneway Housing), CRA, June 2014.
15 GST/HST Info Sheet, page 2. In the Info Sheet, the CRA indicates that the 'self-supply' rules for laneway suites require inclusion of an estimate of the value of the land as part of the fair market value of the new rental unit but, unlike the situation canvassed earlier in this report with respect to larger purpose-built rental housing projects, there does not appear to be any consideration of going beyond the construction cost plus land to include builder profit in the GST/HST calculation.

So, for a new $100,000 laneway house, it would be beneficial for the owner to have the new unit occupied by a relative. Because the land value would be excluded, and the unit would qualify for the New Housing Rebate, the GST/HST payable would be less than if the new unit was built within or attached to the principal residence (where no rebate would apply), or was occupied by a non-relative (in which case, a rebate would apply, but the self-supply rules would apply as well – resulting in a greater HST payment.

If the newly-created secondary suite is more substantial (as illustrated by a $250,000 construction cost) and/or is located in an area where land prices are very high (the example in the bottom half of Exhibit 6 assumes a land value of $200,000), the laneway house actually attracts more HST than if the suite was contained in or attached to the principal residence.[16] Again, it is assumed these dwellings are in Ontario, so there is a rebate of part of the provincial share of the HST for newly-created laneway houses.

- For the new suite contained in a principal residence, the HST would total $32,500 – the 13% HST applied to the construction cost. There is no rebate in this case.
- For the new laneway house which is occupied by a non-relative, or the new laneway house purchased as part of a package including the principal residence, the HST would total $58,500 – the 13% HST applied to the construction cost plus the estimated land cost. There would be no GST rebate since the value is at the top of the rebate schedule; however, the Ontario rebate of $24,000 (the rebate for all dwellings valued at $400,000 or more) would apply, so the total HST payable would be $34,500 ($58,500 - $24,000).
- For the new laneway house which is occupied by a relative, the HST would apply only to the construction cost (not the land) and the New Housing Rebate would apply. The HST payable would therefore be $32,500 (13% of $250,000) less the rebate of $19,500 = $13,000.

In the case where the owner of the principal unit undertakes some or all of the work required to create the secondary suite, the GST/HST payable if the suite is contained in or attached to the principal residence would be reduced since the GST/HST would apply only to the materials and outside labour involved in building the unit.

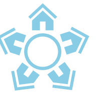
If the newly-built laneway house is separate from the principal residence but occupied by a family member, the owner is eligible for the New Housing Rebate.

However, if the laneway house is occupied by someone unrelated to the owner of the property, or if the laneway house is built as part of a package which includes both a principal residence and a laneway house, the self-supply rules would apply and the value of the land would have to be included in the base to which the GST/HST would apply – and the new units would be eligible for the rebate if they are within the price thresholds.

Findings about "Self-Supply" Rules for Laneway Houses

The confusing array of possible GST/HST tax treatments for laneway houses is unworkable. The differing tax liability arising from such a simple matter as who will be living in the unit invites the property owners who create such units to lie about occupancy. And, in any case, even if a new laneway house is occupied by an elderly parent

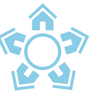
16 The scenario of a new $250,000 laneway house on valuable land is not as far-fetched as some might imagine. The CHBA has a documented case of a new laneway house in Vancouver where construction costs were $240,000 and the value of the land was determined to be $500,000 (despite the fact that it could not be separately sold).



(and thus enjoys the lower GST/HST which would apply with a relative occupying the unit), this situation will not last forever so it is likely to be rented out to a non-relative at some point in the future. Or, the reverse might apply, the owner may be planning for the future occupancy of a new laneway house by an elderly parent who is not yet ready to move from their existing home – but will likely need to in the foreseeable future.

The creation of additional secondary suites is something to be applauded. All levels of government are seeking to encourage the creation of much-needed new rental housing – particularly, as in the case of laneway houses, detached rental units on intensified sites in already-developed areas. The CRA lacks the capability to police such a trivial matter – in view of the more pressing concern regarding the extent of underground activity in residential renovations, the CRA should be concentrating its resources on the more important tax evasion which permeates that sector.

A simple solution to the GST/HST treatment of laneway houses would be to cease mandating the self-supply rules for the creation of rental housing in the case of laneway housing. The self-supply rules are designed to apply to rental housing projects, not single units – and it is pointless to require an estimation of land values where there is no prospect of separating and selling the laneway house. The GST/HST applied to these units should be based on the construction costs associated with creation of the units – but not the land. The ownership and rental rebates available for the creation of new dwellings should also apply – no matter who lives in the newly-created units.



Conclusion

This report has examined in some depth four potential and rather promising changes in federal tax treatment of purpose-built rental housing:

- Zero-rating purpose-built rental housing for the purposes of the Goods and Services Tax (GST) or Harmonized Sales Tax (HST) or, alternatively, rebating the GST/HST collected on the development cost of purpose-built rental housing;
- Deferring capital gains tax and recaptured depreciation due upon the sale of an existing purpose-built rental housing project, providing that the proceeds are reinvested in the development of new purpose-built rental housing;
- Introducing a vendor tax credit structured to provide benefits to those private sector owners having assets with moderate rents who sell to well-established non-profit housing corporations; and
- Rationalizing the 'self-supply' rules regarding the application of GST/HST to new purpose-built rental housing developments and new detached secondary suites.

In each case, there would appear to be a potential for concrete results in the form of additional purpose-built rental housing. The extent to which this is "affordable" by those who need and want rental accommodation will naturally depend both on local market conditions and on the precise program design adopted.

In addition, for those households in "deep need", there will likely be a requirement to provide rent supplements or housing benefits in addition to the rents generated by the limited government support envisaged in this report.