REINVESTMENT IN REAL PROPERTY

February 4, 2008

The Canadian Real Estate Association's
Submission On Why Canada Needs
Capital Gains Tax Deferrals

CREA

THE CANADIAN REAL ESTATE ASSOCIATION

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CREA
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EXECUTIVE SUMMARY

• The Proposal

The Canadian Real Estate Association (CREA) recommends that the federal government amend the Income Tax Act to promote increased reinvestment in real property.

The amendment would effect a deferral of both the capital gains tax and the capital cost allowance recovery for all real property investments when an investment property is sold and the proceeds are invested in another real property within the subsequent year.

Any proceeds that are eligible but not reinvested, or where such reinvestment does not meet the criteria, would be subject to capital gains tax.

Members of Parliament have responded positively to the proposal in discussions with CREA and its members. Dr. James McKellar, Associate Dean and Professor of Real Property at the Schulich School of Business, York University, and Dr. Thomas Wilson, Senior Advisor, Institute for Policy Analysis, University of Toronto, have provided additional research.

• Benefits to the Economy

The proposed amendment would provide significant economic benefits by leveraging underutilized wealth in the economy, supporting labour mobility and addressing Canada's international competitiveness problem.

• Benefits to Middle Class Investors

The current situation effectively eliminates the incentive for many property holders to consider a sale and reinvestment due to the impending tax burden. Investment real estate is widely held as indicated by the fact that 65.9 per cent of those reporting real property gains have net incomes of $50,000 or less, and that they reported 57 percent of all such gains.

• Benefits for Smart Urban Growth

The proposal helps make the federal government an active participant in the regeneration and intensification of urban neighborhoods. This requires properties to be turned over at a rate that is sufficient to promote regeneration.

• Benefits to the Tax System

The proposal would help reduce some of the inherent inequity in the Income Tax Act towards small investors in real property. Over the last 25 years, changes have been introduced that have disadvantaged owners of rental housing, making taxation less equitable and less neutral. Changes include, but are not limited to: the elimination of real estate from the lifetime gains exemption; the denial of deductibility of soft costs for the rental housing industry; and GST rules that discriminate against rentals.

• The Lock-in Effect

Dr. McKellar's additional research focused on the lock-in effect that occurs when holders of old assets with relatively low returns hold on to them for tax reasons, rather than reinvesting in new assets with higher returns.

The lock-in effect is readily demonstrated by the underutilized and often boarded-up buildings found in deteriorating urban cores across the country. Unlike a capital gains tax cut, a deferral of the tax and capital cost allowance recovery would directly remedy the lock-in effect.

• Benefits Outweigh Modest Costs

Dr. Thomas Wilson has prepared an estimate of tax revenue losses that would occur if the CREA proposal were implemented. The total cost in lost tax revenue from individuals, small business and other corporations resulting from deferral of capital gains tax is in the range of $258 million. The cost of deferring the recapture of capital cost allowance is $157 million. The total cost of deferring both the tax and the recapture is therefore estimated at $415 million. This is a modest and manageable amount that must be considered against offsetting revenues. There would be some immediate offsets from fees generated by reinvestments. This revenue stream would grow in future years and, combined with spin-off benefits, would far surpass foregone tax revenues.

• Increased Revenue from Spin-Off Activity

The government will gain additional tax revenue from renovations, maintenance and conversions generated by reinvestments. A study by Altus Clayton for CREA found that each residential MLS® transaction generated an average of $32,200 in additional consumer spending between 2004 and 2006. Commercial transactions are generally considered to generate even greater renovation activity and other spin-offs than the residential sector. A study by DRI Canada found that more than 29 jobs are created for every $1 million invested in renovation.

THE PROPOSAL

The Canadian Real Estate Association (CREA) recommends that the federal government amend the Income Tax Act to promote increased reinvestment in real property.

The amendment would effect a deferral of both the capital gains tax and the capital cost allowance recovery for all real property investments when an investment property is sold and the proceeds are invested in another real property within the subsequent year.

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CREA introduced the proposal in the Finance Committee's Pre-Budget Consultations in 2006. Discussions followed with individual Members of Parliament of all parties and with officials of the Department of Finance. Finally, REALTOR® members of CREA discussed the proposal with 126 MPs during their annual PAC Conference in March 2007. Reaction from MPs has been overwhelmingly positive.

The Department of Finance has raised concerns about the cost to the Treasury in lost tax revenue. CREA has enlisted the services of two of Canada's leading experts on property and taxation to assist with the current round of consultations. Dr. James McKellar, Associate Dean and Professor of Real Property at the Schulich School of Business, York University, prepared the initial proposal. He has conducted additional research on the "lock-in effect." Dr. Thomas Wilson, Senior Advisor at the University of Toronto's Institute for Policy Analysis and a leading authority on taxation, has conducted research into the likely cost of foregone first year tax revenue and the income class of those likely to benefit.

The amendment would provide significant economic benefits for Canada, including:

- Leveraging underutilized wealth in the economy;
- Supporting labour mobility – an essential element to Canada's economic prosperity;
- Addressing Canada's international competitiveness problem resulting from the highest marginal effective tax rate (METR) in the OECD.

Dr. McKellar points out that the proposed deferral will enhance national productivity by directly addressing one of the key factors weighing down the investment climate in Canada – high taxes.

Reports from the World Economic Forum indicate that Canada's global economic stature is slowly eroding. On the WEF index that measures global competitiveness, Canada fell from 13th place to 16th in 2006. Reasons for the slide include Canada's high taxes, its regulated industries, and its overly conservative capital market players.

REINVESTMENT IN REAL PROPERTY

"Canada does not appear to be a leader in tax reform despite falling in line with its OECD counterparts to lower corporate tax rates…. When it comes to real estate, there is clear evidence that capital gains tax as applied against [real property investments] does create friction in the system referred to as the 'lock-in effect'…. While Canada has followed the trend in lowering corporate taxes, other tax measures are still required and among those most worthy of consideration is the tax deferral of capital gains for real estate."
— Dr. James McKellar, Professor of Real Property, Schulich School of Business, York University.

Canada enjoys a stable but concentrated banking system by virtue of federal legislation that restricts foreign competition with Canada's big banks. It is well recognized that there are certain disadvantages inherent in this arrangement when it comes to raising capital for various investor categories. Unlike many other mature economies, the players in Canada's capital markets are few, the major players are typically part of the banking system, and their underwriting practices are highly risk averse, particularly when it comes to small business and investors. Canada is not leveraging its wealth to maintain its competitive advantage. Reinvestment in income property is an effective means to leverage some of this wealth to provide the quality environments that are required to sustain our economic prosperity.

In addition, the deferral will support the increasing pace of labour mobility that is essential to Canada's economic posterity, particularly in light of the economic activity in Western Canada.

Canadians are increasingly migrating to regions where new jobs are plentiful, and they must be able to move their assets with them. Households can move their furniture and their stocks and bonds, but not their real estate investments, without substantial tax consequences. Reinvestment in real property should be facilitated so that investors can reposition existing investments without punitive tax measures. This is necessary if we are to encourage the level of labour mobility that is essential to maintaining growth.

BENEFITS TO MIDDLE CLASS INVESTORS

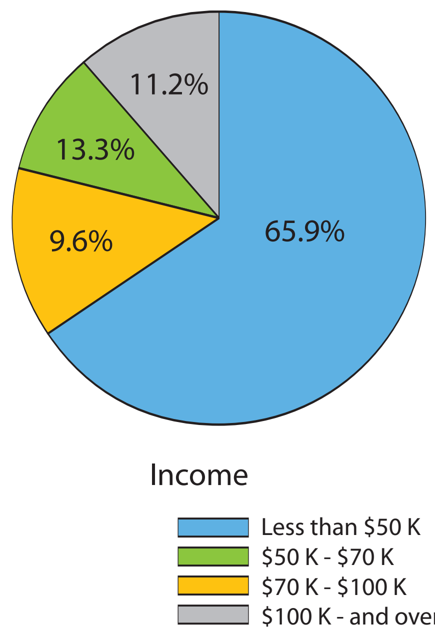
Dr. Thomas Wilson used tabulations from Statistics Canada to analyze the real property gains realized by individuals for tax year 2005. About 66 per cent of those reporting real property gains, a total of 94,455 filers, have net incomes* of $50,000 or lower. They realized gains of $3.8 billion, or about 57 per cent of the dollar value of all such gains. It is these middle class investors, many of whom have long-term holdings, that this proposal is designed to help.

The Income Tax Act effectively eliminates the incentive for many real property holders to consider a sale and reinvestment due to the impending tax burden. The fact that small investors may actively manage properties, but are denied the tax benefits that accrue to larger investors by virtue of the arbitrary rule that they have fewer than five employees, further exacerbates the situation.

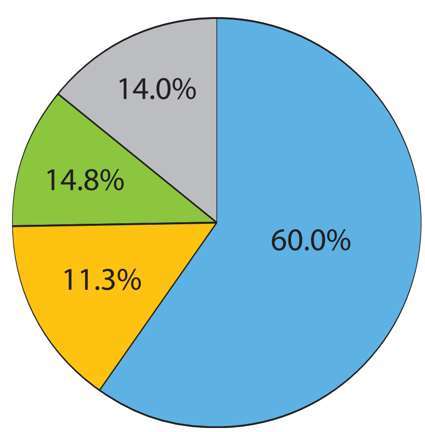
The deferral will facilitate more effective management of real estate investment portfolios in recognition of the fact that Canadians are becoming more financially self-reliant in retirement. This implies more responsibility in handling one's own investment portfolio, precipitated by the shift from defined benefit (DB) to defined contribution (DC) pensions and the increase in the annual RRSP contribution rate.

This recommendation increases liquidity for those who select property as an investment vehicle. The recommendation offers the benefit of portability, so that a household relocating as part of a retirement plan can relocate its property holdings along with its stock and bond portfolio.

2005 income of Canadians reporting real property gains



2005 income of Canadians reporting real property gains eligible under CREA proposal



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* Net income exclusive of realized real property gains

BENEFITS FOR SMART URBAN GROWTH

Dr. McKellar is recognized as one of Canada's leading authorities on urban policy, with extensive experience in both Canada and the United States. His study concludes that this proposal will position the federal government as an active proponent of urban intensification.

"Our urban centres are at a critical stage where intensification of the urban fabric is required and this is now being actively promoted by various provincial and regional government policies to contain urban sprawl and promote public transit," Dr. McKellar wrote. "This can only occur if properties are turned over at a rate sufficient to promote intensification and the regeneration of older neighbourhoods. The federal government can be an active participant in this process through this proposal. In the absence of this provision it may be difficult to convince some property owners that a sale is the requisite step to moving property to its highest and best use."

BENEFITS TO THE TAX SYSTEM

The proposed deferral will mitigate some of the existing inherent tax inequity imposed on small investors in real property.

Over the last 25 years, changes have been introduced that have disadvantaged owners of rental housing, making taxation less equitable and less neutral. Applying a rollover to small-scale real estate investment would go some way to restoring balance. Eliminating real estate from the lifetime exemption in the 1980s was one of several changes that discriminated against real estate. The rationale – to help direct resources toward productive investments – was misguided, as CREA said at the time. Investment in rental property is every bit as productive as other forms of investment. It produces a future flow of accommodation services, just as other forms of investment produce a future flow of good and services."In 1988, all investors in real estate were denied deductibility of soft costs – costs not related to the acquisition of fixed assets, such as the cost of financing, taxes, fees of all kinds, and advertising and promotion costs. Soft costs are the housing industry's cost of carrying inventory. The denial of deductibility is discriminatory because it denies the housing industry a benefit that is allowed to others.

Since it was introduced in 1991, the GST has discriminated against rental housing by providing a rebate for ownership housing but none for rental units. In addition, because residential rents are classified as exempt rather than zero-rated under the GST, landlords are unable to recover tax paid on the purchase, repair or improvement of residential buildings.

With respect to the proposed rollover for real estate investment, the current tax system deems many investors to be passive, thus denying tax benefits such as a lower small business tax rate. This proposal recognizes that, with the proper incentives, small business can evolve into big business and small real property investors often provide customized services for small firms.

The concept of a tax deferral is not new to the Income Tax Act. Subsections 13(4) and 44(1) allow a taxpayer to defer capital gains where a "former property" is involuntarily disposed of, or a "former business property" is voluntarily disposed of and a "replacement property" is acquired. Subsection 14(6) provides similar treatment with respect to eligible capital property. However, rental property is specifically excluded from the definition of "former business property." CREA proposes that the same mechanism currently allowing for the disposal of "former property" or "former business property" be extended to all income producing property.

THE LOCK-IN EFFECT

Dr. McKellar's work this year analyzes the root issue that the proposed deferral is intended to address. He points out that taxes applied against capital gains that are realized only at the time of disposition have disadvantages as well as advantages. The main disadvantage is that the prospect of a tax penalty encourages investors to hold onto property that has appreciated in value to avoid paying tax, thus creating a "lock-in effect."

The McKellar study cited the work of Professor Jim Mirlees of Oxford University, who received a Nobel Prize for studying the structure of taxation, including the lock-in effect. He showed that all taxes induce people to change their behaviour to minimize their tax payments. Some do so more than others. Such changes lower economic efficiency, and therefore the level of income.

The following excerpts from Dr. McKellar's study summarize the problem:

"The "lock-in" effect occurs when holders of old assets with relatively low returns have an incentive to hold on to them for tax reasons rather than sell them to invest in new assets with higher returns. The implication of the lock-in effect is that ventures that are more productive than existing activities remain unexploited because the tax code discourages investors from putting their money into activities with the highest social returns.

"The lock-in effect provides a powerful incentive to hold assets with large accumulated gains, even if other assets would be more productive. The lock-in effect is most pronounced when the investor owns one or a few capital gains assets and cannot diversify the returns on those assets. Lock-in can trap capital in inefficient investments when it could be used more productively elsewhere. The argument is most relevant in the case of small real estate investors who retain holdings long after their effective life simply to avoid tax consequences. This is less relevant to the stock market for obvious reasons. Pension funds are not affected. There is also a social cost in that the lock-in effect has an opportunity cost associated with the removal of valuable land from its most productive use.

"Some countries partially address the lock-in effect with tax rates that decrease with the length of time the asset is held, distinguishing between long- and short-term holdings. Other countries have enacted specific provisions in their tax codes to permit the realized capital gain on the sale of real property to be "rolled-over" without tax consequences into a comparable asset within a specified time period. These rollovers are often referred to as tax deferred exchanges that permit the reinvestment of realized gains in a comparable asset within a specified time period. This mechanism directly mitigates some of the unfortunate consequences of capital gains tax on an asset class that has particular characteristics not found in other asset classes subject to capital gains.

"The lock-in effect can be most readily demonstrated in the underutilized and often boarded-up buildings in deteriorating urban cores across the country. Unlike a simple capital gains tax cut, a deferral of the capital gains tax and the capital cost allowance recovery would directly remedy this lock-in effect. It would allow an investor the freedom to change asset classes, locations and/or sizes without penalty and without the loss of value that has grown in many cases due to inflationary pressures."

BENEFITS OUTWEIGH MODEST COST

Dr. Thomas Wilson has prepared an estimate of tax revenue losses from implementation of the CREA proposal. Dr. Wilson used tabulations compiled specifically for the purpose by Statistics Canada with tax returns reporting capital gains on rental properties for 2005. Separate studies were conducted for the capital gains taxes and recapture of capital cost allowance for individuals and corporations.

The total cost in lost revenue from individuals, small business and other corporations resulting from deferral of capital gains tax is in the range of $258 million. The cost of deferring the recapture of capital cost allowance is $157 million. The total cost of deferring both the tax and the recapture is therefore estimated at $415 million. This is a modest and manageable amount that must be considered against offsetting revenues. There would be some immediate offsets from fees generated by reinvestments. This revenue stream that would grow in future years and, combined with spin-off benefits, would far surpass foregone tax revenues.

(Dr. Wilson's research reports are available upon request.)

INCREASED REVENUE FROM SPIN-OFF ACTIVITY

The government will gain additional tax revenue from increased spin-off activity, such as renovations, maintenance and conversions. A study by Altus Clayton for CREA found that each residential MLS® transaction generated an average of $32,200 in additional consumer spending between 2004 and 2006. This included purchases of furniture and appliances, moving costs, renovations, services and taxes. Commercial transactions are generally considered to generate even greater renovation activity and other spin-offs than the residential sector. Statistics Canada has shown that construction activity has a larger impact on the economy than most other industries by virtue of its greater multiplier effect.

CMHC studies have shown that investment in renovation generates far higher levels of employment than investment in new construction. A study by DRI Canada found that more than 29 jobs are created for every $1 million invested in renovation. In addition, a report prepared for Downtown St. John's Economic Development cites studies showing that employment benefits generated by renovation have a significant *local-level* economic impact. Thus, encouraging reinvestment not only promises benefits in terms of community regeneration, as Dr. McKellar points out, but it keeps a lot of the spin-off activity in the community.

PROPOSED TAX DEFERRAL ON SALE AND REINVESTMENT OF RENTAL PROPERTY (i.e. ROLLOVER ON A LIKE-KIND EXCHANGE)

The Canadian Real Estate Association (CREA), the Canadian Federation of Apartment Associations (CFAA) and Real Property Association of Canada are proposing that a tax deferral apply on the sale of a rental real estate property if another rental real estate property is bought within 12 months. The proposal also calls for the investor to be able to rollover their undepreciated capital cost position and their adjusted cost base into the newly acquired property. This would be similar to the section 1031 "like-kind exchange" currently allowed in the United States, but with fewer limitations and administrative requirements.

This memo sets out estimates of the federal government revenue that would be deferred by the proposal in the first year, based on 2005 income tax return data, the most recent year for which Statistics Canada could provide the necessary data. In the years that follow, the deferral amount should decrease given that taxes payable (deferred from the first and subsequent years) would appear as an additional tax payable thereafter. Over time, the deferral amount would decrease toward zero.

Estimate of tax deferral (first year)

Deferred tax on capital gains	**$258M**
Deferred tax on recapture of CCA	**$157M**
Total revenue deferral	**$415M**

The estimates are based on figures provided by Statistics Canada to Dr. Thomas Wilson, Wilson Economic Research Inc., as well as surveys and estimates by CREA, CFAA and REALpac. Details of the derivation of the estimates are shown in Appendices A and B. The figures shown may be subject to revision when more accurate data is made available.

The estimates are net of offsets such as capital losses, which would prevent taxes on capital gains from being paid in 2005. However, no offsets have been applied with respect to income taxes which will be payable on the increased sales, purchases, renovations and other economic activity which the adoption of the tax deferral proposal may well cause. Such tax increases could well be substantial, reducing the revenue deferral substantially.

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Appendix A – Proposed deferral of tax on capital gains

Individuals

For taxpayers who are individuals, Statistics Canada provided figures for the potential taxes **payable on capital gains on all real property** sold in 2005, namely $715M.

However, the tax deferral proposal applies only to rental property; it does not apply to real property gains on raw land, unqualified farms or business properties. Therefore, a screen has been applied to capture only property with gross rental income greater than $12,000 per year or with any net rental income. That screen is not perfect, because it will include some properties which are not subject to the proposal, and exclude some other properties which are subject to the proposal; however, it will capture the vast bulk of properties that are subject to the proposal. That screen results in the following:

Gross potential tax revenue from gains on apparent rental real property (after rental revenue screen)

$409M

A further relevant screen for rental property is to test whether the CCA class in question was reduced to zero by the sale. Since rental real estate is required to be placed in a separate CCA class, the sale of such property should result in a zeroing out of the class. At this time we do not have the Statistics Canada data applying that screen for individuals. However, for corporations Statistics Canada reports that that test screened out 25% of the potential tax as not applicable to rental real estate. Therefore, as a best estimate, we apply the same ratio to the individual tax revenue:

Gross potential tax revenue from gains on apparent rental real property
(with rental revenue and CCA zeroed out screens) **$409M less 25% = $ 307M**

Note that the figure shown is the gross potential tax revenue. Like individuals, many corporations have capital losses or ordinary losses which they are entitled to deduct, reducing their taxes on capital gains.

$307M less $61M = $246M

$246M would be the amount of taxes on capital gains which could be deferred if everyone who sold a rental property bought another rental property of similar or greater value AND everyone chose to use the deferral. In fact, many people would sell one property without buying another one. Also, just as some real estate investors do not claim the maximum CCA they are allowed, some eligible investors may choose not to use the deferral. To estimate the take up rate among eligible investors, CREA undertook two surveys of investors. The surveys produced take up rates of 66% and 51% respectively. This memo uses the average of the two rates, namely 58%, as the estimated take up rate.

$246M times 58% = $143M

Therefore, the estimated tax deferral of capital gains on rental real property for individuals for the CREA-CFAA proposal is:

$143M

Corporations

The corporation tax returns call for taxpayers to report total rental income, and separately to report real estate rental income as an amount included in the total. However, many corporations do not show the real estate rental income separately. To overcome that problem, Statistics Canada and Thomas Wilson have provided the following figures based on the sum of (1) the total rental income on all types of property for real estate companies (category 531), and (2) the reported real estate income for all other companies (such as manufacturing companies and service companies). Item 1 will tend to overstate the taxes on real estate rental income, while item 2 will tend to understate them. We assume that the two biases will cancel each other out.

Best estimate of gross potential tax on capital gains on rental real estate by corporations:

$244M

Like individuals, many corporations have capital losses or ordinary losses which they are entitled to deduct, reducing their taxes on capital gains. Otherwise unusable ordinary losses were first deducted from CCA recaptures (see Appendix B). The remainder were deducted from real estate capital gains.

$244M less $46M = $198M

As is the case for individuals, not every corporation which has a gain on a sale of a rental property will qualify for the deferral, and some which qualify will not take up the deferral. For example, investors periodically decide to rebalance their portfolios and at such times they may well reduce the proportion of their holdings in real estate. When a company is doing that, sales will not be followed by the purchases necessary for the company to be eligible for the tax deferral. Likewise, a company may not want to carry a deferred tax liability on its books. At this time we do not have a take up rate estimated specifically for corporations. Therefore, we apply the rate used for individuals, namely 58%.

Net realistic tax deferral **$198M x 58% = $115M**

The estimated tax deferral of capital gains on rental real property for corporations for the CREA-CFAA proposal is:

$115M

Net realistic capital gains tax deferral (accounting for take up)

Corporations	**$115M**
Individuals	**$143M**
Total	**$258M**

Appendix B – Proposed deferral of tax on recapture

Corporations

Statistics Canada provided the gross potential tax deferral on recapture on real estate, applying the screens described above to limit the amount to that applicable to rental real estate.

Best estimate of gross potential tax deferral on recapture on rental real estate		$127M
	Deductions for ordinary loss offsets:	$ 17M
	Total	$110M

Since that same eligibility conditions and similar incentives exist as is the case for the rollover of the adjusted cost base as applies for the capital gains position, we apply the same take up estimate

Estimated take up $110M X 58% = $64M

Estimated tax deferral on recapture by corporations (accounting for take up):

$64M

Individuals

We do not have figures for recapture for individuals and Statistics Canada has told us that they may be difficult or impossible to obtain. In order to estimate the tax on recapture for individuals, we note that the tax on recapture for corporations is 52% of the tax on capital gains of corporations ($127M divided by $241M = 52%). We then apply the same ratio to individuals on the expectation that the real estate market will have performed in a similar way for individuals as it did for corporations.

Gross potential tax revenue from capital gains	$307M
Estimated ratio recapture to capital gains	X 52%
Estimated gross theoretical tax deferral on recapture	$160M
Estimated take up percentage	X 58%
Estimated tax deferral on recapture by individuals (accounting for take up)	$93M

Net realistic tax deferral on recapture (accounting for take up)

Corporations	$64M
Individuals	$ 93M
Total	$157M