

# ***Supporting Housing Affordability and Choice***

## **Canadian Home Builders' Association Pre-Budget Submission (August 2007)**

### **Summary**

The Canadian Home Builders' Association (CHBA) congratulates the federal government on the reduction in the rate of GST by 1% last year.

- The CHBA strongly supports the government's commitment to reduce the GST by a further 1%, and urges the government to bring this reduction forward in the next Budget.

However, more needs to be done to support housing affordability and choice across Canada.

In this regard, there are several tax policy issues on the CHBA's agenda with the federal government:

- With almost all new houses in several major centres now ineligible for the GST rebate, it is urgent that the federal government act on its commitment to adjust rebate thresholds to take account of increases in new house prices.
- The definition of 'substantial renovation' should be expanded to encourage renovation work, and to encourage homeowners to hire professional contractors.
- The Contract Payment Reporting System (CPRS) should be replaced with an effective regulatory approach to the underground economy. As well, all firms and individuals in the construction industry should be required to register for a Business Number, even if they wish to take advantage of the GST exemption for companies which operate below the \$30,000 annual sales threshold.
- Rental housing should be zero-rated – i.e. the GST paid by businesses investing in rental housing should be refunded.
- Capital gains tax and recaptured depreciation on the sale of rental housing should be deferred when the proceeds are reinvested in new rental housing projects.
- The deductibility of land carrying costs should be restored.

With respect to federal infrastructure investment, priority should be given to local and regional infrastructure investments that sustain new urban growth, rejuvenate services to existing built-up areas, and reduce financial pressures on new home buyers.

- In order to obtain maximum benefits, federal investment should emphasize water and sewer systems, roads, bridges, transit, and waste management. Benefits from these investments should be systematically monitored and reported.

## ***Supporting Housing Affordability and Choice***

The CHBA is the voice of Canada's residential construction industry.

The Association's membership includes new home builders, renovators, developers, suppliers, trades, manufacturers, lenders and other professionals with over 50 Local Home Builders' Associations and 8 Provincial Associations. The CHBA's Standing Committees and Councils oversee the work of the Association in areas as diverse as technical and economic research, education and training, renovation, urban issues, warranty and marketing. Through the voluntary efforts of its members, the CHBA serves both consumers and producers of housing by supporting quality, affordability and choice in housing for all Canadians.

There are two broad areas of concern with respect to the forthcoming federal Budget – federal taxes as they relate to the housing industry, and federal infrastructure investment. These are dealt with separately below.

### ***1. Federal Taxes***

The CHBA congratulates the federal government on the reduction in the rate of GST by 1% last year. The CHBA strongly supports the government's commitment to reduce the GST by a further 1%, and urges the government to bring this reduction forward in the next Budget.

However, more needs to be done to support housing affordability and choice across Canada.

In this regard, there are several tax policy issues on the CHBA's agenda with the federal government:

#### ***The GST Rebate Thresholds Should be Indexed***

The price thresholds for the New Housing Rebate of GST have remained unchanged since the GST was introduced in 1991.

Only homes priced at \$350,000 or less are eligible for the full amount of the Rebate. There is a phase-out of the rebate for homes priced between \$350,000 and \$450,000. For new homes priced above \$450,000, there is no rebate – the full 6% GST applies to the price of a new home. The GST payable on a \$450,000 home is \$27,000.

The federal government made a commitment to adjust the thresholds over time. According to the *Technical Paper* on the GST released by the federal government in 1989:

“The government will review these thresholds at least every two years and adjust them as necessary to ensure that they adequately reflect changes in economic conditions and housing markets.” [Page 19]

Over the period since the GST was introduced, Statistics Canada's New House Price Index has increased by over 40%. Had the GST rebate thresholds been adjusted to take account of this increase in new house prices, the thresholds in 2007 would be \$490,000-\$630,000.

The lack of indexation of the thresholds has eroded housing affordability. For example:

- In Vancouver, 99.4% of the purchasers of new single-family homes completed in the first five months of 2007 did not qualify for the full GST housing rebate – i.e. less than 1% of buyers qualified for the full rebate. In contrast, in 1991, when the GST was introduced, less than 25% of the purchasers of new houses did not qualify for the full rebate – over 75% qualified for the full rebate.
- In Toronto, almost 85% of the purchasers of new houses completed in the first five months of 2007 did not qualify for the full GST rebate. Less than 20% of the purchasers of new houses qualified for the full rebate. In 1991, one-third of the purchasers of new houses did not qualify for the full rebate; two-thirds qualified for the full rebate.
- The negative impacts on housing affordability extend beyond Vancouver and Toronto. The failure to index rebate thresholds means that one-quarter or more of the purchasers of new houses completed in January-May 2007 in Abbotsford, Victoria, Calgary, Ottawa, Edmonton, Hamilton, Kitchener, Niagara-St. Catharines, and Montreal did not qualify for the full rebate. Significant proportions of new home buyers in other centres - including many smaller centres - also do not qualify.

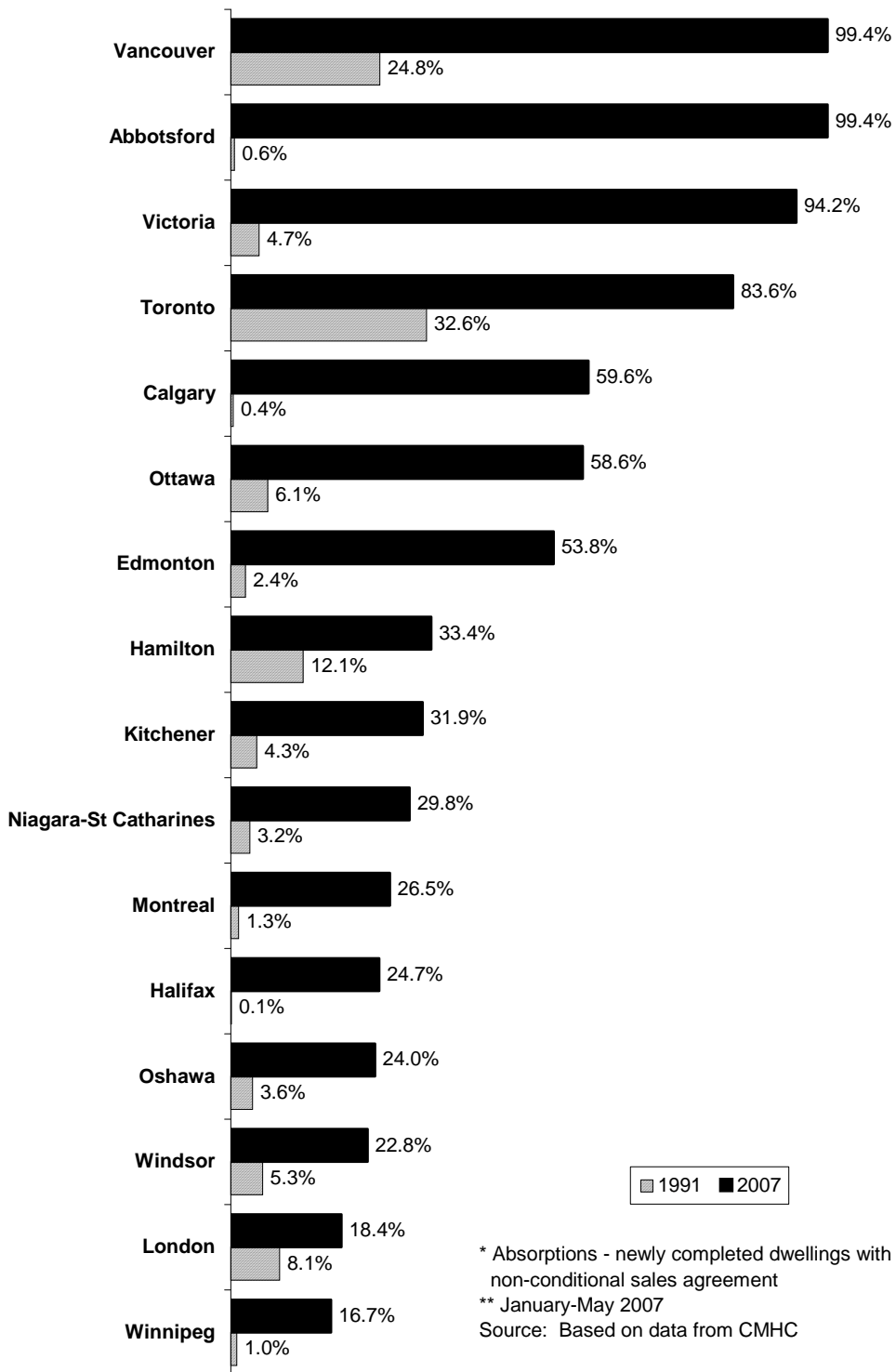
These figures relate to houses completed in the January-May period of 2007 – i.e. mostly houses started last year. For new houses being sold today, the picture would be much much worse since prices have risen significantly in the past year.

The failure to index the GST rebate thresholds has eroded housing affordability across Canada, with homebuyers in high-cost centres particularly disadvantaged. At the same time, the federal government will receive roughly \$275-\$285 million in GST revenue in excess of what would have been received if the thresholds had been indexed.

Also, it is important to note that purchasers of new homes are not the only consumers who are disadvantaged by the lack of indexation of the thresholds. Since new and resale homes are competitive products, the high (GST-included) prices of new housing are reflected in higher prices to buyers in the resale market as well.

*The purpose of the federal government's commitment to index the GST thresholds was to protect housing affordability over time. With almost all new houses in several major centres now ineligible for the GST rebate, it is essential that the federal government act on this commitment on an urgent basis.*

**Share of New Single-Family Absorptions\*  
Priced at \$350,000+, 1991 and 2007\*\***



## ***The Definition of ‘Substantial Renovation’ Should be Changed***

As with new homes, the federal sales taxes collected on renovations increased significantly with the GST. Previously, the 9% FST applied only to the building materials used in construction. Now the 6% GST applies to the *full value of renovation work*, including labour, services and builders’ margins, as well as building materials. Rebates are available for a ‘substantial renovation’ (essentially a total rebuild of a home), but the definition is so restrictive that very few renovation projects qualify.

There is strong evidence of a link between the introduction of the GST in 1991 and growth in underground residential renovation activity. A redefinition of ‘substantial renovation’ to expand the range of work that would qualify for rebates of the GST would encourage homeowners to engage professional renovation contractors – rather than underground operators.

*The definition of ‘substantial renovation’ should be expanded to encourage renovation work, and to encourage homeowners to hire professional contractors.*

## ***Proactive Measures to Address the Underground or ‘Cash’ Economy***

Governments are losing millions of dollars annually through the activities of underground operators.

Also, the underground economy is associated in many regions with criminal activity such as theft of materials from job sites, money laundering, and poor quality work.

The Contract Payment Reporting System (CPRS), the Canada Revenue Agency’s (CRA’s) main response to concerns about underground activity, has been found (by an evaluation of CPRS by CRA) to be “not effective in that segment of the underground economy where transactions are purposefully hidden by both the contractor and the sub-contractor to circumvent tax laws and other legal obligations (commonly known as the ‘cash’ economy)”. In short, the CPRS has failed to measure up to the federal government’s commitment to “level the playing field” for legitimate contractors who file their tax returns and play by the rules.

Making matters worse, many firms and individuals claiming to be exempt from collecting the GST under the \$30,000 annual sales threshold are, in fact, working in the underground economy. Not having to register to be exempt assists them in staying below the radar screen of tax compliance and enforcement authorities.

The Government of Australia has shown that, through proactive enforcement mechanisms, it is quite feasible to combat the cash economy and to increase both the support offered to legitimate contractors and the amount of government revenues. By contrast to Canada, they have in place an effective combination of tax collection policies, enforcement agents, and business registration policies to address the cash economy.

*The CPRS should be replaced with an effective regulatory approach to the underground economy. There are operational models from Australia and elsewhere that are much more effective in reducing underground or cash-based activity. These should be actively examined for application in Canada.*

*All firms and individuals in the construction industry should be required to register for a Business Number, even if they wish to take advantage of the GST exemption for companies which operate below the \$30,000 annual sales threshold.*

## **The GST Should Not Apply to Rental Housing**

The reduction in the GST rate to 6% last year helped to improve the economics of investment in new rental housing projects. Nevertheless, new rental starts remain well below projected requirements.

There is a fundamental question regarding rental housing and the GST:

***Why is an investment in rental housing treated differently from an investment in commercial real estate, such as a rented office or retail complexes?***

An investor in a retail or office complex is not eligible for the GST rebate – however, that investor can use the GST paid as input credits for the GST which will be collected on the rent from the complex. The GST input credits cannot be used by rental housing investors because no GST is collected on residential rents. In the final analysis, unlike an investor in rental housing, an investor in retail or office rental complexes does not bear the GST.

Rental housing is a business. There is no reason why rental housing should be treated differently from other similar businesses.

*Rental housing should be zero-rated – i.e. the GST paid by businesses investing in rental housing should be refunded.*

## **The Federal Income Tax Treatment of Rental Housing Should be Changed**

The GST is not the only federal tax that discourages investment in rental housing. Changes in the income tax treatment of rental housing over the period since the early 1970s have significantly reduced the attractiveness of rental investment. The results of this are reflected in lower volumes of rental starts across the country.

The CHBA has called for reforms to the income tax treatment of rental housing. Recommendations include:

- Deferral of capital gains and recaptured depreciation deductions upon the disposition of rental properties when the proceeds are used to invest in new rental properties;
- Extending eligibility for deductions of rental losses created by capital cost allowance against income from other sources;

- Relaxation of restrictions on the deductibility of soft costs;
- Allowing rental landlords to be eligible for the small business deduction; and,
- Clarification of the types of renovation work on rental properties which qualify for immediate deduction.

In particular, the CHBA strongly supports the government's commitment to allow deferral of capital gains taxes on the sale of assets when the proceeds are reinvested. This would be particularly beneficial for rental housing investment.

Prior to the introduction of the capital gains tax in the early 1970s, rental housing investors could defer the payment of taxes on recaptured depreciation on the sale of a rental property when the proceeds were reinvested in another rental property. This feature of the tax system facilitated the transfer of older rental projects from their original owners (often the developers) to new long-term investors and encouraged the development of new rental projects.

The elimination of this provision, plus the addition of capital gains taxes, has caused a situation where the owners of rental properties are discouraged from selling because of the tax consequences. The restoration of the ability to defer the tax liability on the sale of a rental property would be very beneficial to the operation of the rental market. It would provide owners of existing rental properties with the encouragement (and capital – from the sale of their properties) to reinvest in much-needed new rental projects. The taxes which would be payable on the sale of the properties would be deferred as long as the investors retain the newly-constructed properties.

This would address a long-standing problem in the rental market: there are many long-term investors (such as pension funds, life insurance companies, and Real Estate Investment Trusts) which would like to invest in the rental market, but prefer stable existing rental projects rather than assume the risks associated with new projects. However, the supply of existing rental projects is limited, mainly because the owners are unwilling to sell due to the tax consequences.

The planned initiative would 'unlock' the problem by providing an avenue through which the current owners of existing rental projects would be encouraged to sell and reinvest in new rental housing. Many of these owners are 'risk-takers' who developed the projects in the first place and tend to be more willing to take on the risks associated with building new rental projects. Unlocking their immediate tax liability upon sale of the projects (through deferral) would free-up existing rental stock for purchase by long-term investors, and provide the 'risk-takers' with the encouragement to build much-needed new rental housing.

*Capital gains tax and recaptured depreciation on the sale of rental housing should be deferred when the proceeds are reinvested in new rental housing projects.*

### ***The Deductibility of Land Carrying Costs Should be Restored***

The carrying costs which are incurred by home builders and developers on their land holdings must be capitalized and depreciated over time, rather than deducted as a business expense against current income for tax purposes. Prior to the changes to the tax system in the late 1980s, such

deductions were allowed as a business expense – now there is only a modest exception which allows builders with small land holdings to deduct their carrying costs.

The income tax treatment of home builders and developers with respect to the carrying costs of their land inventories contrasts with the treatment of other types of businesses (such as retailers) which incur carrying costs (e.g. interest payments) on their inventories. Other types of business which have inventories are allowed to deduct interest costs on these inventories in determining income taxes payable.

By requiring home builders and developers to capitalize the carrying costs of land holdings, rather than to treat them as a deductible expense (as occurs in other businesses which must carry inventories), the tax system raises the cost of land development and hampers orderly business planning for home builders and developers. The resulting higher costs must ultimately be passed on to home purchasers through higher prices.

*The deductibility of land carrying costs should be restored.*

## **2. Federal Infrastructure Investment**

Numerous reports over the past decade identify a physical ‘infrastructure gap’, mainly at the municipal level, totaling \$60 billion or more. This amount is required both to rehabilitate and/or replace ageing capital stock, and also to support new growth.

In the past, the federal government, the provinces and municipalities have all contributed to financing growth-related new infrastructure. This recognized the critical importance of infrastructure in facilitating growth and promoting prosperity – locally, regionally, provincially and nationally.

*All levels of governments benefit from growth through greater prosperity (and increased revenues). All governments should share in funding the infrastructure required to accommodate growth.*

The CHBA has long advocated that federal infrastructure funds should focus on four priorities: clean air; clean water; clean land; and efficient roads and transit. The aim should be to support healthy communities and economic growth on a sustainable basis, with measurable environmental, economic development, and housing affordability benefits from individual infrastructure projects and from whole infrastructure systems.

The May 2007 federal Budget contained over \$16.5 billion in additional infrastructure funding commitments. Total federal infrastructure investments will exceed \$37 billion in the years ahead.

The challenge now is to secure the greatest possible benefits from these local and regional investments in cooperation with provincial and municipal governments and with the private sector. New local infrastructure investments should benefit housing affordability and choice, for example, by opening up new land for development and assuring competitive land markets;

providing site services to enable brownfield sites to be safely and rapidly developed; creating opportunities for community rejuvenation; and, resolving bottlenecks in urban transportation networks.

*Priority should be given to local and regional infrastructure investments that sustain new urban growth, rejuvenate services to existing built-up areas, and reduce financial pressures on new home buyers. All of these will help ensure that there are tangible benefits from growth for new and existing communities.*

*To obtain maximum benefits, federal investment should emphasize water and sewer systems, roads, bridges, transit, and waste management. Benefits from these investments should be systematically monitored and reported.*