Intelligence MEMOS

From: Brian Lewis

To: Canada's ministers of housing

Date: August 28, 2023

Re: **No Time for Half Measures: Tax Policy Options to Grow Rental Housing**

A significant shortfall in housing supply is an urgent issue across Canada.

The need for rental housing is especially acute, especially because the current shortage and corresponding skyrocketing rents is particularly problematic for new entrants – young people and immigrants in particular – for whom it is the only feasible option. High rents and limited availability also raise concerns for low-income or otherwise vulnerable individuals who need to relocate.

The Ontario government has proposed opportunities to encourage creation of rental housing through the tax system. Specifically, the **province** has called on the federal government to defer the Harmonized Sales Tax (HST) on all new large-scale purpose-built rental housing projects. This deferral is unlikely to have a meaningful impact on the construction of rental housing. It would support cash flows temporarily – conceivably useful in some circumstances – but it would not have a meaningful net impact on costs.

Fortunately, Canadian governments could consider a wider range of better tax policy options that would generate a more meaningful increase in rental housing construction.

Governments could reduce or eliminate, rather than deferring, HST on rental housing projects. The existing New Residential Rental Property HST rebate, offered by the federal and many provincial governments, could be enhanced. By increasing the rebate percentage or adjusting the unit value thresholds, the program could offer more significant and effective cost relief towards rental housing costs, thereby encouraging investment and additions to supply. There is a particularly strong case for adjusting the threshold – stuck at $450,000 since 1991. It would be $851,300 if it had been adjusted for inflation, according to one recent C.D. Howe Institute **study**, which would translate into $52,169 in HST savings for most Ontario new home buyers.

Another option would be to halve the proportion of rental income included for income tax purposes, improving the after-tax return on investing in rental income properties and providing a powerful incentive for investment given the prevailing high marginal tax rates on personal income. This incentive would be comparable to the tax treatment of capital gains income, upon which a 50-percent inclusion rate is applied to encourage investment in long-run capital growth rather than short-term returns. In the case of rental properties, favourable tax treatment would be a way to offset the unintended consequences of extensive government regulations on the pricing and use of investment in these assets. From a public policy perspective, rental housing presents a solid case for favourable tax treatment, even stronger than the case for capital gains.

Reduction or elimination of current restrictions on applying capital cost allowance (CCA) deductions from income is another possible tool. Specifically, allow the full deduction of the CCA for investors without existing rental properties rather than limiting it to the amount needed to reduce net rent income to zero. Taking this approach to CCA deductibility would allow new investors in rental projects to deduct a net rental loss from other income.

An investment tax credit offered on the construction of rental housing is also an effective way to lower construction costs and boost supply. Investment tax credits are currently in place for a wide variety of purposes, including, for example, **clean investments**, new buildings, machinery, and equipment in the Atlantic region, certain mining expenditures, and creating licenced childcare spaces for employees, **among others**. In all instances, these policies encourage investment in areas that are public policy priorities. Surely the need for rental housing supply calls for similar treatment.

The federal government could also consider a tax exemption for the capital cost recapture and capital gain on the disposition of a rental property rolled over into new investments. This policy would encourage the re-investment of capital gains into rental housing while removing the current disincentive to dispose of assets related to capital cost allowance recapture.

Tax incentives could be calibrated in a way that supports other policy goals. To support building of environmentally sustainable and affordable housing units, governments could provide a more significant income tax exemption, or a relatively higher investment tax credit could be provided. Incentives could be scaled based on the proportion of units that meet these goals. For example, projects with over 50 percent affordable units could get a 100-percent exemption, 25 percent a 75-percent exemption with 10 percent getting 60 percent.

Increasing the supply of rental housing requires bold and meaningful policy actions. For example, Ontario **has taken** many steps to reduce regulatory obstacles and induce municipal cooperation. Meanwhile, labour shortages also need addressing for any chance of meeting the provincial target. Investment also needs to increase sharply, and there are opportunities to significantly encourage that through the tax system. Unlike the largely symbolic impact of HST deferrals, tax policy options are available to the federal government that could generate a meaningful rental housing supply response. Given the significant need for and challenges related to rental housing supply, this is no time for half-measures.

Brian Lewis is a senior fellow at the C.D. Howe Institute and the Munk School of Global Affairs and Public Policy and former Chief Economist for Ontario.

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