Intelligence MEMOS

From: Jeremy M. Kronick and Alexandre Laurin

To: Real Estate Watchers

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Re: **How Capital Gains on Housing Won't Cool the Market**

The housing market is hot, and has been for several years, especially in Canada's largest cities. Many policy attempts and proposals have been made to slow it down, almost always focusing on the demand side. The latest entrant is a capital gains tax on principal residences.

The argument for taxing capital gains on the sale of owner-occupied principal residences is twofold. First, the argument goes, the tax will decrease demand, putting a stopper on illogical price appreciations. Second, governments are starved for tax revenue, and taxing these gains would help fill that gap.

In practice, however, neither of these is likely to play out as expected.

In some ways, taxing the gains on the sale of principal residences seems logical. After all, the capital gains on the sale of all other residential properties are taxable – over and above the purchase price, transaction costs and home improvement expenses. Moreover, capital gains on investment assets such as stocks and bonds are also taxable on disposition (with the exception of registered retirement savings and TFSAs).

It is also true, however, that the tax exemption for principal residences significantly lowers the cost of relocating to another owner-occupied home. Taxing the capital gains would increase the cost of moving to another home, resulting in some people choosing to stay in their current homes rather than relocate. For others needing to relocate, renting their current home and becoming renters themselves elsewhere may become a more tax-advantageous option – benefiting from the fact that owners who rent their homes can deduct mortgage interest and property tax from their income, unlike owner-occupied homes.

Either way, the capital gains tax would then have a negative impact on supply (new listings), offsetting gains on the demand side. The desired reduction in housing prices would not be realized – and at worst, house prices could increase.

The US does have a principal residence capital gains tax (albeit with a sizable $500,000 exemption), but also allows for the deduction of mortgage interest payments and property taxes from taxable income. One option, then, would be to follow that model and make mortgage interest payments and property taxes deductible. However, the impact on house prices is unclear, as the net impact on demand and supply is ambiguous, with one tax preference replacing another. But perhaps more importantly, the tax revenue boon from the capital gains tax would not materialize, as new revenues would at least partially (if not entirely) be offset by the fiscal cost of housing deductions.

Another option would be allowing no such deductions and instead providing a sufficiently high capital gains tax exemption so that only few people are affected – but what is the point of seriously complicating the tax system for a few additional tax dollars? Moreover, any exemption based on house value brings back the demand at the bottom end of the market – precisely the segment where we are trying to ease affordability.

Finally, many are counting on the value of their principal residence to fund their retirement – most have not kept track of the cost of home improvements over the years, because they didn't have to. To be politically palatable, any consideration of a capital gains tax on principal residences would have to be accompanied by an adjustment to the cost base for existing homes equal to their current market value, so that only future capital gains become taxable. The result: big benefits to those who already own homes – not so much for the next generation of homeowners who would end up paying for the tax.

The reality is that taxing the gains on principal residences is unlikely to make housing more affordable.

Even a more realistic proposal for taxing those gains, allowing US-style deductions, would still have an ambiguous impact on prices and likely not raise any new net tax revenues. And, for practical reasons, the tax would likely have to be restricted to future gains only, meaning our kids would be the ones paying for it.

Taxing capital gains on principal residences will not save the day.

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