

Economics

IN FOCUS

April 24, 2024

Still work to be done to spur rental supply

by Benjamin Tal benjamin.tal@cibc.com

Governments at all levels are finally treating the housing affordability crisis with the urgency it deserves. The latest federal budget produced the most aggressive array of housing policies seen in generations.

The decision to tackle the demand side of the equation by capping the number of non-permanent residents is a giant step in the right direction and will go a long way to bring population growth closer to its long-term average. Governments are also showing more openness to the notion that an effective and long-lasting solution would be to dramatically change the role of rental activity in the country's housing mix. Simply put, the propensity to rent in Canada must rise, and the market should realign to increase the supply of rental units. Better availability of low-cost financing for purpose-built rentals along with the recent removal of the GST/HST on the construction of rental units are already starting to change the math for a growing number of developers.

But that's not enough. Here are two changes that would have an even bigger impact. The first is the treatment of the capital gains tax upon the sale of a commercial property, such as an apartment building. In the US, 1031 exchange is a mechanism whereby a gain on the sale of a commercial real estate asset may be deferred for tax purposes by acquiring a new "like-kind" property. That reinvestment incentive can be used by investors of all types: individuals and trusts to businesses of all sizes. The logic here is that US developers have an incentive to pour the receipts from selling off one project into new real estate investments to defer paying capital gains taxes, encouraging funds to remain in the sector. Importantly, companies that don't develop new real estate projects but merely improve existing properties and sell them and "flippers" cannot take advantage of a 1031 exchange — their real estate is considered inventory and is specifically excluded from tax-deferral treatment under the Code.

A 2022 study by Ernst and Young quantified not only the direct impact on US taxpayers engaged in 1031 exchange, but also the additional stream of indirect economic activity. Overall, 1031 exchange generated close to an estimated 600,000 jobs, \$30

billion of labour income along with \$55 billion in value added GDP in 2021. In addition to contributing to federal, state and local tax revenue due to increased activity, the study found that the Code works to reduce the cost of capital and therefore increases capital spending in a faster and more efficient way.

Unfortunately, with some exceptions, that mechanism does not exist in Canada. The current tax environment in Canada discourages such dynamism. Adopting the US model would not only incentivize the development of rental units in Canada but also, at the margin, it would improve economic growth and efficiency.

Another way to dramatically increase rental supply is to rely heavily on the concept of a secondary rental suite. The Government of Canada intends to introduce a Canada Secondary Suite Loan Program, enabling homeowners to access up to \$40,000 in low-interest loans. That's a positive development. But what we really need are incentives for developers to build homes with secondary suits. This would result in a gradual change in our current collective mindset into one that treats the house as a money generating business by adding Accessory Dwelling Units (ADUs) to the property.

The opportunity to build new and renovate existing houses with legal ADUs, or basement apartments, is a win-win-win-win. Win number one is the homeowner's affordability as rental income supports the mortgage payment. SVN Rock Advisors, which formalized that concept in a recent book series titled "The Self-Funding House", estimates that the income requirements for mortgage qualifications can drop by 30%-60% depending on the living arrangements chosen by the owner. Win number two is for the renter, since the average rent on those units is estimated to be 20% lower than that of conventional apartments. Win number three is for the environment, since existing infrastructure is getting both a house and rental in the footprint of one house. Win number four is safety, as those new units will be built to code as opposed to many existing secondary units where safety is unfortunately compromised.

Granted, this is not exactly optimal. Home buyers would ideally prefer not to be landlords. But we do not live in an ideal world. The reality is that given the fundamentals of the housing market, the choice is increasingly between a self-funding house or no house at all. Common sense suggests that demand for such units will only rise. Developers will have a golden opportunity to capitalize on this trend by constructing rental-ready houses or rough-in for future implementation. The concept is already being tested successfully by major developers in areas such as the Niagara region, Ottawa, Southwestern Ontario, and Alberta.

Adopting the 1031 exchange mechanism in Canada, and increasing reliance on the self-funding house concept are two additional ways to put a big dent in the millions of new homes needed by 2030.

Contacts:

Avery Shenfeld
avery.shenfeld@cibc.com

Benjamin Tal
benjamin.tal@cibc.com

Andrew Grantham
andrew.grantham@cibc.com

Ali Jaffery
ali.jaffery@cibc.com

Katherine Judge
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
[Bloomberg @ CIBC](#)

economics.cibccm.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2024 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license.