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