WORKING GROUP REPORT

Tax Treatment of Real Estate Gains

FAIR TAX • COMMISSION • DE L'ÉQUITÉ FISCALE

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SUBMISSIONS

1 Membership List

Membership List

Penny Bethke	Executive Director, Labour Council Development Foundation
Patrick Boyle	Partner, Fraser & Beatty
Cheryl Craig	Owner, Cheryl Craig Careers and Member of Board of Directors, Ontario Chamber of Commerce
Mitsi d'Souza	Case Worker, Centre For Equality Rights and Accommodation
Philip Dewan	President and CEO, Fair Rental Policy Organization of Ontario
Jim Flood	Director of Government Relations, Ontario Real Estate Association
Peter Goldthorpe	Director of Information and Legislative Services, Ontario Home Builders' Association
Michael Kainer	Partner, Sack, Goldblatt, Mitchell
Bruce Lewis	Partner, Lewis & Collyer
Robert MacKenzie	President, MacKenzie and Associates
Robert Poirier	Broker, Royal LePage Real Estate Services, and Secretary, Federation of Agriculture (Glengarry County)
Ted Robinson (Chair)	Commissioner, Planning and Development Department, City of Ottawa
Leslie Robinson	Law Reform Director, Metro Tenants' Legal Services
Sheldon Silver	Partner, Goodman & Goodman
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Fiona Stewart	Co-ordinator, Affordable Housing Action Group

1a Government Participants

Government Participants

Anne Guthrie	Policy Advisor, Taxation Policy Branch Ministry of Treasury and Economics
George Hough	Policy Advisory, Housing Policy Branch Ministry of Housing
Barbara LaVasseur	Legal Services, Assistant Deputy Minister's Office Ministry of Consumer and Commercial Relations
David Roote	Director, Special Projects Ministry of Revenue
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2 Final Submission Supported By:

- Cheryl Craig
- Philip Dewan
- Jim Flood
- Peter Goldthorpe
- Robert Poirier
- Ted Robinson
- Sheldon Silver
- Larry Smith

WORKING GROUP: TAX TREATMENT OF REAL ESTATE GAINS

The group was established by the Treasurer to address the following questions:

> Does the current tax treatment of real estate transactions ensure that a fair share of speculative profits are taxed. If not, what improvements to the existing tax treatment could be made or what additional taxes could be introduced.

The group consisted of individuals with different backgrounds and represented a wide range of interests and opinions. In dealing with the Treasurer's questions, the group identified and discussed four main policy issues:

(a) the effect of the current tax treatment of real estate transactions on the affordability of real estate;

(b) the effect of tax policies on speculative behaviour;

(c) the revenue raising potential of a special tax on real estate gains; and

(d) opportunities to enhance fairness in the tax system.

A. Current Tax Treatment

(i) Current Tax Rules

Under current rules, gains derived from the sale of real estate are, with two exceptions, taxed in the same manner as gains derived from the sale of any type of property. If the real estate disposed of is inventory or a trading asset in the hands of the taxpayer, any gain realized on the disposition of the asset will be taxed at full individual or corporate rates. Any loss realized on the disposition will be deductible in the computation of income. For individuals, the combined federal and Ontario tax rate in 1991 on income in excess of $83,633 was 49.11%. For corporations, the effective combined federal and Ontario tax rate in 1991 was approximately 44.3%.

If the real estate disposed of constitutes capital property in the hands of the taxpayer, 75% of any gain realized on the disposition of the asset will be taxed at full individual or corporate rates. If the taxpayer realizes a loss on the disposition of the property, 75% of the loss can be deducted, but only from capital gains. Losses incurred in connection with the disposition of capital property cannot be deducted in computing income from other sources, eg. business, employment or professional income.

Whether a gain or loss from the disposition of any property, including real estate, is to be treated as a capital gain or loss or as ordinary income or loss, will depend on the intention of the taxpayer when the property was acquired. If the taxpayer intended to use the property for investment purposes, the property will be treated as capital property. If the taxpayer intended to trade in the property, that is, to make a profit by disposing of the property rather than by holding it, the property will be treated as a trading asset or inventory. In determining what the taxpayer's intention was, a number of factors, including the length of the period of ownership, the frequency of similar transactions, the reasons for sale and the financing of the property, will be taken into account.

Exceptions

One exception is the exemption from tax for gains derived from the sale of a principal residence by an individual taxpayer. This exemption applies only to the sale of a principal residence and not to any other type of property.

The second exception is created by the recent change in the $100,000 lifetime capital gains exemption. It should be noted that this exemption will no longer apply to real estate gains accruing after February 25, 1992 or to gains realized on real property acquired after February 29, 1992.

It should also be noted that there is no provision in the *Income Tax Act* (Canada) permitting a taxpayer who disposes of real estate to elect to treat any gain derived from the sale as a capital gain. Such an election is available to a taxpayer who disposes of Canadian securities.

(ii) Tax Administration

Personal income tax is levied under the *Income Tax Act* (Canada) and the *Income Tax Act* (Ontario). Tax on corporations is levied under the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario).

Since 1962, Ontario and all other provinces except Quebec, have had their personal income tax collected under the provisions of the Federal-Provincial Tax Collection Agreements. By this arrangement, the federal government, via Revenue Canada, Taxation, is responsible for personal income tax administration and collection for all member provinces. In return for this service, the provinces covenant that provincial personal income tax legislation and regulations will conform to federal statutes, regulations and interpretations.

While most provinces have their corporations taxes collected under the authority of the Federal-Provincial Tax Collection Agreements, Ontario administers and collects its own corporations taxes. Even so, the federal and Ontario statutes, regulations and interpretations conform in most respects.

B. Current Economic Environment

The group spent some time discussing current economic conditions in the province of Ontario and there was a strong perception that the economy had deteriorated from the time the group was convened by the Treasurer in the summer of 1991 to the date of this report. All economic indicators at both the federal and provincial levels would suggest that the Ontario economy is in a state of serious recession. Added to this problem is the fact that federal and provincial government annual deficits are very high. As well, government debt at both levels is at an all-time high.

It is clear that the high level of government debt and budgetary deficits will impede governments in their attempt to stimulate the economy. At the same time, attempts to raise revenue through fiscal measures is generally regarded as counter-productive for the economy. In its February 1992 Budget, the federal government actually reduced tax rates and enriched certain investment incentives.

It would appear that current economic conditions have had a profound effect on the real estate market and may have fundamentally altered traditional expectations and relationships. It is not uncommon to find that real estate values in both the residential and commercial sectors have fallen 25% to 40% over the last two years. The federal government has recognized the poor condition of the residential real estate market and, in its February 1992 Budget, permitted individuals to withdraw $20,000 from RRSPs for the purposes of acquiring a house. It also reduced the down-payment requirement to 5% for properties that qualify for NHA mortgage insurance.

Quite apart from current economic conditions, it is unlikely that we will see a return to the boom period that characterized the real estate market in the second half of the 1980s.

That boom began with pent-up demand from 1981-2 recession. This was quickly augmented by the entry into the market of the baby boomers and high levels of immigration. The level of demand that resulted from these factors was then magnified by unprecedented growth in income and real growth in Ontario's economy. All this, in turn, gave rise to a period of relatively high inflationary expectations.

While the current recession may have created some pent-up demand in the market for residential properties, there is no corresponding demand for industrial and commercial real estate. In fact, there is ample evidence that there is a significant over-supply of commercial and industrial real estate in Ontario. This will mean that there will be adequate resources to meet any increased demand for housing. As well, high real rates of interest and the emergence of the baby-bust factor mean that the demand of the 1980s will not be repeated in the 1990s. In addition, recently released figures indicate that the rate of inflation is less than 2%.

C. Speculative Behaviour

The group looked both at whether or not speculation as such should be discouraged and at the potential effectiveness of using the tax system to do so. It also addressed the question of how one might define speculation sufficiently clearly for use in defining a potential tax base.

To the extent that speculation exists, it has both positive and negative influences. On the positive side, speculation increases liquidity and enables a hedging of risks. It increases liquidity by increasing the number of buyers and sellers in the market. It reduces risks by enabling developers to hedge the risks associated with carrying costs. Associated with this is the argument that speculation contributes to the maintenance of a larger inventory of housing on the market. For example, the practice of pre-selling, which is often cited as speculation, reduces builders' financial risks and thereby reduces the required rate of return and hence, housing prices, and encourages the expansion of the housing stock.

On the negative side, speculation may magnify the boom and bust cycle in the real estate market by increasing the volatility and level of housing prices in the short run. Under some circumstances, speculation may also contribute to tenant nervousness and increase rates of household turnover.

The group found that purely speculative activities could, generally, not be isolated from the ordinary business and investment activities of taxpayers. Furthermore, there was no evidence brought before the group to suggest that there was any significant or undue speculative behaviour in the Ontario real estate market today. There is, therefore, little basis for introducing anti-speculative legislation since there are few benefits to be gained, but significant potential long-run costs associated with such legislation.

D. Revenue Generation

After examining the revenue implications of special taxes on real estate gains in Ontario and other jurisdictions, the group concluded that these taxes generally raised little revenue. They also observed that such taxes were often subsequently rescinded. The group reached no conclusions as to the revenue potential for any new taxes.

The group also noted that the goals of revenue generation are fundamentally at odds with goals of eliminating speculative behaviour.

E. Affordability of Real Estate

The tax system can also be used to influence housing affordability. This can be done through the provision of tax incentives to encourage demand or supply, or through the provision of tax disincentives to discourage activities which may reduce affordability.

Positive tax incentives can take many forms. These include such existing incentives as no tax on imputed net rent and no tax on capital gains on a principal residence, and capital cost allowance in excess of economic depreciation on residential investment properties, as well as the recently proposed ability to withdraw RRSP funds on a tax-free basis for home ownership. They also include such potential incentives as mortgage interest deductibility and property tax deductibility for principal residences, and the use of tax-free home ownership savings plans; accelerated depreciation and expensing currently capitalized construction costs on residential investment property; and equalizing property taxes on rental and home ownership housing. Tax incentives operate by increasing the flow of resources to the housing sector. Such incentives are appropriate if market imperfections inhibit the optimal allocation of resources to housing, if positive externalities in housing consumption exist and are unexploited, or if housing policies are used as a "second-best" solution for income redistribution. No evidence was presented to the group to indicate additional tax incentives are required for these reasons, or to indicate insufficient resources are being devoted to housing.

Negative tax incentives can be used to discourage a variety of activities which may be thought to reduce affordability, such as monopoly or oligopoly concentration of ownership and speculative activities. No clear-cut evidence was presented to the group to establish a precise link between these activities and housing affordability. Under certain circumstances, speculation can increase short-term volatility in the housing market and increase housing costs over part of the housing cycle. Any such increase in house prices is temporary and self correcting, and may be counter-balanced by the additional liquidity such behaviour provides. To the extent that positive speculative holdings exist, housing prices may also be higher in the long run if new construction costs increase with the stock of housing. This effect, however, is unlikely to be significant in the long run because supply will expand to compensate for this demand. Finally, even if speculative activity increases housing costs during the final stages of a housing boom, no evidence was provided to indicate that the benefits from curtailing this activity warrant the long-term costs associated with the loss of liquidity in the market. Consequently, we do not recommend any additional negative taxes to attempt to enhance housing affordability.

F. Special Real Estate Taxes in Ontario and Other Jurisdictions

The group investigated experience and practice in taxation of real estate gains in Ontario and other jurisdictions. The goal of this aspect of the group's work was to identify lessons from the experience of other jurisdictions that might be relevant to the taxation of real estate gains in Ontario.

The group identified and investigated in general terms precedents for special taxes on speculative-type real estate gains. It found that special taxes on real estate gains had been enacted in the past in Alberta (1913 to 1951) and Ontario (1974 to 1979) in Canada and in Great Britain (1967 to 1971) and Australia (New South Wales, 1970 to 1973). Current special taxes on real estate gains are found in Vermont (since 1973) and in Japan (Tokyo) and Taiwan.

In general, the group found that these taxes were in effect for relatively short periods of time, raised relatively little revenue and were administratively complex. Although conjectures might be made about the reasons for the early repeal of these taxes (little revenue raised; end of the price boom that led to their establishment; change of government) the group was not able to identify in the literature any clear evidence that points either to success or to failure of these taxes.

The group also concluded that special circumstances in Vermont (concern about massive out-of-state development) and in Japan (Tokyo) and Taiwan (High urban density and extreme price pressures) limited any value these precedents might have for such a tax in Ontario.

G. Fairness

The group examined the concept of fairness in the context of three general principles: horizontal equity, vertical equity and social equity.

With respect to horizontal equity, the group was generally of the opinion that the current tax treatment of real estate gains largely satisfies this requirement. The new restriction on the ability of taxpayers to utilize the capital gains exemption in connection with real estate gains, however, places vendors of real estate (other than principal residences) at a serious disadvantage as compared to other taxpayers. Some members of the group expressed concern about this inequity and exception to the concept of horizontal equity.

With respect to vertical equity, the group was again generally of the opinion that this requirement is largely satisfied by the current tax treatment of real estate gains as provided for in the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario) since higher-income households pay proportionately more tax than lower-income households with respect to gains on real estate.

For the most part, the issue of fairness focused on the concept of social equity, and it was in this area where there was the greatest differences of opinion. This issue subdivided into three more specific concerns. One had to do with the nature of land, another with factors that contribute to rising land values and the third with housing affordability.

With respect to the nature of the land, some members of the group were of the opinion that, for a number of reasons, land is a unique commodity and that this uniqueness should be reflected in special tax treatment. Other members emphasized the fact that land, like all other commodities, is developed by private enterprise in the context of a free market. It was concluded, therefore, that special (i.e. harsher) tax treatment in the absence of other fundamental changes in the development process would result in severe market distortions and hardship for the general public.

Some members of the group expressed the opinion that increases in the value of real estate result from public investment and/or community action (i.e. zoning changes, publicly-funded infrastructure, etc.). It was suggested that this could justify a special tax on real estate that returns a portion of the increase in value to the community. Other members suggested that current profit margins compensate for risk that results from the vagaries of government standards, policies and regulations. As well, appreciating real estate already yields additional revenues through the process of reappraisal to market value in the property tax system.

The group addressed the issue of housing affordability from two distinctly different perspectives. One dealt with using the tax system to lower prices and the other involved utilizing the capacity of the tax system for wealth redistribution.

With respect to lowering prices, the general conclusion was that a special tax on real estate gains would not result in lower long-term price levels. Under some circumstance, special tax treatment may smooth the peaks and valleys of boom/bust cycles but the group was concerned about the long-term costs that could attend this short-term benefit. With respect to wealth redistribution, it was the general opinion of the group that the net revenue generating capacity of a special tax on real estate gains was so low that no significant wealth redistribution would be possible.

<u>RECOMMENDATIONS</u>

The Treasurer has asked whether the current tax treatment of real estate transactions ensures that a fair share of speculative profits is taxed.

The group considered, primarily, the current tax treatment of such gains, the current economic conditions and the effect of speculative behaviour on the affordability of real estate.

With respect to the current tax treatment of real estate gains, the group could find no significant distinctions between the current tax treatment of such gains and the current tax treatment of gains from the disposition of other types of property. The exceptions are the treatment of principal residences and the new restriction on the applicability of the capital gains exemption to real estate gains.

With respect to the current economic environment, the group concluded that there is no evidence of any significant speculation in real estate in Ontario today. Furthermore, the evidence that was available indicated that the inflationary pressures of the 1980s were not likely to recur in the 1990s and that, consequently, real estate speculation should be of relatively little significance in the foreseeable future.

In any event, there is considerable doubt as to whether speculative activity has any significant net adverse consequences even when it does exist in the economy. Since both in the United States and at the federal level in Canada, governments have been prompted to introduce measures that will increase real estate activity, the introduction of negative incentives in the real estate sector would appear quite inappropriate at this time.

Governments have, generally, recognized that a healthy and viable real estate market is fundamental to the preservation of financial institutions and private capital.

In the light of these findings, it is the recommendation of the majority of the group that there should be no change in real estate taxation that causes a different tax treatment for real estate and other assets, and that under the current economic conditions, there is no justification for an increase in the tax burden on real estate transactions. Inequities in the current tax system undoubtedly exist. There is no evidence, however, that such inequities are peculiar to real estate or that taxpayers who realize gains on the disposition of real estate have an advantage over other taxpayers.

Consequently, the majority of the group recommend no change in the existing tax treatment of real estate gains. There may be some justification in a re-examination of the federal and provincial systems of taxation in order to determine whether the interests of all Canadian are being served although, even in this context, the current economic conditions in Ontario and Ontario's competitive position in North America must, at all times, be recognized.

March 23, 1992.

2a Appended letters from:

- Ted Robinson (Chair)
- Cheryl Craig
- Philip Dewan
- Jim Flood
- Robert Poirier
- Larry Smith

March 24, 1992

The Honourable Floyd Laughren
Treasurer of Ontario and
Minister of Economics
Ministry of Treasury and Economics
Frost Building South
Queen's Park
Toronto, Ontario
M7A 1Y7

Dear Mr. Laughren:

Subject: Fair Tax Commission - Tax Treatment of
Real Estate Gains Working Group

As requested, I have attempted to consolidate the various points of view that exist within the Working Group. Unfortunately, your request for all positions to be sent to you directly has no doubt created some confusion as I understand minority positions, personal opinions, and working papers have already been sent to your office. I trust that I can clarify some of the confusion that currently exists or that may occur.

At the outset, I would like to express my concern that the Working Group has not been able to follow the prescribed process. I would have preferred to finish our process as originally established, by identifying clearly the areas of agreement (which I might add are many) and submitting the total package to the Fair Tax Commission for comment. I believe the first half of the letter you received from Patrick Boyle (copy attached) accurately describes the disappointment and frustration by many of the Working Group members of your most recent action. As this has been a very complex process, I would be pleased to brief you personally on all aspects of the process to date, our findings and conclusions, so that you can fully understand the background to the various positions.

SUMMARY:

The first major objective of the Working Group was to seek consensus so that a clear position could be put forward to allow you the opportunity to take appropriate and meaningful action. Considerable time was spent seeking that consensus. We attempted to achieve it by trying to increase the general knowledge level of all Working Group members to allow them to fully understand some of the basic tax policies that currently exist. To assist in this area, extensive readings on related subjects were made available, guest speakers were scheduled on a regular basis, submissions written by interested parties were circulated to all members when received and finally, information was shared by the more knowledgeable members of the group through stimulating discussions. It was my objective to have opinions based on knowledge and fact, rather than just those that are based on "gut feel" or personal philosophy. Unfortunately, most of the position papers that are presented to you contain a mixture of both.

With respect to the submissions, you will find that the first paper prepared by Sheldon Silver et al, represents the opinion of a majority of the active members of the Working Group and it recommends no tax options at this time. It most closely reflects the process followed by the group and addresses nearly all of the issues raised.

The second paper prepared by Marion Steele has elements that could lead to a compromise position. Unfortunately, two components of her report (one which dealt with principal residence and the other regarding timing) were of major concern to a number of members. I was advised by staff that she was originally willing to modify those two areas but is now out of the country. I wanted to (and still wish to) work on her report but it requires waiting until she returns at the end of the month. This would mean that the report would not be finalized until mid-April which is unacceptable to you.

The third paper is a more extreme pro-tax position of Marion Steele's paper. It probably best represents the problem that we had in reaching a consensus. While many of the concepts presented were reviewed in detail at numerous meetings, these firmly held opinions were not supported by documents, accepted philosophy or expert opinion which would enhance their validity.

The last paper contains opinions that were expressed at the onset of the process. The Working Group did its utmost to try to accommodate these concerns. For instance, we divided the main Working Group into smaller, specialized caucuses to allow for freer expression of ideas and questions. We also requested formally and informally guest speaker lists or topics which would best deal with their specific concerns. Finally, we called a special meeting to address one of their major concerns centred around native rights and philosophy. Unfortunately none of the three attended and the speaker that they had invited did not show. They refused to attend any meetings after that point.

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CONCLUSION:

As a process, I feel that the Working Group concept that provides the opportunity for a lay person such as myself to get involved in tax policy is an excellent one. Our Working Group for the most part worked hard, heard and learned a great deal and was commited to a quality final product. We were also fortunate to have Matthew Akman, an able staff person of the Fair Tax Commission available to us. We found him to be very hard working who often had to work weekends and long hours to get us the information that we needed to progress to the next step. While we do not have a final position that all of us can sign, I feel the process has generally been a rewarding one for the majority of people who participated.

With respect to my own opinion, I was leaning towards the paper written by Marion Steele but was not able to resolve the principal residence and timing areas contained in the latter part of her report. I am particularly concerned that a tax on principle residence at this time would run counter to the recent budget initiatives of the Federal Government through the RRSP program for home ownership and efforts of Premier Rae who had requested similar action. Consequently, I am left with no other option than to support the paper written by Sheldon Sivler et al. I do so with the belief that this report is the one that reflects most of the issues discussed, is founded on fact and research, and is not as influenced by personal opinion as the other positions.

Thank you for inviting me to participate in the Working Group. I found it to be a fascinating, rewarding, and challenging experience, and should you need my services again in the future, I would be more than happy to assist.

Yours truly,

E.M. Robinson
Chair
Tax Treatment of Real Estate
Gains Working Group

Attachment

c.c. Working Group Members
Ms. Monica Townson
Mr. Matthew Akman

Cheryl Craig
CAREERS
"The resourceful people in human resources."

20 March 1992

Mr. Ted Robinson, Chair
c/o Mr. Matthew Akman
Real Estate Gains Group
Fair Tax Commission
1075 Bay Street - 6th Floor
Toronto, Ontario
M5S 2B1

"BY COURIER"

Dear Ted:

Enclosed is a copy of a document which I submitted to the Group in December, and a copy of the report drafted by Silver, Smith, Flood and Goldthorpe, which I support. It is apparent to the reader that the two documents convey the same message.

I have a concern regarding the process of the Real Estate Gains Group which is threefold, and the issues are interrelated:

(i) Length of the process;
(ii) Absenteeism;
(iii) Lack of financial compensation.

The process was to be completed by October '91, the delay was caused to some extent by absenteeism. Absenteeism, in some cases, was the result of the length of the process. People who are not receiving remuneration for their time, sometimes believe what they are doing has little or no value, and they tend to be less conscientious towards the task and/or other more pressing matters take precedence.

May I suggest that it is an unrealistic expectation, to expect businesses, and other organizations to underwrite the cost of a political and/or governmental process.

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A Division of C.D. Craig Enterprises Inc.

Essentially, I am a self-employed (hands on owner/manager), single parent. The fixed costs associated with my home/family, and my business, are my sole responsibility. If my time is sought and I am unable to obtain some form of financial compensation, my business and ultimately my family will suffer. I would appreciate it very much, if some form of financial compensation for my time was provided when I am removed from my normal revenue generating activity. If in the future this was not the case, I could not afford to participate.

Ted, I hope my input has been helpful. It was a pleasure to meet, and interact with, members of the group. I wish to thank the staff, who were most supportive.

Yours truly,

Cheryl Craig

Cheryl Craig,
Committee Member

Encl.

Copy of letter and documents to:

Mr. Floyd Laughren
Treasurer of Ontario and
Minister of Economics

CC/pc

FAIRTAX DOC. DEC. 10/91

TAX TREATMENT OF REAL ESTATE GAINS.

The question asked by the Treasurer was:

"DOES THE CURRENT TAX TREATMENT OF REAL ESTATE TRANSACTIONS ENSURE THAT A FAIR SHARE OF SPECULATIVE PROFITS ARE TAXED? IF NOT, WHAT IMPROVEMENTS TO THE EXISTING TAX TREATMENT COULD BE MADE OR WHAT ADDITIONAL TAXES COULD BE INTRODUCED?"

In addition, the FAIR TAX COMMISSIONERS asked:

"WHAT POLICY INSTRUMENTS (TAX OR REGULATORY) COULD BE EXPANDED OR ENACTED TO IMPROVE ON THE CURRENT TREATMENT OF LAND SPECULATION REAL ESTATE GAINS?"

The question which was asked but not discussed (however, in all fairness, I was unable to attend all meetings) was:

"IF A REAL ESTATE GAINS TAX IS INTRODUCED WHAT FURTHER NEGATIVE IMPACT WILL IT HAVE ON BUSINESS AND CONSUMER CONFIDENCE? WHAT KIND OF IMPACT WILL REDUCED CONFIDENCE HAVE ON THE ALREADY DEPRESSED ONTARIO ECONOMY? HOW WILL THAT NEGATIVELY IMPACT ON OTHER TAX/GOVERNMENT REVENUES?"

Outlined below are my comments in point form.

1. My answer to the Treasurer's original question is.."yes, real estate transactions are being taxed fairly". Land Speculation Taxes previously implemented cost more to collect than was collected, and in most cases the normal market cycle took care of the speculative activity.

2. Every time an additional 1% cost is added to the price of a home, people on the bottom 5% of the market are no longer able to afford to buy a home.

3. People driven from the home ownership market remain in the rental market. Consequently, there is downward presure on the rental market. Those people at the bottom end of the rental market are further disadvantaged.

4. If the need to increase government revenues is the reason behind implementation of a real estate gain tax, there are other ways to improve government revenue. (This will be expanded upon below.)

5. If the need to produce more affordable housing is the reason behind implementation of a real estate gain tax, there are other ways to do this without adding a new tax. (This will be expanded upon below.)

6. If the need to control land speculation is the reason behind implementation of a real estate gain tax, it has already been proven, it does not work.

7. If the government goal is to increase revenues, it will not do this by increasing taxes. Fewer funds are left in the hands of the wealth creators, be they employees or employers, reduces disposable income. A higher level of disposable income results in consumer confidence. Consumer spending occurs and governments reap the benefits through increased volume of corporate and personal tax revenues.

8. Affordable housing can be achieved through co-operative efforts of the public and private sector. Tax dollars are already over committed. If private investors can be assured of a stable period of legislation and achieve a reasonable return on investment, they will invest in rental housing. If the supply increases, prices tend to stablize.

9. The easing of restrictions on "in-fill housing", these are housing units over stores, or basement apartment in private homes, could have the effect of providing additional units to the rental market. (Don't you remember that first apartment you had when you first left home?)

10. Development costs and the length of time it takes to bring a project on stream, have become so high, many smaller builders have been driven from the market. Consequently, development has fallen, by economic default, into the hands of a few large corporations. Development costs have driven up the price of affordable housing and governments have to seek ways to reduce the costs they have created. Again, a partnership must beformed to meet these challenges.

11. Speculation is not necessarily a bad thing. If investors see ways to earn a better return on their capital by "speculating" on land deals, when, in the long run society as a whole benefits because of this investment, that is a strong positive. Speculators assemble lands that later are carried through the development process. Later these projects become industrial/commercial properties or homes. The government has not tied up taxpayers funds and will actually recieve revenue during the pre-development and post-development process. Businesses have proper facilities provided and people have homes in which to live, and they all pay taxes in various forms to governments as well

RECOMMENDATIONS:

I strongly recommend that no new tax be implemented at this time. I strongly recommend that a sincere effort be made to understand the need to allow the private sector to do the job that has to be done. Governments should be removing road blocks, reducing taxes and simplyfying the tax system, to encourage private investment. Our economy will improve and we all will enjoy an improved quality of life. Let's learn from the lessons of Eastern Europe.

CHERYL CRAIG

Real Estate Gains Tax Committee
Fair Tax Commission - Ontario

ADDENDUM

As indicated by my signature on this report, I am in fundamental agreement with the analysis and recommendations of the document. However, there are a number of comments and recommendations which I would have liked to see included. Given the unreasonable directive by the Treasurer on March 16, 1992 that Working Group members choose between the draft reports as available at that time and submit final comments by March 23, 1992, there was not time to consider the integration of these comments with the main report.

In the course of our deliberations, the Working Group discussed on several occasions a concern that a more restrictive tax treatment of real estate gains as they effect residential rental properties could lead to higher rents for tenants in the province. This discussion is referenced in the separate report drafted by Professor Marion Steele when she notes that some group members believe "that a tax on *long-term* gain would tend to reduce affordability for renters in the long run, by reducing the long-term attractiveness of investment in real estate to investors." Based on the economic discussions which I heard in the group, I am of the view that, in fact, this argument can also be applied to taxation of even relatively short-term real estate gains, particularly when the recent federal budget changes already provide a substantial incentive to invest in fields other than real estate.

This is a vital consideration given that the affordability of rental housing is a subject of constant concern in the province. A wide variety of policies at all three levels of government already contribute negatively in this area: rent controls as they impact long-term supply, the much higher property taxation of large rental buildings versus single-family homes, development levies and a host of other measures contribute to higher rent levels than would otherwise be necessary. Any consideration of changes to the tax treatment of real estate gains should evaluate very rigorously the impact of such changes on rental affordability. Based on the lack of documentation provided to the Working Group, it appears that this issue is often not adequately considered when capital gains changes are debated.

On quite a different issue, the Working Group also spent a substantial amount of time discussing the current application of the principal residence exemption. While I am wholeheartedly in agreement with the recommendation of this report that the exemption from capital gains tax on sale of a principal residence be maintained, I believe that it is worth recommending further scrutiny with regard to the definition of principal residence. Specifically, it was suggested by several members of the group that the practice of allowing taxpayers with more than one residence to choose the one to which they wish to apply the residence exemption be reconsidered. If the purpose of the measure is to promote homeownership, the property to which the exemption is applied should be the home – i.e., they place where the taxpayer principally resides – not a cottage, secondary residence or other property.

.../2

The Group also discussed the rationale for allowing foreign properties to receive the exemption. Presumably, addressing the issue of the definition of principal residence would deal with this concern as well, in that off-shore properties would automatically be excluded from the exemption if they were not truly the principal residence.

Amending this definition clearly lies within the purview of the Government of Canada which is responsible for the Income Tax Act (Canada). However, there is no reason that the Province of Ontario cannot make this an agenda item in the ongoing tax consultations between the two levels, and I would recommend that the Province initiate such discussions.

Philip M. Dewan

March 23, 1992

REALTOR

Ontario
Real
Estate
Association

99 Duncan Mill Rd.
Don Mills, Ontario
M3B 1Z2
Tel: (416) 445-9910
Fax: (416) 445-2644

TO: Matthew Akman

FROM: Jim Flood

SUBJECT: Your Memo of March 17, 1992

DATE: March 18, 1992

DELIVERY: Courier/Facsimile

This will serve as formal notice that I support the working group report as drafted by Sheldon Silver, Peter Goldthorpe, Larry Smith and myself.

Please relay this position to the chairman of the working group and any other appropriate individuals.

\vma

GLENGARRY FEDERATION OF AGRICULTURE
R.R. #2, P.O. Box 12
GREEN VALLEY, Ontario
KOC 1LO

(613) 525-3857

March 18th, 1992

Fair Tax Commission
1075 Bay Street
6th Floor
TORONTO, Ontario
M5S 2B1

Re: Tax Treatment of Real Estate Gains Working Group

Att: Matthew Akman

In response to your Fax of March 17th, 1992 and the Ministers letter to Ted Robinson dated March 16th, 1992, I have no choice but to support the submission authored by Sheldon, Jim and Peter:

(1) Within the huge volume of data collected and reviewed by the working group there was no evidence that a Special Tax on Real Estate Gains did reduce the price of homes and make them more affordable.

(2) In the present poor economic conditions of the Province of Ontario a New Tax on Real Estate Gains would only depend the present recession. Should Gains be taxable, losses should be deductible; in the present market there may be more losses than gains.

(3) Since principal residences have been and still are exempt because they are a basic necessity, A-1 Agricultural Land should also receive the same treatment since it is the base for the production of food and food is possibly more important to our survival then shelter.

.../2.

(4) Tightening of the present Land Transfer Tax on "Quick Flips" and also the special 20% tax on foreign purchasers should be made before any consideration is given to the implementation of any new tax on real estate transactions.

(5) Supply and Demand are the main factors that affect the price of homes. Rather than searching for areas to increase taxes more effort should be made to facilitate the availability of residential land.

If you have any questions please feel free to contact the undersigned.

Respectfully submitted,

Robert E. Poirier

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Department of Economics
UNIVERSITY OF TORONTO
150 St. George Street
TORONTO, CANADA M5S 1A1

March 23, 1992

Mr. Matthew Akman,
Fair Tax Commission,
Tax Treatment of Real Estate Gains
Working Group,
1075 Bay Street,
6th Floor,
Toronto, Ontario.
M5S 2B1

Dear Matthew,

Pursuant to our telephone conversation of this morning and various correspondence last week, I am writing to indicate that I am in support of the document authored by Sheldon Silver, et.al.

As I indicated in our telephone conversation I have considerable difficulty with some of the analysis and design of the recommendations in the document by Marion Steele. I hope that my concerns would be passed on to Ted Robinson and given consideration in his covering report.

Thank you once again for all you assistance to the working group.

Yours sincerely

Lawrence Smith
Professor of Economics

LS/lc

3 Final Submission Supported By:

- Penny Bethke
- Patrick Boyle
- Michael Kainer
- Bruce Lewis
- Robert Mackenzie
- Marion Steele

REPORT
OF PART OF THE
REAL ESTATE GAINS WORKING GROUP

EXECUTIVE SUMMARY OF RECOMMENDATIONS

PREAMBLE

Over the past two decades Ontario has seen immense movements in house prices, far greater than any which occurred in the 1950s and 1960s. The volatility of the last two decades culminated in the extraordinary 1985-1989 boom centred in southern Ontario. Nonresidential real estate was affected by the same phenomenon.

While the boom was underway spirits were high and there was a rush to buy. At the same time, there were concerns. Some people who had expected to become homeowners found prices unexpectedly high. Some social housing groups found land priced beyond their reach. The boom redistributed wealth in an arguably capricious and socially dysfunctional way. Some speculators, especially those engaging in so-called "quick flips", may not have paid their fair share of taxes either because their gain was reported as a capital gain instead of an income gain or because unreported transactions escaped the collection mechanisms of both of the Income Tax and Land Transfer Tax systems. Some non-resident purchasers were able to structure their transactions to avoid paying the 20 per cent non-resident Land Transfer Tax. The general perception that this type of transaction frequently took place was destructive of public confidence in what is and must remain largely a voluntary compliance tax system.

Booms are inevitably followed by busts. The greater the excess, usually the greater the correction. Ontarians have been living through a severe correction for two years. They are now well aware of the widespread damage caused by the deflation following overshooting prices and over-expansion. Homeowners who have to sell find it difficult to do so. Sellers who had bought towards the end of the boom realize heavy losses. Both residential and commercial landlords have difficulty finding tenants. The weakness in the real estate market transforms previously safe mortgages into risky assets, results in foreclosures, and endangers the creditworthiness of financial institutions. Perhaps worst of all, new investment is greatly depressed and there are heavy job losses in the construction sector.

During a recession there is time to consider alternatives and, with the lessons of the last boom painfully evident, there is motivation to try to prevent the worst excesses from recurring. In that spirit this report is written and its recommendations are made.

RECOMMENDATIONS

The working group considered many possible tax changes, but the undersigned decided to adopt a cautious approach, recommending only three changes.

1. **Enhanced enforcement:** The first recommendation is directed at increasing fairness and discouraging speculation by tightening the Land Transfer Tax and the reporting requirements for transactions. The aim is to

- capture land transfer tax on quick flips (e.g. sales of agreements of purchase and sale)

- capture fully the special land transfer tax of 20 percent on foreign purchases of recreational and agricultural land.

The recommendation is:

(a) The Land Transfer Tax Act and/or Regulations should be amended to provide that on registration of any transfer of real estate the Land Transfer Tax Affidavit be delivered by both the transferor and the transferee and, if there is any difference between the value of the consideration received by the transferor and the value of the consideration paid by the transferee, the chain of intermediate transactions be fully disclosed by each of them to the extent it is within their knowledge. This information would be used by the authorities in enforcing land transfer tax on the intermediate transaction, if applicable, and in enforcing payment of income tax.

(b) The non-resident land transfer tax should be tightened to make it clear that changes in beneficial ownership are subject to tax, regardless of the form of the transaction.

These changes would increase land transfer tax revenue and improve disclosure for income tax liability.

2. **Taxation of quick flips:** The second recommendation has two purposes. The first purpose is to discourage short-term speculative purchases. To the extent that speculators buy during booms and sell during busts, discouraging speculative purchases would tend to dampen the boom and bust cycle in real estate prices. The second purpose is to increase clarity in the tax treatment of real estate capital gains. It would in one important respect—a period of holding requirement—make Ontario's tax treatment of real estate gains more like that of most other OECD countries. The aim is to ensure that gains on real estate holdings of less than two years are taxed as ordinary income. Note that this would have little effect on the riskiness of long term investment: if a long term investor found it necessary to change plans and sell within two years, he or she would bear additional tax only if there in fact had been a gain.

The recommendation is:

A minimum holding period of two years should be necessary in order to qualify for capital gains treatment for an interest in real estate. This should be done by means of changes in the federal Income Tax Act.

If that is not possible, Ontario should impose a tax on real estate gains which

(a) are reported as capital gain for purposes of income tax, and

(b) are realized on properties held for not more than two years.

In the case of an Ontario-only tax the tax rate should a graduated one. For example the tax could be 25 percent of the individual's combined federal and Ontario marginal income tax rate, in which case the rate for the highest income individuals would be about 12.5 percent.

Administration of an Ontario-only tax would be through the Land Transfer Tax system or through the requirement that the taxpayer submit a supplementary schedule with their income tax return.

3. **Modified principal residence exemption:** The third recommendation is directed at increasing fairness by restricting the capital gains exemption for principal residences under certain limited circumstances. The aim is to tax those who use a capital gain realized on their principal residence for current consumption; specifically the aim is to preclude use of this capital gain for other than purchase of another principal residence or for retirement saving or for investment in Canadian small business. This recommendation would prevent individuals who occupy a series of homes as principal residences from realizing tax-free cash from these transactions. The recommendation is:

> Ontario should attempt to have the federal income tax changed so that the taxable portion (seventy-five percent) of capital gains on principal residences is not exempt from taxation unless
>
> (a) another principal residence is purchased within two years, and
>
> (i) its price is higher than the sale price of the former principal residence, or
>
> (ii) its price is lower than the price of the former principal residence, but seventy-five percent of the price difference is invested in an RRSP
>
> or
>
> (b) seventy-five percent of the gain is invested in an RRSP.
>
> To the extent gains on principal residences become taxable under the above provisions, capital gains treatment would be available so that 25 percent of the capital gain would in any event not be included in income.
>
> In addition to RRSP's other types of reinvestment would qualify to defer taxation of the capital gain from a principal residence, such as investment in certain Canadian small businesses. Further consideration should be given to the precise kinds of small businesses that would qualify and the rules that would be applicable.
>
> If the federal Income Tax Act is not changed, Ontario should tax seventy-five percent of capital gains on principal residences as set out above and the tax rate should be the provincial marginal tax rate of the individual taxpayer. Administration would be through the Land Transfer Tax system or through the requirement that the taxpayer submit a supplementary schedule with his or her income tax return.

OTHER ISSUES

We explored a number of other issues in the application of the income taxation system to real estate. We are not in a position to make recommendations on these issues, but we believe further investigation of these issues is warranted.

TIMING

Careful consideration should be given to questions of the timing of the introduction of any changes in the tax system as it applies to real estate gains. We believe that now, when few expect substantial gains soon, would be a good time to introduce the change; while no gains are being made, no tax will be payable. At the same time, a tax delayed until the economy improves would likely miss the next real estate upswing.

REPORT OF PART OF THE REAL ESTATE GAINS WORKING GROUP

PREAMBLE

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While the boom was underway spirits were high and there was a rush to buy. At the same time, there were concerns. Some people who had expected to become homeowners found prices unexpectedly high. Some social housing groups found land priced beyond their reach. The boom redistributed wealth in an arguably capricious and socially dysfunctional way. Some speculators, especially those engaging in so-called "quick flips", may not have paid their fair share of taxes either because their gain was reported as a capital gain instead of an income gain or because unreported transactions escaped the collection mechanisms of both of the Income Tax and Land Transfer Tax systems. Some non-resident purchasers were able to structure their transactions to avoid paying the 20 per cent non-resident Land Transfer Tax. The general perception that this type of transaction frequently took place was destructive of public confidence in what is and must remain largely a voluntary compliance tax system.

Booms are inevitably followed by busts. The greater the excess, usually the greater the correction. Ontarians have been living through a severe correction for two years. They are now well aware of the widespread damage caused by the deflation following overshooting prices and over-expansion. Homeowners who have to sell find it difficult to do so. Sellers who had bought towards the end of the boom realize heavy losses. Both residential and commercial landlords have difficulty finding tenants. The weakness in the real estate market transforms previously safe mortgages into risky assets, results in foreclosures, and endangers the creditworthiness of financial institutions. Perhaps worst of all, new investment is greatly depressed and there are heavy job losses in the construction sector.

During a recession there is time to consider alternatives and, with the lessons of the last boom painfully evident, there is motivation to try to prevent the worst excesses from recurring. In that spirit this report is written and its recommendations are made.

1. INTRODUCTION

The working group on the taxation of real estate gains was established by the Treasurer to address the following questions:

> Does the current tax treatment of real estate transactions ensure that a fair share of speculative profits are taxed? If not, what improvements to the existing tax treatment could be made or what additional taxes could be introduced?

In subsequent correspondence the Treasurer made it clear that he wished the group to interpret its mandate broadly.

Part 2 of this report summaries our views of the potential issues implicit in the Treasurer's questions. Part 3 summarizes what we learned about the current tax treatment of real estate in Ontario and about special real estate and capital gains taxes in Ontario and other jurisdictions. Part 4 reports on special real estate and capital gains taxes in Ontario and other jurisdictions. Part 5 analyzes why standard tax rules favour rental real estate, especially in inflationary times. Part 6 presents the options we considered and sets out our conclusions.

2. POTENTIAL ISSUES IMPLICIT IN THE TREASURER'S QUESTIONS

Flowing from our consideration of the Treasurer's questions, we identified four main issues that might lie behind them:

- contributing to affordability by reducing real estate prices
- controlling speculative activity by changing economic behaviour
- raising revenue
- enhancing fairness through the tax system

(a) **Affordability of Real Estate:** We considered a number of factors affecting housing and real estate affordability including the regulatory framework for development, public infrastructure investment, general population growth, the shift in population from rural areas to urban centres and from smaller to larger urban centres and concentration of land ownership. We agreed that speculation could affect price levels in both the short and long-term, but the degree of the price effects is unclear. There was general agreement that regardless of the effects of speculation during times of rising prices, it is unlikely that speculative activity is the fundamental, originating cause of real estate booms, but speculative activities and the related inflationary expectations, have the effect of exaggerating the boom-bust cycle.

Views among members of the working group on the potential for a tax to reduce the peaks and troughs of real estate price movements were diverse. Some believed that a tax on *long term* gains would tend to reduce affordability for renters in the long run, by reducing the long-term attractiveness of investment in real estate to investors. Others felt that this was a theoretical issue only since other factors are much more relevant to the setting of both residential and commercial rents. There was a broadly held view that a tax on *short term* holdings would have few negative effects and might have the positive effect of increasing affordability in booms, by dampening speculative behaviour.

(b) **Modification of Speculative Behaviour:** The group looked at whether or not speculation should be discouraged. Arguments for speculation focused on the role of speculators in the real estate market in absorbing risk and increasing liquidity by increasing the number of buyers and sellers in the market. A family attempting to sell its house in a slow market will benefit from the presence of speculative purchasers. Profits from speculation may simply reflect the value to society of shifting risk and increasing liquidity. Speculation may encourage the expansion of the housing stock. For example, pre-sales to speculators of some units in a condominium building will increase the likelihood that the building will be built, because the builder's financial risks are reduced. Speculators' holdings may cause problems for developers, however, if these holdings are dumped on the market when the developer still has units to sell.

Arguments against speculation include the following. First, speculation may magnify the boom and bust cycle in the real estate market by increasing prices more quickly and to higher levels than would otherwise be the case in an upswing and causing them to fall more quickly and further than would otherwise be the case in a downturn. Second, the landlord turnover associated with some short-term speculative activity may, in effect, reduce tenants' security of tenure; speculation may also tend to reduce community stability by increasing involuntary household mobility.

The group found that purely speculative activities could not be clearly defined and isolated from the ordinary business and investment activities of taxpayers for the purposes of a special tax. In the real estate market, many buyers are motivated, at least in part, by the prospect of receiving a gain. The group therefore concluded that a special or extraordinary tax should not be targeted exclusively to transactions motivated by speculative considerations.

(c) **Revenue Generation:** After examining the revenue implications of special taxes on real estate gains in Ontario and other jurisdictions, the group concluded that these taxes generally raise little revenue. The amount of revenue raised by a speculation tax will depend, in part, on the tax rates and goal of the tax. The goal of revenue generation is fundamentally at odds with the goal of completely eliminating speculative behaviour as defined by way of a special tax, but not necessarily at odds with reducing speculation.

(d) **Fairness:** The group divided the fairness questions in the taxation of real estate transactions into two broad categories: questions that focused on gaps in the current tax treatment of real estate gains that might contribute to unfairness between taxpayers; and questions of social equity that addressed the issue of the appropriate division of benefits from real estate price escalation between private owners and the public.

The concept that equals should be treated equally—horizontal equity—is broadly accepted as a fundamental principle of taxation. In assessing the fairness of the income tax system, for example, the Carter Commission in the 1960s popularized the concept through the oft-quoted phrase "a buck is a buck". While embracing this notion in principle, however, the group identified a number of issues that arise in the attempt to translate principle into specific tax system design.

A second fundamental principle of taxation is that the proportion of income or wealth taxed should rise as income or wealth rises; this is the principle of vertical equity.

Perceptions in the group of the relevance of social equity to fairness in the taxation of real estate gains depended on individuals' views of the nature of real estate. Some members of the group held the view that real estate is like any other asset. They felt that real estate is no more fundamental to society than, for example, natural resource commodities which are currently traded actively in a variety of markets including the purely speculative futures market. They concluded that real estate should be treated like any other asset for tax purposes. Others held the view that real estate is fundamentally different for a number of reasons: the importance of land as the resource base for the provision of shelter and food; the importance of keeping land in certain locations in industrial and commercial use to provide jobs; the negative social impact of price volatility in real estate markets; the special nature of rental real estate as an asset, which means that tax rules which are similar to, or more restrictive than, those for other assets result, nevertheless, in favourable tax treatment for rental real estate. Real estate is also different because a large portion of increments in real estate values is attributable, not to the efforts of its owner, but to the collective efforts of the community, and to the infrastructure provided by the government.

Those signing this report believe that it is unfair, and damaging to society for large redistributions of wealth to occur, resulting from real estate price booms and busts, which are more a matter of luck than the result of individuals' work effort and saving. Large swings in house prices in the 1980's meant that a family that moved to Toronto at the right time benefited from a large windfall, while a family that moved at the wrong time suffered a large loss. We believe it is desirable to attempt to dampen real estate price booms and busts, or, at the least, reduce the extent to which unavoidable booms and busts distort the distribution of income and wealth.

3. CURRENT TAX TREATMENT OF REAL ESTATE IN ONTARIO

Before the tax treatment of real estate gains is described, it is useful to provide a brief description of the current tax administration in Ontario.

(a) **Tax administration:** There are two distinct régimes used in the administration of Ontario's taxation of real estate transactions. First, for *personal* income tax, liability arises under the Income Tax Act (Ontario), which generally provides that Ontario tax will be a percentage of federal tax payable under the Income Tax Act (Canada). Second, liability for *corporate* income tax is set out in the Corporations Tax Act (Ontario).

Since 1962, Ontario and all other provinces except Québec, have had their personal income tax collected under the requirements of the Federal-Provincial Tax Collection Agreement. By this arrangement, the federal government, through Revenue Canada, Taxation, is responsible for personal income tax administration and collection for all member provinces. In return for this service, the provinces covenant that provincial personal income tax legislation and regulations will conform to *federal* statutes, regulations and interpretations.

While most provinces have their corporation income taxes collected under the authority of the Federal-Provincial Tax Collection Agreements, Ontario administers and collects its own Corporations Tax. Even so, the federal and Ontario statutes, regulations and interpretations conform in most respects.

These current arrangements, especially in the case of the personal income tax, constrain the implementation by Ontario of tax changes. Ontario and the federal government need to co-operate if these changes are to be made, or alternative options which do not use the income tax system will have to be developed.

Note that Ontario also administers the Land Transfer Tax Act.

(b) **Current Tax Treatment of Real Estate Gains:** There are a number of general rules applicable to the taxation of real estate gains. None of these general rules is specific to real estate, though there are some particular features of these rules that are specific to real estate. These are noted below. These rules include the following:

(i) **Capital gains treatment:** *One hundred percent of profits from trading* in real estate are included in income and taxed at the applicable individual or corporate tax rate, while only *seventy-five percent of capital gains* from real estate are included in income and taxed at the applicable rate. For a brief discussion of the trading profits/capital gains distinction, see 6(b) below. Individuals and certain trusts can exclude capital gains on qualifying principal residences. Non-residents of Canada living in certain countries (including the USA) are exempt from Canadian tax on capital gains resulting from the sale of shares of a company, provided not more than half of the value of the company derives from Canadian real estate.

(ii) **Borrowing costs:** If real estate is a capital asset, i.e., an income-producing property, interest on money borrowed to pay for it is deductible in computing income. The amount deductible is *not* limited to the income produced by the property. If real estate is inventory (e.g., building lots or houses to be sold), interest is similarly deductible.

(iii) **Depreciation:** If real estate is an income producing property, depreciation at specified rates (Capital Cost Allowance, "CCA") is deductible in computing income. Typically the CCA rate for building and improvements is four percent per annum on a declining balance basis. We note that: CCA is deductible even if the building has in fact appreciated in value; CCA is "recaptured" on sale (for example, if the sale price is greater than the acquisition cost, on sale the total of all CCA claimed on a property is taxed, in effect, at income tax rates); there are restrictions on creating losses from CCA to shelter other income (these restrictions are specific to real estate and certain other assets).

(iv) **Realty taxes, etc.:** If real estate is an income producing property, property taxes, repair costs and other carrying costs are also generally deductible in computing income. Acquisition costs (e.g., legal fees, land transfer tax) are capitalized. If real estate is inventory, these amounts are generally all deductible in computing income. However, generally accepted accounting principles (GAAP) and the federal and provincial tax laws require that the deduction of some of them be deferred until the property to which they relate is sold. This better matches the cost of goods sold with sales revenues.

(v) **Losses:** Generally, one hundred percent of losses resulting from trading in real estate are deductible in computing income subject to tax. Unutilized losses can be deducted against income earned in the following seven years (carried forward) or in the prior three years (carried back). Generally, seventy-five percent of capital losses from real estate transactions can be deducted against other capital gains, but cannot shelter other income. Unutilized capital losses can be carried back three years and can be carried forward indefinitely. They can still be deducted only against capital gains.

(vi) **Timing:** Generally, income gains and capital gains are included in income only at the time of actual sale. Two important cases of deemed disposition are the following. First, persons transferring property to non-arm's length persons (e.g., relatives or related companies) are deemed to have sold it for fair market value. Second, individuals are deemed to have sold property immediately before their death; this results in taxation of unrealized net appreciation in property values at that time. This deemed disposition may be avoided by leaving the property to a spouse.

(c) **Land Transfer Tax:** Purchases of land are generally subject to land transfer tax. Land transfer taxes are in substance a sales tax payable by the purchaser as a percentage of the purchase *price*. The percentage rates applicable on most transactions are: 0.5 percent on values up to $55,000; 1.0 percent on values between $55,001 and $250,000; 1.5 percent on values over $250,000; and where the property consists of one or two residential units, 2 percent of value in excess of $400,000. In addition, there is a special *non-resident* land transfer tax of 20 percent payable on purchases of agricultural and recreational land by foreign individuals or corporations which do not qualify for specified deferrals leading to eventual exemption. These taxes are triggered by changes in ownership of the land. Transactions involving financing only are not taxable.

4. SPECIAL REAL ESTATE AND CAPITAL GAINS TAXES IN ONTARIO AND OTHER JURISDICTIONS

The group investigated experience and practice in taxation of real estate gains in Ontario and other jurisdictions. The goal was to identify lessons from this experience.

(a) **Special taxes:** The group identified and investigated, in general terms, precedents for special taxes on speculative-type real estate gains. Most have been of short duration. These taxes have been enacted in Canada in Alberta (1913 to 1951) and Ontario (1974 to 1979), and in Great Britain (1967 to 1971) and Australia (New South Wales, 1970 to 1973). Currently, special taxes on real estate gains are found in Vermont (since 1973), in Japan (Tokyo) and in Taiwan.

While conjecturing about the reasons for the early repeal of these taxes (little revenue raised; administrative complexity; end of the price boom that led to their establishment; change of government), the group was not able to identify in the literature any clear evidence that points either to their success or failure.

The group noted that these taxes tend to have in common an emphasis on the period of holding as an important element in defining transactions that would be included in the tax base.

(b) **Capital gains taxes:** The group also examined the tax treatment of gains from real estate transactions in various income taxation systems. The group focused on how capital gains are treated.

The group looked at the income tax systems of other nations, especially members of the Organization for Economic Cooperation and Development (OECD). These countries fall into two broad categories: those which treat all capital gains as income for tax purposes; and the majority, with favourable tax treatment of capital gains.

Countries that provide for special treatment for capital gains tend to take the period of holding into account explicitly in determining whether or not gains from a particular transaction qualify as capital gains income. The qualifying period of holding varies from jurisdiction to jurisdiction but in almost all cases falls in the range of two to five years. For example, Germany treats long-term capital gains favourably, but for real estate holdings of under two years, capital gains are taxed at income tax rates. Sweden severely penalizes short-term holdings: the tax rate on real estate gains falls sharply at two years and also falls at three, four, and five year. Switzerland also has a rate falling sharply over five years. Australia taxes real estate gains as income for holdings of under a year. *(Data taken from Toronto Board of Trade submission; Table attached.)*

In many countries, real estate is singled out from other assets for special, less generous treatment of gains, sometimes with respect to the holding period and sometimes with respect to tax rates.

5. WHY STANDARD TAX RULES RESULT IN FAVOURABLE TAX TREATMENT FOR RENTAL REAL ESTATE, ESPECIALLY IN TIMES OF INFLATION

Rental real estate has characteristics as an economic asset which mean that the application of tax rules which are similar to those for other assets, nevertheless can result in favourable tax treatment for rental real estate, especially in times of inflation. This outcome is largely the consequence of the capital intensity of production of rental service—little labour is used so that costs are largely capital costs—in combination with the interaction of inflation and the tax system. From another point of view, the favourable treatment of rental real estate is a problem of the mismatching of income and expense. The special characteristics of rental real estate, other than its capital intensity, are explained below.

(i) **Great leverage possibilities:** High-ratio loans are usually readily available to finance the purchase of real estate. This has a number of consequences. First, for a given equity a purchaser can acquire a high valued asset if he or she purchases real estate. Second, because of leverage *in combination with capital intensity*, the interest carrying costs of rental real estate are likely to be high relative to gross rental income, for recently purchased property.

(ii) **Depreciation for tax purposes in excess of true depreciation:** Depreciation for tax purposes (Capital Cost Allowance) for buildings was reduced in the 1987 tax reform but it is still greatly in excess of true depreciation in most cases.

(iii) **High likelihood of loss or zero net income for tax purposes in times of inflation:** This follows from the characteristics discussed above. When the rate of inflation is high, interest rates tend also to be high, tending to result in net rental losses in the early years of ownership. This loss tends to be offset by increases in the value of the property, but this increase is *not taken into account by the tax system* until and unless the property is sold. Thus, inflation has an asymmetric effect: *net losses* in the early years of ownership, resulting from inflation, are *fully deductible* from other income for tax purposes, but *inflationary gains* in the value of the property *are not taxed* until and unless the property is sold; and, if the gain is deemed a capital gain, it is taxed at less than income tax rates.

Over the life of the holding, the net rental loss will decline, because rental income will rise while mortgage principal will decline. Once net rental loss has declined to zero, however, the CCA may be used to reduce net rental income down to zero (for tax purposes), so that there may be a substantial period of time before *any* income taxes are paid on the property. *Contrast this with the situation of an owner-operator of a factory:* interest charges and the CCA will not be nearly as large a proportion of gross revenue as it is for rental real estate, and so it is likely net revenue will be positive even in the early years of ownership. Consequently, the factory owner will tend not to have a tax loss to deduct against other income.

(iv) **The tax system in effect pays a major portion of a real estate speculator's carrying costs:** This follows from the last characteristic. The net income loss (except that created by the CCA) is deductible against other income so that the speculator gets a refund; in effect he or she is partially financing the holding with the tax that otherwise would be paid. It is important to note that this will only be true if the speculator rents out the property or attempts to do so. It is also true *in principle* that the courts could rule that the speculator's net losses should be capitalized, but we believe this is unlikely to ever occur. (We contrast this with the situation of land developers, whose interest charges must be capitalized, thus putting them at a major disadvantage relative to a speculator in developed land who is able to rent the property.)

Conceptually, the tax system views a rental property as a depreciating asset which is generating income, thus justifying the deduction of interest costs from rental income, *and the deduction of net rental loss against other income*; while non-income generating assets held for future sale are treated as inventory, with interest costs treated as part of the cost base when the land is sold. If, however, the main motive for holding property is the speculative motive—i.e. the prospect of making a capital gain—and if the property depreciates very little in use, the economic role of the holder of rental real estate is very similar to a speculator in any other commodity, but the net carrying costs of the latter are not tax deductible from other income, while those of the former are.

A striking difference between the tax situation of short-term holders and long-term holders *over the whole holding period* is the following. While *short term* holders of rental real estate, over the whole holding period, are likely to generate a net rental loss and so a *deduction* against other income, in contrast *long term* holders will tend to generate positive net rental income and so *pay income tax* over much of the holding period (although the day when income tax is paid may be staved off by purchasing additional properties). If a given property is held for ten years by short-term holders, each of whom holds only, for example, two years or less, it is likely that the property will always generate a tax-deductible income loss; if a single holder owns the property for the whole period of ten years, it is likely in contrast, to generate taxable income for some of these years. Before the recent exclusion of real estate gains from the personal capital gains exemption, it was possible that the holder of a property could declare deductible losses during the holding period and yet pay no tax when the property was sold.

6. ISSUES IN THE TAXATION OF REAL ESTATE GAINS—OPTIONS AND CONCLUSIONS

(a) **Land Transfer Tax Administration:** The group identified two issues in the administration of the Land Transfer Tax Act. First, some transactions involving agreements of purchase and sale or options to purchase take place before closing and registration of the transfer of the land (so-called quick flips). In certain circumstances they may now be subject to land transfer tax. Under our land registration systems there is no requirement to register these transactions. Because they are unregistered, there is concern that many of these transactions are unreported. The same transactions would also normally be subject to income tax. There was a perception that there may be a significant number of these transactions that are also not reported for income tax purposes. We concluded that relatively simple steps could be taken to tighten up enforcement.

At present a Land Transfer Tax Affidavit is attached to every transfer of land registered in Ontario. This discloses the value of the consideration and information as to the type of building and residency status of the transferee, all of which are needed in order to calculate the proper land transfer tax. However it also contains information respecting the assessment roll and school tax support of the transferee, which are used in relation to municipal taxes. The same form could, with some addition, also be used for the purpose of both land transfer tax and income tax on unregistered transactions that may have occurred prior to the registration. It would not be necessary to require the intermediate transaction to be registered, but it would be desirable to improve disclosure of the circumstances that might give rise to land transfer tax or income tax.

The recommendation is:

> The Land Transfer Tax Act and/or Regulations should be amended to provide that on registration of any transfer of real estate the Land Transfer Tax Affidavit be delivered by both the transferor and the transferee and, if there is any difference between the value of the consideration received by the transferor and the value of the consideration paid by the transferee, the chain of intermediate transactions be fully disclosed by each of them to the extent it is within their knowledge. This information would be used by the

authorities in enforcing land transfer tax on the intermediate transaction, if applicable, and in enforcing payment of income tax.

Persons reviewing the land transfer tax affidavits for each transaction would then be able to determine whether or not there had been any intermediate transaction. The details might be fully disclosed, but if not, the knowledge that there had been intermediate transactions could lead to appropriate investigations. Information could then be used to determine whether the intermediate transactions had been adequately reported and dealt with both by those responsible for administering the *Land Transfer Tax Act* and those responsible for administering the *Income Tax Act*.

An additional copy of the land transfer tax affidavit is now delivered for use by the assessment authorities. We would suggest that in implementing the recommendation, consideration be given to whether the appropriate technique is a fourth copy of the affidavit for analysis for the purpose of dealing with intermediate transactions.

Second, the administration of the *non-resident* land transfer tax is currently unable to track changes in beneficial ownership to determine the taxability of transactions involving corporate entities. Thus, it is perceived some transactions that should result in the payment of the non-resident land transfer tax, do not do so. The group concluded that the non-resident land transfer tax should be tightened to make it clear that changes in beneficial ownership are subject to tax, *regardless of the form of the transaction*. The group did not study the matter in enough depth to determine any specific recommendation to achieve this purpose.

(b) **Short term gains—horizontal equity issues:** An important horizontal equity issue is the lack of clarity in the definition of income qualifying for capital gains treatment in the Canadian (and therefore Ontario) income tax system.

•Short-term Capital Gains

The Canadian income tax system looks primarily to the purpose for which a taxpayer acquired an asset in determining whether or not profits from its sale should qualify for capital gains treatment. Profits from the sale of assets acquired for the purpose of generating income over a period of time qualify for capital gains treatment. Otherwise, such profits are considered to be trading income and are taxed as income; that is, they attract a higher effective rate of tax. When the taxpayer's true purpose is a contentious issue, the courts are forced to make a judgment based on the surrounding circumstances . There is no "period of holding" rule, to unambiguously determine which gains qualify for the favourable capital gains treatment.

That lack of clarity creates two types of problems. First, transactions which might appear at face value to generate trading income because of the short holding period involved, have at times, been found by the courts to be capital gains. Second, and perhaps more important, the interpretation uncertainty introduced into the system by the lack of a simple period-of-holding rule means that taxpayers, in their self-assessment, have grounds to opt for the interpretation which yields the most favourable tax treatment. This interpretation will only be challenged if there is an audit by the tax authorities. With limited audit coverage, there is the potential for profits to be undertaxed, because of inappropriate classification as capital gains.

We support the proposition that a period of holding requirement should be incorporated into the rules for determining whether or not a transaction should qualify for capital gains treatment. We recommend as follows:

A minimum holding period of two years should be necessary in order to qualify for capital gains treatment for an interest in real estate.

Beyond two years the ordinary considerations for determining whether a gain is a capital gain or an income gain should apply. At this time we recommend that these changes should apply only to real estate gains. In the event it were determined to use a longer minimum holding period, consideration would have to be given to the treatment of the deductibility of losses by persons deemed to receive income treatment by virtue of this rule.

•A Design Option

If possible, we believe that these changes should be made in the federal income tax and the Ontario corporate income tax. The February 1992 federal budget, by making real estate gains ineligible for the lifetime personal capital gains exemption (a recommendation which we were considering making) has partially reformed the system, and simplified our recommendation. If further changes are not possible, Ontario should bring in a special tax to capture for Ontario taxpayers the tax that would otherwise be collected in a reformed system. Accordingly, we support the introduction of a tax that would apply only to gains taxed as capital gain.

One particular design option with this objective was considered:

- •A tax *rate* equal to 25 percent of the combined federal and Ontario marginal income tax rate.
- •A tax *base* equal to all real estate gains reported as capital gains for purposes of income tax, where the property was held for a period of *two years or less*.

Administration would be through the Land Transfer Tax system or through the requirement that the taxpayer submit a supplementary schedule with their income tax return.

(c) **Long term gains—principal residences and horizontal equity:** On horizontal equity and neutrality grounds, capital gains on principal residences should only be exempt from taxation under certain circumstances as set out below. Our view on taxation of principal residences is tempered by the fact that many Canadians believe that home ownership is an important end in itself. The compromise proposal put forward below would leave untouched the exemption of capital gains on principal residences in the vast majority of cases. It recognizes the importance of home ownership as a traditional means of providing for old age. However, we feel that historically the complete exemption has provided undue benefits to home owners beyond what would be necessary to permit home ownership, homeowner mobility and retirement savings through home ownership. The proposal would tax the relevant portion of the capital gain on a principal residence *only where it is used not for continued home ownership, for retirement saving or other designated types of reinvestment, such as investment in certain Canadian small businesses.*

Our recommendation is:

Ontario should attempt to have the federal income tax changed so that the taxabie portion (seventy-five percent) of capital gains on principal residences is not exempt from taxation unless

(a) another principal residence is purchased within two years, and

(i) its price is higher than the sale price of the former principal residence, or

(ii) its price is lower than the price of the former principal residence, but seventy-five percent of the price difference is invested in an RRSP

or

(b) seventy-five percent of the gain is invested in an RRSP.

To the extent gains on principal residences become taxable under the above provisions, capital gains treatment would be available so that 25 percent of the capital gain would in any event not be included in income.

In addition to RRSP's other types of reinvestment would qualify to defer taxation of the capital gain from a principal residence, such as investment in certain Canadian small businesses. Further consideration should be given to the precise kinds of small businesses that would qualify and the rules that would be applicable.

If the federal Income Tax Act is not changed, Ontario should tax seventy-five percent of capital gains on principal residences as set out above and the tax rate should be the provincial marginal tax rate of the individual taxpayer. Administration would be through the Land Transfer Tax system or through the requirement that the taxpayer submit a supplementary schedule with his or her income tax return.

Note the effect of this tax change on a short-term speculator who made a practice of occupying a series of properties in order to benefit by the principal residence exemption. This tax change would mean that he or she would not be able to take any untaxed cash out of this operation.

This recommendation for principal residences is substantially similar to the current US and Swedish treatment.

(d) **Other horizontal equity issues:** We also have concerns about a number of other issues:

deductibility of losses from real estate from other income, especially in the case of foreign real estate, non-residential real estate and luxury residential units;

deferral of tax resulting from the Capital Cost Allowance in excess of depreciation, especially in the case of foreign real estate, non-residential real estate and luxury residential units;

taxation of gains on realization rather than on accrual;

non-taxation of gains which are in effect realized when there is non-recourse refinancing of property.

We do not feel ready to make a recommendation for a change in any of these areas but we believe they should be investigated further.

(e) **Longer term gains—social equity issues:** Social equity issues arising from long-term gains from real estate arise from the fact that among the factors that contribute to increases in real estate values are zoning changes and public sector infrastructure investment (e.g. subways). These are related to public actions rather than to private effort or investment.

While we believe a broadly-based tax on betterment would not be practical, we believe that a variety of taxes aimed at capturing external benefits from public activity would be beneficial and might be an important source of funding for public infrastructure in the future.

We are not ready to make a recommendation for a specific tax in this area but we believe it should be investigated.

7. TIMING

Careful consideration should be given to questions of the timing of the introduction of any changes in the tax system as it applies to real estate gains. We believe that now, when few expect substantial gains soon, would be a good time to introduce the change; while no gains are being made, no tax will be payable. At the same time, a tax delayed until the economy improves would likely miss the next real estate upswing.

SCHEDULE "A"

TABLE 1
SUMMARY OF GAINS TREATMENT OF REAL ESTATE, VARIOUS COUNTRIES

Country	Taxes gains arising from disposal of Real Estate?	Owner-occupied home exempted?	Gain Indexed to Inflation?	Improvement Adjustment?	Tax payable under	Rates	Notes
Australia	√	usually	√	N/A	1 yr	Taxed as income	New South Wales Land Development Contribution Tax 1970-1973; capital gains taxes since 1986
Austria	√	√	N/A	N/A	5 yr	Taxed as income	first 6,000 Aus. Shillings not taxed; no capital gains tax
Belgium	√	√	√	√	8 yr	0-1: 100% of income tax rate; 1-5: 33%; 6-8: 16.5%	no capital gains tax
Denmark	√	usually	√	√	7 yr	0-3: 50%; 3-4: 40%; 4-5: 30%; 5-6: 20%; 6-7: 10%; 7+: 0%	owner-occupied residences exempt after 2 years and if under 1,400 sq. m.; capital gains tax since 1958
Finland	√	usually	√	N/A	10 yr	0-4: 100% of income tax rate; 5-6: 80%; 9-10: 60%; 7-8: 40%	owner-occupied residences exempt after 2 years; first MK 1,000,000 exempt; capital gains tax since 1920
France	√	√	N/A	N/A	2 yr	Taxed as income	disposals under 30,000 F exempt; capital gains tax since 1976
FR Germany	√	√	N/A	N/A	2 yr	Taxed as income	capital gains tax since 1934
Greece	√	√	√	N/A	unlimited	0-5: 25%; 6-10: 20%; 16-20: 15%; 20+: 10%	
Ireland	√	usually	√	N/A	unlimited	0-1: 60%; 1-3: 50%; 3-6: 35%; 6+: 30%	I£ 2,000 annual exemption; capital gains tax since 1975

Country	Taxes gains arising from disposal of Real Estate?	Owner-occupied home exempted?	Gain Indexed to Inflation?	Improvement Adjustment?	Tax payable under	Rates	Notes
Israel	√	√	N/A	N/A	21 yr	0-1: 60%; 2-3: 50%; 4-6: 35%; 7+: 30%; 21 yrs: exempt	Introduced 1963; present status unknown
Italy	√		N/A	N/A	5 yr	all properties subject to tax	gains tax assessed by government according to formula; municipal levies on real property gains since January 1, 1988, of up to 30%
Japan	√	√	N/A	N/A	10 yr	up to 96%	First 30,000,000 Y exempt; repurchase necessary to avoid gains taxation; capital gains tax since 1946
Korea	√	√	N/A	N/A	N/A	0-2: 60%; 2+: 30%	Implemented 1989
Luxembourg	√	usually	√	N/A	10 yr	0-2: Taxed as ordinary income; 2-10: 28.5%	10,000 LF exemption under 2 yrs; 1,250,000 LF exemption over 10 yrs; capital gains tax since 1979
Malaysia	√	once in a lifetime	√	√	6 yr	0-2: 20%; yr 3: 15%; yr 4: 10%; yr 5: 5%; yr 6: 0%	Land Speculation Tax 1973-75; Real Property Gains Tax 1975
Mexico	√	√	√	N/A	2 yr	0-2: 12%	
Netherlands							No capital gains taxes
New Zealand							Property Speculation Tax 1973-79; no capital gains tax currently
Norway	√	√	√	N/A	2 yr	as income or 30%, at taxpayer's option	capital gains tax since 1911

Country	Taxes gains arising from disposal of Real Estate?	Owner-occupied home exempted?	Gain Indexed to Inflation?	Improvement Adjustment?	Tax payable under	Rates	Notes
Portugal	√	usually	√	N/A	unlimited	gains taxes apply to 50% of gain at rate of 24%	Repurchase necessary within 2 years to avoid tax on owner-occupiers; capital gains tax since 1965
Singapore							No capital gains taxes
South Africa							No capital gains taxes
Spain	√	usually	√	N/A	2 yr	Taxed as ordinary income	Locally-imposed Municipal Capital Gains Tax; repurchase necessary to avoid tax on owner-occupied home; comprehensive capital gains tax since 1978
Sweden	√	usually	√	√	5 yr	0-2: 100%; 2-3: 75%; 3-4: 50%; 4-5: 25%; 5+: 0%	owner-occupied exempt on excess over repurchase price of new residence; capital gains tax since 1928
Switzerland	√		some cantons	N/A	5 yr	base rate 25% + extra: 1-2: 100%; 2-3: 60%; 3-4: 40%; 4-5: 20%	Canton-based Real Estate Gains Tax (Basel Canton cited); 2,000 SF annual exemption in most Cantons
Taiwan	√	√	usually	N/A	N/A	40% to 60%	Land Value Incremental Tax (determined by government formula). Repurchase necessary within 2 yrs to avoid tax on owner-occupiers
Turkey	√	√		N/A	5 yr	0-5: 15% to 50%; 5+: 0%	First TL 100,000 exempt; Real Estate Capital Gains Tax 1970-1982

Country	Taxes gains arising from disposal of Real Estate?	Owner-occupied home exempted?	Gain Indexed to Inflation?	Improvement Adjustment?	Tax payable under	Rates	Notes
U.K.	√	√	√	N/A	unlimited	30%	£6,600 annual exemption; <u>U.K. Betterment Levy</u> 1967-1971; capital gains tax since 1965
U.S.	√	usually		N/A	unlimited	100% of gains taxed as income	Owner-occupiers taxable on excess over repurchase of new residence; capital gains tax since 1913
State of Vermont	√	√			6 yr	80% CGT if under 4 mo if gain over 200%; 5% CGT if over 6 yr and gain under 100%	<u>Land Gains Tax 1973 -</u>
Canada	√	√		√	unlimited	75% of gain taxed as income as of 1990	<u>Ontario Land Speculation Tax</u> 1974-1978; <u>Alberta Unearned Increment Tax</u> 1913-1956; $100,000 lifetime capital gains exemption

Notes: In most countries the gains treatment of real estate differs from that applying to other assets only in regard to the length of the holding period required to avoid taxation. Canada is somewhat unique in having a large lifetime capital gains exemption, which is equally applicable to all moveable and nonmoveable property transactions, and in having no minimum duration over which nontaxable gains are permitted to be realized. Italy, Japan, Korea, Malaysia, Spain, Switzerland, Taiwan and the State of Vermont specifically subject short-term gains in real estate to higher rates of taxation than other assets.

<u>Underlined</u> notes refer to special real estate antispeculation taxes which are currently being, or have been, levied in various countries. The Board of Trade has been able to obtain some information concerning the effects of such taxes in Australia, New Zealand, the U.K., Japan, Ontario and the State of Vermont; it has not been able to obtain information on the effects of such taxes in Israel, Italy, Malaysia, Spain, Sweden, Switzerland, Taiwan, Korea and Turkey.

N/A: Not available. Information could not be found.

Sources: Price Waterhouse, *Worldwide Summary of Individual Taxes*, 1990
Price Waterhouse, various individual country tax guides, 1989-1991
Organization for Economic Cooperation and Development, *Taxation of Net Wealth, Capital Transfer and Capital Gains of Individuals*, 1988

3a Appended letters from:

- **Patrick Boyle**
- **Robert Mackenzie**
- **Marion Steele**

PATRICK J. BOYLE
Breslau, Ontario

March 20, 1992

The Honourable Floyd Laughren
Treasurer of Ontario and Minister
of Economics
Queen's Park
Toronto, Ontario

Dear Mr. Laughren:

I am writing as a member of the Ontario Fair Tax Commission working group you appointed in June of 1991 to review the fairness of the current tax treatment of real estate transactions.

You appointed eighteen members to this working group along with a number of civil servants from relevant Ministries and several staff members of the Fair Tax Commission. Our working group held its first meeting in the beginning of July, 1991 and we have met regularly for the last nine months. Our meetings were initially to learn about the issues. This educational process alone took a considerable period of time given the varying backgrounds of the working group members and because of the large number of factors which people perceive as contributing to the related issue of the affordability of real estate generally. The working group then continued to meet to discuss and consider the different issues before us and more recently it had been working on developing its written report to you.

I recognize that it has taken the working group much longer than you had originally anticipated to get to where it is. The members are painfully aware of this as it has been our volunteered time that has stretched out to nine months from the original two months you asked of us. I am sure that all of the working group members feel that the time has been well spent and was necessary for such a large and diverse group to fully address the difficult and, at times, emotional issue of a speculation tax which you put before us.

Having been a participant in the process to date, I was both surprised and disappointed by your letter of this past Monday, March 16th. By your letter you have unilaterally terminated discussion and ended the process of working towards a consensus. You have insisted that members report to you on their support for one of two draft reports or any separate report which they may choose to develop. You have placed a deadline of next Monday, March 23rd on making our individual submissions. The problem such a short time period creates is exacerbated by the fact that this is the March holiday week for most Ontario school children. It is my view that this action by you has been the single most damaging event affecting our working group's progress.

Your understanding of the breakdown of the working group into different groups ranging from members of the real estate development community that would benefit from maintaining the status quo at one end through to a group of more left-leaning socialist members interested in upsetting the status quo is correct. I cannot believe that you find this surprising given the fact that you intentionally chose people from throughout the spectrum based on their credentials of being associated with certain interests or causes in our society. I earnestly believe that the members of each of these different groups, along with all of the other members of the working group, were sincere and candid about their respective positions and in their dedication and efforts in working through these differences.

In addition, there were a number of members of the working group who could not fairly be described as being in the groups at either end of the range. These people, of whom I feel I am one, were not in complete agreement with either of these groups on each issue and proposal discussed and were not able to subscribe fully and in an unqualified way with all of the positions of either of these groups. With the exception of the authors of each of the two draft reports that were circulating as at the date of your letter of this past Monday, I doubt that any member felt that either of these draft reports were documents they could fully subscribe to.

You should be aware that the working group was very well and ably served by Matthew Akman, the Fair Tax Commission staff member attached to our group and that Barbara Ostroff, our designated "facilitator", made a valuable contribution to the process. I feel we were also very ably assisted by each of the provincial Ministry representatives sitting in on our working group meetings. It was our group's aim to develop a single report and to that end several drafts of a single group report were circulated and discussed. This process was only abandoned when a number of members perceived that that one of the appointed Commissioners of the Fair Tax Commission, as distinct from its staff members, was trying to advance his own views by becoming involved in the drafting of the report between meetings of the group. If that perception was correct, it would be highly inappropriate given that you have structured the Fair Tax Commission process to have the working groups report to you separately from the reports that the Commissioners themselves have been asked to deliver to you on the same topics. In any event, the perception that this was occurring was sufficient to trigger the end of working on a single draft report.

This was not however the end of the group's commitment towards trying to work towards a single report. It was agreed that two different persons or groups of persons who are working group members would undertake the task of trying to prepare separate draft reports which could form the basis of a single consensus report. These were the two draft reports that were circulating as at the date of, and to which you refer in, your letter of Monday, March 16th.

By way of this my individual report to you, I must tell you that I cannot describe any of the reports being delivered to you as fully setting out my views, my concerns or my recommended solutions to the issues you referred to our working group. I believe that there is merit in each of the reports or draft reports that I have read and that you should not discount any of them. They are each well reasoned and represent legitimate points of view.

In the last several days, I have participated in the finalization of one of these reports. A copy of that report is attached. On balance, I feel that this report more closely reflects my views and there is nothing in this report with which I disagree.

I have learned much from my involvement with this working group of the Fair Tax Commission. I trust you will learn from each of the reports being submitted to you by our working group members.

Yours very truly,

Patrick J. Boyle

PJB/a
Enclosure

cc Mr. T. Robinson
Chairman of the working group

cc Mr. M. Akman
Fair Tax Commission

cc All working group members
cc All civil servants attached to working group

MACKENZIE & ASSOCIATES
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VIA FAX (519) 368-7152

TO: Matthew Ackman
FIRM: Fair Tax Commission
NAME:
CITY:
FAX: 1-416-325-8235

FROM:
FIRM: MACKENZIE & ASSOCIATES
NAME: Robert MacKenzie
CITY: INVERHURON, Ontario
FILE: Fair Tax Real Estate Basic Working Group Report.
DATE: Mar 23/92
TIME:

TOTAL NUMBER OF PAGES SENT INCLUDING THIS COVER SHEET - 1
IF YOU DO NOT RECEIVE ALL OF THE PAGES, PLEASE ADVISE AS SOON AS POSSIBLE.

MESSAGE

I support the report document that I have worked on with yourself Bruce [illegible] & Marion Steele

To: Matthew Akman
Fair Tax Commission
1075 Bay St.
Toronto

Mar 20, 1992

From: Marion Steele

I authorize the version of the "alternative" report discussed by the staff and myself Mar 18 1992 (or later) as my submission to the Treasurer of Ontario

Marion Steele
M. Steele
(member of the working group on the tax treatment of real estate gains)

4 Final Submission Supported By:

- Penny Bethke
- Michael Kainer
- Bruce Lewis

March 23, 1992

The Honourable Floyd Laughren
Treasurer of Ontario
Seventh Floor
Ministry of Treasury and Economics
Frost Building South, Queen's Park
Toronto, Ontario
M7A 1Y7

Dear Mr. Treasurer:

Re: Real Estate Gains Working Group

The undersigned support the "Report of Part of the Real Estate Gains Working Group", a copy of which is attached hereto as Schedule "A". That report was originally prepared by Professor Marion Steele. It has been amended and reworded in light of input from Working Group members Patrick Boyle, Robert MacKenzie and ourselves. This report is submitted by the three undersigned to amplify that report and bring a number of important matters to your attention. This report deals with the following areas:

I. BACKGROUND

II. THE PROCESS USED BY THE REAL ESTATE GAINS WORKING GROUP

III. SHORTCOMINGS OF THE REAL ESTATE INDUSTRY REPORT

IV. COMMENTS ON PROFESSOR STEELE'S REPORT AND ADDITIONAL RECOMMENDATIONS

I. BACKGROUND

This report is being written in response to the request contained in your letter of March 16, 1992, addressed to Mr. Edward Robinson, Chair of the Tax Treatment of Real Estate Gains Working Group. In your letter, you correctly assess that the diversity of views within the Working Group made a single report an impossibility. We strongly disagree with a draft report prepared by Messrs. Silver, Goldthorpe, Smith and Flood, a copy of which is attached hereto as Schedule "B". It is written, as you characterize it in your letter, from the perspective of the real estate industry (although perhaps only a part of that industry) and in this report we call it the Real Estate Industry Report.

It should be stated that early on in the process an attempt was made at a "consensus" report (although even the term "consensus" would not have a common meaning among the Working Group members). The initial draft of a report prepared by the Fair Tax Commission staff assigned to the Working Group was quite an accurate reflection of the discussions at the Working Group, was a good description of a number of options which were discussed and contained a list of useful recommendations. A number of the suggestions contained in this report are drawn from the staff report.

II. THE PROCESS USED BY THE REAL ESTATE GAINS WORKING GROUP

Inadequate representation of powerless: The composition of the Working Group did not accurately reflect the composition of the population of Ontario. The three members of the Working Group who are associated with the most powerless groups in our society stopped participating in the process after several meetings. They did this on the basis of a conscientious decision on their part that they could not make a meaningful contribution since they were unable to make their views felt in the process that the Working Group was using. All three of these persons were women, and they included the only member of the Working Group who was a member of a visible minority. They were personally associated with community groups representing tenants, persons who experience discrimination in housing, and the homeless. We attach as Schedule "C" the paper they have written reflecting their views on this matter.

While it is perhaps superfluous for us to add anything to their paper, our observation was that both when they attended the Working Group meetings and later, when they ceased to attend, the observations which they expressed in that paper were correct. The majority of the members of the Working Group reflected the values of those strata of society that are more powerful and have more of the wealth of the province. We attempted as best we could to represent what we perceived were the interests of the homeless, tenants and other persons whose problems are intimately related to real estate, but yet have traditionally not had a voice in our system and seemed not to have a meaningful voice in this particular process. However in our view, our efforts could not adequately compensate for more direct participation had the Working Group's process been more open. In evaluating the various views that are made known to you, you must have care to ensure that the views and needs of tenants, the homeless, the victims of housing discrimination and the other less powerful groups in our society are adequately served.

Inability to reach agreement: The Working Group was comprised of persons from a variety of backgrounds, some of whom were associated with various bodies representing the interests of those who develop real estate. Many of them had strongly held views on the taxation of real estate, which seemed to be consistent with the policies of their organizations. The composition of the Working Group in this manner has led to its inability to give any single report. While we are not prepared to say that anyone necessarily came to this process with a closed mind, their preconceptions led to an inability or unwillingness to have meaningful consultation in the Working Group sessions.

The question asked by the Treasurer in establishing the Working Group could be interpreted fairly narrowly:

> Does the current tax treatment of real estate transactions ensure that a fair share of speculative profits are taxed? If not, what improvements to the existing tax treatment could be made or what additional taxes could be introduced?

In addition, the Fair Tax Commission by letter of June 19, 1991 broadened the issues to be considered by the Working Group. They asked the Working Group to address an additional question:

> What policy instruments (tax or regulatory) could be expanded or enacted to improve on the current treatment of land speculation real estate gains?

Despite the above, the initial framing of the issue permitted a number of Working Group members to attempt narrow the scope of the inquiry as much as possible. Professor Steele's report is a fair effort at making recommendations under a narrow construction of the question. In essence, it recommends better enforcement, treating short-term gains as income in all cases—largely an administrative improvement—and preventing the principal residence exemption from being used as a device to achieve unfair redistribution of wealth. To that extent, the authors of this report endorse those conclusions as they relate to the narrow question.

The issue, however, is a much larger one. There were times in the group's discussions when the "bigger picture" was referred to. In particular, some basic problems in the income tax structure were identified and discussed. These included the "asymmetry" between full deductibility of operating losses and only partial inclusion of capital gains realized on the same property, and the practice of deferring tax over very long periods by using capital cost allowance to reduce income where no depreciation has, in fact, occurred.

Unfortunately, the dynamics of the Working Group discussions were such that these basic questions were not adequately examined. This was doubly unfortunate because there was a large amount of expertise in the Group. It included persons involved in the real estate development business, tax lawyers, economists specializing in the economics of land and persons associated with the development of non-profit housing. Such expertise could have been put to good use in proposing creative solutions to some of the problems raised. For example, although there was virtually unanimous concurrence that better enforcement of existing taxes relating to real estate was desirable, the Real Estate Industry Report does not address this issue at all. We can only explain this in terms of their ideological predispositions

A number of others in the Working Group, including ourselves, approached the matter quite differently. They had a general sense that the tax system was unfair and could be improved in a number of ways, including ways which would more fairly tax real estate gains. They were looking for techniques, devices, methods and approaches to rectify inequities in the system. They felt that the combined expertise of the Working Group should have given them the tools to produce a report that would make proposals to that end.

Unfortunately, the whole process was extremely frustrating to all concerned. Quite frankly, the quality of reports prepared by the real estate group, Professor Steele's report and this one are not what they ought to be, in good part due to the fact that wrangling among the group members stifled productive debate. The time that might have been spent preparing a well-reasoned, well-researched report was, for the most part, wasted in an attempt to bridge a great gap between the real estate industry representatives and others in the group.

Thus Professor Steele's report and this report represent merely an outline of some suggestions. The background work to support and detail the recommendations has not been done. We trust, however, that you and your staff will be able to make good use of them in your planning.

III. SHORTCOMINGS OF THE REAL ESTATE INDUSTRY REPORT

The recommendation of the Real Estate Industry Report is that there should be nothing done. The authors of the Real Estate Industry Report must be the only group of Canadians who feel the tax system does not require change. The real estate industry group states that there is "no evidence" that inequities in the tax system are peculiar to real estate.

We would agree that inequities in the tax system are not peculiar to real estate. That, however, is no justification for refusing to redress the inequities that do exist in the taxation of real estate. Obviously, the topic of the Working Group was just this. For that reason alone, some effort to deal with the real estate problems should have been made. More significant, however, is that we believe that there is something inherent in the nature of real estate which makes it different from other assets. At the very least, because of its permanent nature and the method of registration of land in Ontario, it is an asset whose transfer is easily tracked and where gains may be relatively easily identified. In the Working Group discussions some of the writers of the Real Estate Industry Report implied that taxing real estate gains because those gains are more easily detected or measured is somehow a penalty to those involved in the real estate development industry. The authors of this report do not believe that it in any way penalizes participants in the real estate industry to properly tax gains made by them. If gains in other industries or sectors go untaxed due to the nature of the assets or transactions, that is no excuse for failing to attempt to tax real estate fairly. Hopefully, other working groups will address the inequities in those other fields.

A major point of departure between authors of the Real Estate Industry Report and others is their view as to the nature of land and whether it should be treated as an asset like any other asset. The Real Estate Industry Report makes the point in several ways that there is no reason to treat real estate differently since it is indistinguishable in an economic sense from other "commodities". In our view, this is incorrect. The Working Group, in fact, had, in the materials presented to it by the Commission staff, a variety of reports which very eloquently described the unique nature of land. Further, there was a presentation in which the point was made that the United Nations Conference in Human Settlements (Habitat 1976) in Vancouver proclaimed that land

> cannot be treated as an ordinary asset controlled by individuals subject to the pressures and inefficiencies of the market . . . the pattern of land use should be determined by the long-term interests of the community.

The Real Estate Industry Report does not really deal with the issue other than by making the bald statement that land is subject to market forces. We prefer the detailed economic analysis contained in Professor Steele's report. We feel that this issue cannot be discussed separately from consideration of the enormous impact that the cost of land and real estate generally has on the economy and the quality of most people's domestic and working lives.

It is obvious that land is unique in its permanence and immovability as an asset for ownership. Because of this unique nature, certain economic consequences flow. Real estate is the starting point for development of industry and commerce. The price of land and buildings and its effect on all industry and commerce can be very significant. For example, the group discussed the attractiveness to industry in the Toronto area of selling its land holdings at the peak of the most recent real estate boom in the 1986 to 1989 period. Profits from the sale of real estate holdings might have been far in excess of earnings from its actual operations. We believe that the rapid escalation of real estate values contributed to the flight of industry from the Toronto region during the most recent boom period and the permanent loss of a substantial number of jobs. In the case of residential real estate, a home is usually the single largest asset purchased by a family, and generally exceeds the value of their second most valuable asset by a multiple of many times. In many cases, mortgage costs are the largest living cost and affect the amount of disposable income available for other economic activity. Once again, the value of real estate has a very significant impact on that family and may affect a number of their decisions.

In our view the taxation of real estate does have an impact on the cost of land and buildings. It is obvious that there is a distinct advantage in keeping the price of land at a reasonable level. Even the real estate group at page 8 of their report states that "special tax treatment may smooth the peaks and valleys of boom/bust cycles" in the real estate market. Despite this it does not feel that this is justification to impose such a tax. We agree that a speculation tax would have this effect. In addition, regardless of the stage in the boom and bust cycle such a tax would assist in keeping the cost of land and buildings at a reasonable level. It is our view that the combined effects of the nature of land and its current favourable tax treatment relative to its nature results in land prices being higher than they ought to be. As is pointed out by Professor Steele and in submissions made by the Toronto Board of Trade, other jurisdictions in the world including most countries in Western Europe have long recognized these differences and have taxed land accordingly. While there may be legitimate differences of opinion as to the techniques or devices for taxation of land and other real estate, it should be beyond argument that it should be given a distinct tax treatment (as it already is in several respects in the Canadian system).

The Real Estate Industry Report makes reference to serious problems in the Canadian economy including levels of debt and budget deficits. The Working Group never really discussed these matters and certainly did not relate real estate values or taxation of real estate to them. The real estate industry representatives appear to be saying that the sorry state of the Canadian economy would be worsened by tinkering with the tax system since this might act as a further disincentive to investment in Ontario or might otherwise further the flight of capital from the province. They also make the point that real estate appears to be at a very low point and with no prospect of future increases. They take this as further justification for doing nothing since, the argument goes, if prices never rise there would be no need for a speculation tax.

We disagree. If, in fact, real estate values have fallen to a low point, now is exactly the time when a tax on real estate gains ought to be imposed. When the Ontario economy recovers, the profits to be made from investments in real estate may well be very large. The history of real estate increases in the past would bear this out. Timing is a very significant factor in the effectiveness of a tax for this type of activity.

We do not recommend retroactive taxation of real estate gains. However, we do suggest that tax changes be made at this time notwithstanding that it appears that little revenue will be generated currently and that there is currently little need to use the tax system as a disincentive to increasing real estate prices. The reason for our recommendation is that a valuation point must be established ("V Day") to establish the base value on which real estate profits should be taxed. It makes good sense that V Day be established at a low point in the cycle. By way of example, one of the inadequacies of the 1974 Land Speculation Tax in Ontario is that the valuation day for gains was established in April of 1974. The largest real estate gains of that boom had already been made prior to that time and were, therefore, untouched by the imposition of the tax. General principles of fairness precluded the imposition of the tax on a retroactive basis and, therefore, unjustifiable and in many cases unconscionable profits were not appropriately taxed.

The real estate Industry Report suggests that "long run costs" of imposing a tax outweigh the benefits of imposing one. The report is vague as to what those long run costs are. We suspect one of the supposed costs is that there will be a dampening effect on prices if new taxes are added to real estate gains. Our view is that such a dampening effect is a useful thing and will only be of assistance to average Ontarians. This relates to the issue of timing since the effect of taxes imposed now may very well be to assist in keeping prices down on a long-term basis. It is clear from the literature that was reviewed by the Working Group that measuring the effects of these types of taxes is not easy. At least one of the authors of the real estate Industry Report stated in the deliberations of the Group that he "never saw a tax that lowered prices". Perhaps not. We suggest, however, that a tax could inhibit the growth of prices especially where prices are not, in fact, determined by the costs of production, which often appears to be the case in the real estate market especially in a rapidly rising market. It was noteworthy that the one person who was invited to speak to the Working Group as a typical small developer indicated— contrary to what is often presumed to be the development industry's position— that he didn't care if the people who bought from him were speculators and that he would charge what the market would bear in any situation. Therefore, development charges and other taxes would not increase prices. He was already increasing them to the maximum!

The real estate Industry Report in several places suggests that inaction is appropriate because there is no clear cut evidence of the effects of further taxes. It also states that "no clear-cut evidence was presented to the group to establish a precise link" between monopolistic and oligopolistic practices and housing affordability (page 6). The standard of proof may be unrealistically high. From the debates between the economists on the Working Group, and in reading a variety of studies relating to costs of land and the reasons for change in land values, it is clear that there is no consensus among economists as to what the causes are and what remedies are to be used to deal with those rising prices.

However, it seems evident to us that taxing a larger portion of real estate gains will make holding real estate a somewhat less desirable investment. This should mean prices for real estate will be lower. It should also mean that large amounts of money otherwise invested in real estate can be freed up to be invested in more productive ways.

We do not accept the notion implicit in page 4 of the real estate Industry Report that speculation has good and bad aspects and its negative effects are only to slightly magnify the boom-bust cycle in the short run. In our view speculation is a major cause of the boom-bust cycle. The alleged benefits of speculation are largely economic theories. In periods of boom there is a far larger number of real estate transactions than in other periods. The negative and immediate effects on these transactions are far more important than any supposed long run benefits. The practice of pre-selling to people who intend to occupy the houses has the effect mentioned on page 4 of their report. But pre-sales to speculators are part of and foment the type of fear, insecurity and hype that lead to the wild and destructive booms that have occurred in the recent past especially in the greater Toronto area. This activity should be discouraged.

IV. COMMENTS ON PROFESSOR STEELE'S REPORT AND ADDITIONAL RECOMMENDATIONS

One matter which is not made entirely clear in either the real estate Industry Report or in Professor Steele's report is the jurisdictional problem relating to taxation in general and, in particular, real estate taxation. The terms of the tax collection agreement between the federal government and the provinces may restrict the ability of Ontario to impose tax on real estate in the most comprehensive and efficient way, which is through the general income tax system. It is our view that modifications to the general income tax system would be the most desirable method. Therefore, our recommendations are for joint action by the federal government and Ontario. But if the federal government does not wish to participate, we recommend action by Ontario alone. Obviously, this will create some additional administrative burdens and is being recommended as an alternative solution if a more basic change to the overall income tax system cannot be effected.

We support the recommendations contained in Professor Steele's report although we do not always fully agree with the rationale for the recommendations. As discussed in connection with the Real Estate Industry Report, there was insufficient consideration within the group of a number of matters due to basic ideological differences between Working Group members which precluded meaningful debate. Therefore, while we support the recommendations contained in Professor Steele's report, we feel the recommendations could and should go farther. Following our comments on Professor Steele's report will be a list of other possible tax measures that we recommend. It should be made clear, however, that the very flawed process by which the Working Group arrived at its multiple reports meant that inadequate consideration was given to further taxes on real estate. Therefore, the absence of further recommendations should not be taken as a determination that no further changes are desirable.

Professor Steele's report suggests that the Working Group "decided to adopt a cautious approach" to recommending tax changes. It is true that in an effort to gain as wide an acceptance as possible among Working Group members to the proposals, a reduced and less ambitious series of recommendations was the focus of the discussion. However, the authors of this report do not believe that the recommendations contained in Professor Steele's report should be the only changes.

Our comments in respect to each of the recommendations in Professor Steele's report are as follows:

1. **Use of Land Transfer Tax Act:** We agree that taxation of transactions under the *Land Transfer Tax Act* is useful both as a revenue generating device and as a means of requiring information to be reported as to values at which land changes hands for other tax purposes. There are, however, limitations in using the *Land Transfer Tax Act* as a means for taxing real estate *gains* since it is a tax based on real estate *prices*. Use of the land transfer tax and land registration systems is best seen as a way of better enforcing taxation of real estate gains as opposed to a way of creating further substantive provisions by which real estate ought to be taxed. The Working Group discussion concerning changes to these systems was to the effect that improvements in the land transfer tax and land registration systems would require that real estate "flips" be recorded in some fashion. In addition to generating land transfer tax on the flips, it would also form a record for purposes of general taxation. This is an example of how the unique nature of land and the systems for registration of ownership of it lend themselves to special technical treatment. When an opportunity exists to better enforce tax rules due to the nature of the transaction, the tax system should take full advantage of that.

   An illustration of the type of transaction contemplated is useful:

      A is the registered owner of real estate.

      B makes an offer to purchase the real estate from A which is accepted by A.

      Before the transaction closes between A and B, B "sells" the offer to C.

      C closes the transaction with A by receiving a deed of the land from A.

      C pays A the price that B agreed to pay A for the land. In addition, C pays B a further amount representing a "profit" to B.

   In the above illustration, under the current system no registration or public record exists of the "sale" between A and B or between B and C. Land Transfer Tax is payable only with respect to the registration of the transfer to C. We do not have a recommendation as to whether it is appropriate to assess land transfer tax on the intermediate transaction in these circumstances. However, income tax is due and should be paid. There is a general perception that many of these transactions are not reported for income tax purposes and the suggestion in Professor Steele's report should have a significant positive effect.

2. **Tax on Short-Term Speculative Purchases:** We agree with the stated purpose in Professor Steele's report that a tax that deals exclusively with short-term speculative purchases is desirable. We agree that it is likely to discourage short-term speculative holding and will clarify tax treatment of real estate gains by providing at least one objective measurement of a transaction which should be treated as regular income and not get special and more favourable capital gains treatment. In the event there is any ambiguity about the recommendation, we wish to clarify that holdings which are greater than two years would not automatically qualify for capital gains treatment. Such longer holdings may also be categorized as income by applying the usual tests which have been developed by the courts to distinguish income as opposed to capital gains.

   It is very important to note that a large number of other countries have adopted such a test based on duration of holding. Ontario would hardly be unique nor would it be treating holders of such real estate more harshly than they would be treated in other jurisdictions.

3. **Principal residence exemption:** We support the recommendation that the exemption available for gains on the sale of principal residences should be modified. We agree that the modifications should include those matters contained in Professor Steele's report, which provide generally that the gain is exempt only where it is used to acquire another principal residence or is utilized for retirement savings purposes or investments that are likely to generate increased employment.

   The rationale set out in Professor Steele's report for narrowing the exceptions from taxation of principal residences should be expanded somewhat. Arguably, by exempting gains from sale of principal residences, the tax system is giving a significant tax saving to one group of Canadians which is already advantaged in that it owns property of significant worth. Losses to the tax system by benefiting this group obviously are at the expense of others, such as those who live in rental accommodations. However, the system of special tax treatment for principal residences is so ingrained both in the tax structure and in the psyche of many Canadians that we are not recommending wholesale rejection of the concept.

   We do, however, wish to limit where the exemption is available. The exemption should only be available where it is justifiable. Many Canadians regard their principal residence as an asset to be used for their support in older age. The recommendation, therefore, is that as long as the gains are put back into the acquisition of another principal residence or a Registered Retirement Savings Plan (RRSP), the gains would not be taxed. The proceeds of that RRSP would then be taxed in the normal way as the money is withdrawn from the RRSP. In addition we agree with Professor Steele's report that other uses of the proceeds of sale, such as investment in small business, should be considered for the same exemption.

   Under the proposal in Professor Steele's report no reduction of a realized gain would be available for mortgage interest, taxes or similar costs. It was suggested in the Working Group that these items ought to be considered as well as imputed rent for the use of the property during the period it was held. No one could suggest any system that would fairly and reasonably provide for these items. Also, the proposal does not recognize any adjustment for inflation. In our view the proposal is appropriate since twenty-five percent of the gain is exempt under all circumstances. The remainder of the gain should legitimately be subject to the proposed system without entering into the intricacies of adjusting these matters.

A number of details of the rules relating to this provision will need to be dealt with, such as:

(a) rollovers, such as on transfers to spouses and transfers of residences on family farms;

(b) payment into a Registered Retirement Income Fund or annuity for a sale after age 71 when an RRSP is otherwise closed under current rules;

(c) provision for deemed disposition and taxation on death of the last surviving spouse where the house is held until death;

(d) provisions for adjusting the cost base for capital improvements to the principal residence; and

(e) limitations on maximum additional contributions to RRSP's for very large gains.

4. **Principal residence treatment adjustments:** There are several problems with the current principal residence exemption that we feel could be rectified relatively easily. Currently, a principal residence can be inside or outside Canada. In our view principal residence treatment is not justified where the property is located outside Canada. One of the implicit rationales for the favourable treatment of principal residences is the assumption that such favourable treatment will result in more purchases of homes which is a stimulus to the Canadian economy. Ownership of housing outside the borders of Canada does nothing to assist the Canadian economy.

- ***Additional recommendation:***

  To qualify for principal residence treatment the principal residence must be in Canada.

If an individual owns more than one residential property, that individual will have a choice as to which property to declare as his or her principal residence. It is possible that an individual will claim a residential property as a principal residence where the person has not really resided in the residence at all. This is particularly problematic where short-term speculators are involved. As noted above, this is one area where there is considerable consensus that this type of activity should be discouraged as it has no social or economic value.

- ***Additional recommendation:***

  To qualify for principal residence treatment the taxpayer must actually reside for most of the year in the principal residence.

5. **Additional non-resident issues:** There are two related problems that we feel should be rectified. In our view gains by Canadian residents on real estate outside of Canada should generally be taxed as ordinary income (with capitalization of losses).

There is no need for Canada to give more favourable tax treatment to investments outside of the country that will not create any jobs here.

- ***Additional recommendation:***

  Gains by Canadian residents on real estate outside of Canada should generally be taxed as ordinary income (with capitalization of losses).

Conversely we feel that gains by non-residents on Canadian real estate should be taxed as ordinary income (with capitalization of losses) except when such real estate is used in an active business. There is no need for Canada to give favourable tax treatment to investments by non-residents unless they will create jobs in Canada.

- ***Additional recommendation:***

  Gains by non-residents on real estate in Canada should be taxed as ordinary income (with capitalization of losses) except when such real estate is used in an active business.

6. **Land Speculation Tax:** Finally we come to the basic question of whether there should be a land speculation tax. For all the reasons stated above and in Professor Steele's report regarding the special nature of land and the harm caused by land speculation, in our view land speculation should be actively discouraged. At present the marginal income tax rate for persons in the highest tax bracket in Ontario is slightly less than fifty percent. In our view this rate is too low. Capital gains that make a constructive contribution to society are taxed at a rate that is lower than ordinary income. We feel that the speculative gains on real estate should be taxed at a higher rate.

   Unfortunately, we are unable to make any detailed recommendation. As was set out above the Working Group process broke down before this type of issue could be seriously explored. Even the staff report referred to above does not deal with it, since it seemed to be so far from the type of policy that would be accepted by most members of Working Group.

   While we can't propose any details of this tax, we feel in general that it should apply to all gains on real estate except certain predefined categories, such as principal residences and real estate used in an active business (including farming and real estate development).

   It is our strong view that increased taxes on land speculation should be part of the income tax system. If at all possible there should not be a separate land speculation tax administration as was created by the 1974 *Land Speculation Tax Act*. If the federal government is not prepared to co-operate, then the surtax system mentioned in Professor Steele's report should be used.

- ***Additional recommendation:***

  Land or real estate gains should be taxed at a rate higher than ordinary capital gain or income rates. This should be accomplished through the income tax system, if possible, and should apply to all gains on real estate other than these that are within certain predefined categories. Examples of categories that would be excluded from this treatment include principal residences and real estate used in an active business (including farming and real estate development).

CONCLUSION

In our view the proposals in Professor Steele's report and our additional recommendations will have a dampening effect on prices and contribute significantly to reducing the boom-bust cycle. If implemented now, they will work to keep prices down on a long-term basis. To the extent that they do not eliminate speculation, they will likely create significant revenues from gains that are not now bearing their fair share of taxation. In our view the combined effect of these taxes and the revenue that will be generated will have the effect of both keeping real estate more affordable and providing more resources to government.

PENNY BETHKE

MICHAEL KAINER

BRUCE LEWIS

FairTaxComRep23mar

5 Final Submission Supported By:

- **Mitsi d'Souza**
- **Leslie Robinson**
- **Fiona Stewart**

To: Fair Tax Commission

Re: Taxation of Real Estate Gains Working Group

From: Working Group Members: Mitzi d'Souza, Leslie Robinson and Fiona Stewart

December 18, 1991

We have met to discuss our experience with this working group and our input to the report of the group. We have drafted the following commentary for inclusion in the report:

Taxation of Real Estate Gains Working Group

Report from Working Group Members: Mitzi d'Souza, Leslie Robinson and Fiona Stewart

This report addresses our ability to participate in the Working Group and issues relating to access to the Working Group process. Mitzi d'Souza was appointed after the Working Group had begun in response to the observation that no persons of colour were represented on the Working Group and that community group representation was under represented on the Working Group. Mitzi d'Souza is a woman of colour who represented private non-profit housing interests and poor people who experience discrimination in rental housing. Leslie Robinson is a woman who was appointed as a representative from the non-profit housing sector, but represented the interests of residential tenants on the group. Fiona Stewart was appointed as a representative of the non-profit housing sector, but represents the Affordable Housing Action Group, a coalition organized on the principle of the right to housing.

I. Expectations of Working Group Participation:

We agreed to participate in the Working Group with the expectations that we would have the opportunity to analyze the issues and develop proposals based on the perspective of our constituency which can be described as those who do not own the land they live on. We also held the expectation that the Working Group process would be designed to allow our perspectives to be brought forward and for us to participate effectively in the Working Group.

A. Perspective

We had expected an opportunity to analyze taxation of real estate gains based on considerations of who owns land, the rights and benefits enjoyed by landowners versus who does not own land and the effects of being without the rights and benefits enjoyed by landowners. We had expected opportunities to develop proposals to support and claim improved rights for those who are landless. We had hoped that legislation would be developed relatively quickly after the report of the Working Group which would use the tax system to change present injustices and to realize international covenants that Canada has ratified.

B. Process

We had expected that the Working group would be fairly representative of all interests. We had expected and had requested that meetings would be designed to include small group and sub-committee work in order to ensure adequate participation opportunities. We had expected that meetings would be chaired appropriately so that those who tend to dominate discussion would be held back and that those whose voices and perspective are not dominant would have opportunities to express their views. We also expected that the meetings would be chaired in an orderly manner and that agendas would be adhered to.

II. Working Group Structure

A. Representation

The Working Group members were predominantly men, all white people (except Mitzi d'Souza, co-author of this report), predominantly land owners (only two members do not own land) and predominantly representing business interests. The imbalance in representation was observed at the first meeting of the Working Group. Leslie Robinson made specific requests that the membership of the group be modified to represent those who were not well represented, particularly members of the Native community, persons of colour and community representatives who are low income and non-land owners. Pursuant to those requests two new appointments were made, Mitzi d'Souza and a white man from the Ontario Real Estate Board. Mitzi d'Souza's appointment is felt to be tokenistic. All three authors of this report stopped attending Working Group meetings part way through the deliberations due to frustrations with the process and a sense that real participation and an attempt to redress the fundamental injustices posed by the lack of rights for disadvantaged groups was significantly hampered.

B. Meeting Structure

Meetings were not structured in a way to ensure participation by all; those who traditionally dominate in groups were supported by this lack of structure. The first few meetings were not chaired in accordance with any rules of order; some members spoke out whenever the impulse moved them while others held their hand up to be recognized and were not recognized by the chair. Meetings were almost always held in committee of the whole. There were no sub-committees formed. An early request to develop caucuses for proposal development based on support or non-support of the possibility of a tax received no response.

The Fair Tax Commission Information Package contains the following question:
"Q. How will the Commission be structured to ensure involvement of a wide array of groups and citizens?" The answer to this question needs to include consideration of how those who have traditionally not had input into tax legislation will be able to participate. Simply sitting everyone around the same table will not do it. In a system where some people are accustomed to dominating, because they are men or because they are business leaders or because they are white, that power imbalance will only be perpetuated if it is not specifically re-balanced.

The time frame for meetings was limited by the request for a report by the end of October and time demands were made on members significantly in excess of the initial request for participation.

C. Lack of Political Direction

The Working Group was given no political direction from the Treasurer or any other government authority. A request was made by one member for prior positions on land speculation tax made by the Treasurer; there was no response to this request. The Treasurer made a number of public statements about taxation of primary residences during the Working Group deliberations thereby limiting the ability of members to promote taxation of capital gains on primary residence.

D. Technical Focus

Discussions at the Working Group meetings attended by us focused primarily on technical issues. The broad policy implications which we had hoped to address were lost in the technical considerations. Presentations made by economists and tax lawyers were not countered with presentations from those who are landless and whose lives are negatively affected by the current tax treatment of real estate gains.

III. Outcome for Disadvantaged Groups

Based on the Working Group structure and our experience in the group, we report on the outcome for the disadvantaged groups that we represent.

As Working Group members, we have not had adequate opportunity to provide input into the report of this Working Group. We may agree with some of the options listed in the report, but there may also be options that are missing which we could have provided.

The Fair Tax Commission Information Package asks the question, "What are the advantages of involving the public in tax reform?" The advantages are listed as 1) an increase in the public's understanding of the tax system and 2) people's belief or faith in the tax system as being relatively fair to all Ontarians.

Because disadvantaged groups were disabled from participating, the opposite to these two desired outcomes was in fact achieved.

Due to our frustrating and negative experience with this working group, we have come out of the process feeling more disenfranchised, more disempowered and more cynical than when we started.

Additional copies of this Report and/or Highlights of this Report may be obtained from:
Fair Tax Commission, 1075 Bay Street, 6th Floor, Toronto, Ontario M5S 2B1

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