Housing Market Digest

Greater Toronto Area, September 2023

HST on New Rentals

The federal and Ontario governments have agreed that HST will not be applied on new rentals. This will have some impact on project viability, but is only one step.

Rental construction collapsed after the 1972 tax reform. One of the most damaging factors was limitation on the use of depreciation to create losses that could reduce tax on income from other sources. In response to that crash, two years later "MURB" was created (a new tax class), which allowed for depreciation of new rentals to be used to reduce tax on other income. MURB was very successful. Most of the red brick high-rise rental buildings you see in the GTA were MURBs.

Many of the MURBs were deals in which upper-middle-class people bought fractional interests in buildings (rather than titles to individual units).

The Department of Finance became concerned about the tax losses and so MURB was eliminated in the early 1980s. Then, builders discovered legal structures that could be used to permit tax deductions against other income. When that option was shut down by the federal government, rental construction collapsed once again.

A new-MURB provision might be a powerful tool to create new rentals. There would once again be hand-wringing about tax avoidance. But it would be more accurate to call it tax deferral, if the structure requires that when the investor sells the property in future, there is calculation and recapture of excess depreciation.

There is also a discussion happening about the depreciation rate used for tax purposes. In 1987, the rate was reduced to 4% from 5%, and the suggestion is that the rate be returned to 5%. That would also improve project viability. But, the impact will be constrained: for most potential new rentals, after interest and operating expenses there won't be enough net income available to actually utilize the increased deduction. For accelerated depreciation to work, it probably needs to be accompanied by new-MURB.

In 1990, I wrote a book ("On the Agenda: The Demographic Challenge to Rental Housing Policy in Canada"), which is the last link on this page: https://www.wdunning.com/recent-reports.

The understanding I had (at the time) about the tax issues is in Chapter 4. The summary of the chapter starts at the middle of page 10. The detailed discussion starts at page 70.

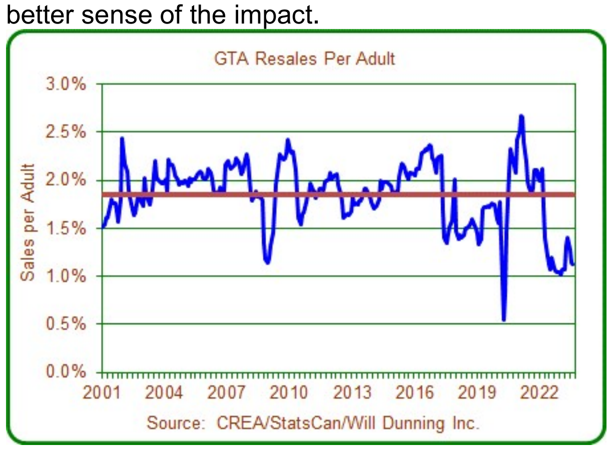
At the time (in 1990), the book was seen by very few people, and those who did see it had mixed reactions. CMHC put the book in its library, but my recollection is that it was never promoted. It has been invisible. I think that it could have contributed to some of the discussions that have occurred during the past 30+ years.

Today, I would express myself differently in a lot of places. But, I can look back at it and feel that the interpretations were largely correct, and even many of the forward-looking conclusions. Individuals remain the natural investors in new rentals, because they can give more consideration to principal repayment and capital appreciation. They can decide to invest at lower rents than a corporation or institution.

I'm not saying that new-MURB is a complete solution. It is one important item on a long list. Two items that need more attention are development charges and infrastructure funding, and, secondly, the game of whack-a-mole that has been played in mortgage regulations for the past decade.

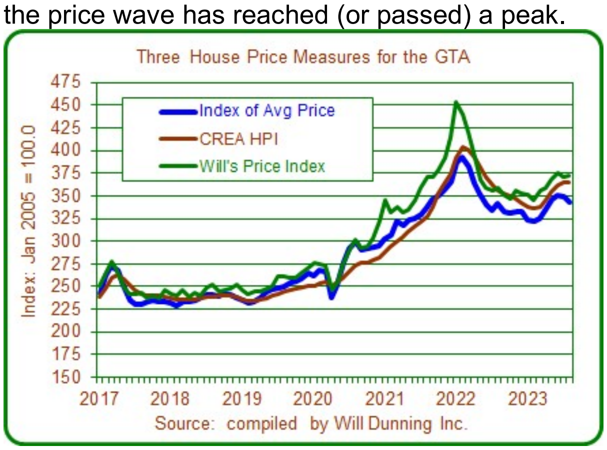
Resale Market

Sales slowed a bit more in August, to an annualized rate of 66,000. This is 39% below the population-adjusted long-term average. As I've said previously, we aren't yet seeing the full effect of the interest rate increases that happened during the spring. September and October will give us a better sense of the impact.



Listings continue to creep upwards from low levels. The sales-to-new-listings ratio is now (at 42%), versus the 52% threshold for a balanced market. (52%). While active listings have expanded, they are still far (29%) below the long-term population-adjusted average.

I look at three different price measures for the GTA. As of August, all of them now suggest that the price wave has reached (or passed) a peak.

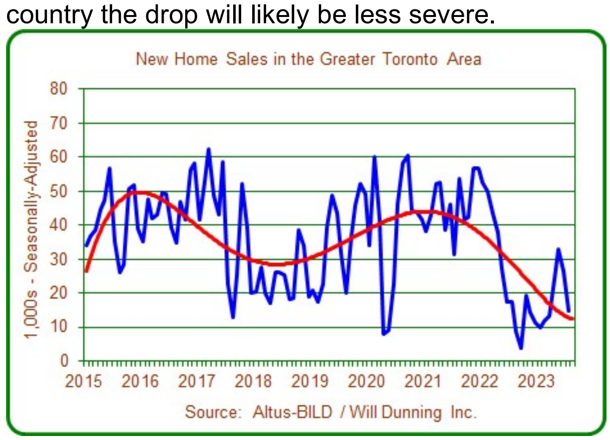


Interest Rates

Movements in bond yields have been less extreme during the past month, but yields remain elevated, in the area of 4% for 5-year maturities. My opinion estimate for special-offer 5-year fixed rate mortgages is up a bit, to 5.95%. The mortgage versus bond spread is a bit fat, at almost 2% (it should be below 1.75%). The variable rate is unchanged, at 6.4%.

Housing Starts

Housing starts aren't yet showing much impact from high interest rates. But, new home sales data for the GTA (from BILD and Altus) has turned down once again, from a short-lived partial recovery during April to June (the last datapoint is for July). This data points to a large drop in new starts next year. The GTA is the most interest-sensitive market in Canada, so for the rest of the country the drop will likely be less severe.



How to Reach Will Dunning Inc.

Email: wdunning@sympatico.ca
Web site: www.wdunning.com
Twitter: @LooseCannonEcon

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