

FEDERAL GREEN HOUSING MEASURES: RENEWAL AND AFFORDABILITY

USING FEDERAL TAX INCENTIVES TO
ENCOURAGE BUILDING RETROFITS WHILE
MAINTAINING AFFORDABILITY IN RENTAL
HOUSING ACROSS CANADA

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Photo courtesy of Jesse Colin Jackson

ABOUT THE CENTRE FOR URBAN GROWTH + RENEWAL

The Centre for Urban Growth and Renewal (CUG+R) is a non-profit research organization founded in 2009 with the mission to engage in cross-disciplinary research initiatives fundamental to achieving livable and sustainable urban, suburban and rural environments. The Tower Renewal Partnership is CUG+R's primary initiative.

ABOUT THE TOWER RENEWAL PARTNERSHIP

Tower Renewal is a model to transform Canada's remarkable stock of postwar apartment towers and their surrounding neighbourhoods into more complete communities, resilient and healthy places, fully integrated into their growing cities. Led by the Centre for Urban Growth + Renewal and supported by a group of core partners, the Tower Renewal Partnership is a collaborative initiative working to preserve and enhance this key housing through research, advocacy and demonstration projects. The Tower Renewal Partnership's goal is to enable reinvestment into these dynamic neighbourhoods, working toward building lower-carbon, healthier and more complete communities.

ABOUT DKGi

DKGI Inc. provides services for development of real estate and real estate investment and for the development of market investment strategies. Services include development of real estate investment pro-forma, site development strategies, and investment fund structure and property identification.

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1. INTRODUCTION

1.1 CONTEXT

In January 2019, an apartment tower in the St. Jamestown neighbourhood of Toronto suffered a burst water supply pipe which caused a massive failure of the building's electrical system. Water, heat and power were shut off, resulting in the displacement of residents. This single building is home to about 1,000 residents who went without power for three days. This building failure was a result of systems reaching their end of life – a condition indicative of aging systems found in thousands of buildings throughout Canada.

Built in the apartment housing boom of the 1960 and 70s, many buildings are reaching a critical age. In buildings where critical investments have not taken place, more are at risk of going offline. Rehousing the residents from the loss of one tower in Toronto will put substantial pressure on an already saturated rental market, with many residents required to stay in motels, or double up with family. The loss of two, three, ten or more buildings could prove a disaster.

Since they are the backbone of the purpose built rental housing system in Canada, there is a public imperative to ensure these types of buildings are sustained. Beyond preventing the loss of this housing through managed neglect, this housing can be modernized to meet the changing demands of 21st century Canada in response to changing demographics, a changing climate and contemporary expectations of life safety and public health.

It is increasingly urgent that action be taken to avoid losing crucial housing to deterioration or loss of affordability. Encouraging investments into the existing rental housing stock to meet 21st Century expectations while not negatively impacting affordability presents several challenges, particularly in private buildings. This report examines options for achieving these complementary goals.

With 76% of Canada's rental units more than 36 years old, it is not just apartment towers that require reinvestment. Many purpose-built rental units across Canada are contained in low- and mid-rise buildings that are aging and in need of reinvestment. A balanced, healthy rental market is necessary to provide housing that meets the needs of all types of Canadians. Ensuring rental units of all kinds are renewed and sustained, while remaining affordable, is critical to meeting the National Housing Strategy's goal of providing housing that meets the needs of all Canadians by 2030.



1.2 RESEARCH METHODOLOGY

The Tower Renewal Partnership (TRP) has previously completed comprehensive financial modelling based on reference data for a number of owner types and retrofit types. Using different building owner types (private non-profit, small, mid-sized, large private investment funds and publicly traded owners) and an assortment of building conditions (rents, repair needs, state of repair/retrofitting), 'typical' cases have been created for evaluation. These cases have then been modelled to analyse the economic impact of retrofitting on revenues, rents, profits and asset values, and to assess economic motivations and thereby identifying funding shortfalls.

This scope of this report includes:

1. Examining the cost of retrofit levels, from base state of repair to best in class low-impact and healthy housing;
2. Testing the financial capacity of various building types to engage in retrofits;
3. Assessing the motivations and financial capacity of not-for profit and for-profit owners to undertake retrofits;
4. Testing the use of tax system changes, loans, grants, and low-interest financing to close financial gaps and stimulate retrofit activity without relying on rent uplift and loss of affordability.

Though the work of the TRP is focused on apartment towers, this report provides expanded recommendations that are applicable to all types of purpose-built rental buildings in need of retrofit and reinvestment. This includes low- and mid-rise apartment buildings. However, it should be noted that the financial capacity and performance of these types of buildings may vary from the economics of the taller buildings.

1.3 WHAT IS TOWER RENEWAL?

Tower Renewal is a strategy to ensure that the affordable apartment tower stock is maintained, enhanced and prolonged. The Tower Renewal approach works in tandem to achieve quality of life improvements and realizing federal policy objectives related to climate change, affordable housing, poverty reduction and economic development.

There is considerable international precedent to support the Tower Renewal approach. Over the past 30 years, many European countries, including the UK, Germany, the Netherlands and Sweden have implemented national retrofit programs targeting postwar apartment tower housing. Most importantly, these programs have introduced government-driven financial tools and programs to enable retrofits at scale, resulting in significant positive impacts on their economies.

With much of Canada's affordable purpose-built rental housing in need of renewal, the time to act is now. However, costs - along with the need to maintain affordability - continue to be a primary barrier. As a result, the TRP has previously undertaken research uncovering the financial challenges and potential solutions. In 2017, the National Housing Collaborative and the Tower Renewal Partnership produced Financial Tools for Tower Renewal, which proposed program design considerations for federal housing repair and renewal programs. In June 2019, the TRP released Tower Renewal and Retrofit Finance in support of the Canadian Mortgage and Housing Corporation's interest in encouraging the retrofit and renewal of Canadian post-war towers, taking a deeper dive into the economics of comprehensive retrofits in apartment towers.

This report employs and summarizes the past several years of TRP research, focusing on governmental actions that will encourage broad uptake of retrofits across the Canadian rental housing stock.

1.4 FINANCIAL INCENTIVE CONTEXT: SUPPORTING HOUSING RENEWAL WHILE MAINTAINING AFFORDABILITY THROUGH THE TAX SYSTEM

Given the significant appreciation in real estate values across many Canadian markets over the last 20 years, the market value of many housing assets has increased significantly. This value increase has likely had two results: it allowed asset values to increase without significant increases in income – higher rents – and the resulting capital gain liability has slowed the sale of these assets as owners have to devise strategies to avoid or reduce that liability. As investment and building upgrades that could require building code updates and GHG reduction enhancement frequently occur upon sale with new ownership, communities have been provided with affordable rental housing resources but also heavy GHG production problems. **Ideally, policy intervention would both preserve the rental affordability, enhance housing quality and reduce GHG emissions.**

The advantage of working with tax incentives to address policy priorities like GHG reduction and affordability is that, if done correctly, they can be accomplished with minimal additional government investment by leveraging the existing federal tax infrastructure and relying on clear economic incentives (credits) and bright line penalties (recapture of credits). Designing programs could be done by the CRA in consultation with Environment Canada and Canadian Mortgage and Housing Corporation.

The largest inventory of affordable rental housing is owned and operated by public trusts and companies, private companies and individuals. In gross numbers, approximately 30% of Canadian households rent, and an estimated half of these living in purpose-built multi-unit rental housing. The inventory of purpose-built rental housing is largely older stock, facing significant requirements for capital reinvestment.

Significant work has been undertaken to identify the opportunity for reinvestment in multi-unit residential buildings with the objectives of building performance improvements and improving the livability of older buildings. Building owners in certain markets in Canada have demonstrated the value and the economics of large-scale building reinvestment and improvement. However, this approach is not widespread in all urban areas, and the inventory of older multi-unit buildings remains a high contributor to GHG emissions, and in some instances contribute to poor quality of life in low income neighbourhoods. Where investments are being made, it is often on the basis of increased rental revenue gains, diminishing housing affordability.

Reinvestment in existing rental housing is largely driven by three factors – regulation (compliance with building code, local bylaw or other legislation), market demand (response to competition in attracting tenants) and pricing (ability to generate sufficient returns on investments made in the buildings). The decisions to reinvest vary depending on the form of ownership, past investment activity, rental housing demand and pricing as well as the tax treatment. Public policy objectives such as reductions in GHG emissions or preservation of rental housing affordability are not paramount in these decisions.

1.5 POLICY CHALLENGE

The policy challenge is how building owners can be provided with sufficient incentive to proceed with reinvestment, and in some instances recapitalize their purpose-built rental assets and **not have this result in significantly higher rents**. Building investment decisions are in part determined by the cost of capital and the likelihood of gaining sufficient return on these investments over time. The decision to invest, in its most simple form, is one in which the building owner determines that the capital invested can provide sufficient return compared with other options or opportunities available to the owners. As noted above, all owners are not equal in terms of access to capital, impact of capital investment decisions, condition of property, current and future pricing and the tax impacts. Therefore, it is a challenge to find mechanisms that induce new capital investment in buildings that respond to this array of factors.

From a public policy perspective, the interest is in improving building performance, maintaining affordability and improving the quality of rental accommodations through the commitment of public resources. Each order of government has different policy and fiscal tools to achieve these results. For the Federal Government, these are largely confined to the provision of access to financing (access to crown borrowing rates or guarantees including mortgage insurance) or through the tax treatment for building owners related to the investment decisions they make.

As the tax code played a key role in incenting the original construction of many of these buildings through the 1960s and 70s, tax policy can play a role today in ensuring the resilience and continued affordability of rental housing in Canada. Several options are explored in the sections below.

2. THE COSTS OF RETROFITTING

Tower Renewal and Retrofit Finance (TRP, 2019) was developed in support of the Canadian Mortgage and Housing Corporation's interest in encouraging the retrofit and renewal of Canadian post-war towers. This study highlights the high costs of retrofits, and the financial capacity of owners to undertake them. It was found that on an individual building basis, most buildings lack the ability to leverage sufficient financing to engage in comprehensive retrofits (those that address housing quality and GHG reduction goals) without either an increase in revenues – ie rent increases – or financial support for retrofit capital expenditure (ie public grants / low interest loans). Further, the buildings with substantive repair backlogs (typically lower rent buildings of poor quality) require greater upfront investment for retrofits. As a result, without a substantial loss of affordability it is unlikely that most buildings throughout Canada will engage in retrofits without targeted government support.

The following section summarises the cost of various levels of retrofits, and high level findings related to building financial capacity. For a detailed overview of this financial analysis, please see *Tower Renewal and Retrofit Finance* (TRP, 2019) at www.towerrenewal.com.



2.1 RETROFIT LEVELS: WHAT IS INCLUDED IN A RETROFIT?

All retrofits are not created equal. Retrofits vary from core state of repair investments, upgrades to meet current health and housing quality standards, and a range of energy retrofits from modest to near-net zero. On top of energy retrofits, creating barrier-free accessible units is also very costly and has little Return On Investment (ROI). Further, buildings with substantive repair backlogs will require greater upfront investment for retrofits.

To understand the costs of various levels of retrofit, a study was undertaken to model the construction scope required to achieve retrofit outcomes, and the capital costs required to undertake this work. A full description and costs can be found in Levels of Retrofit (TRP, 2019).

Please note that the costs contained in this report are based on a 230-unit, 19-storey apartment tower built in 1967. It contains a mix of 1-, 2- and 3-bedroom units and is a concrete slab building with a masonry envelope, natural-gas heating and a domestic hot water system. It is assumed that the building has not seen any type of retrofit and has relatively poor performance in terms of energy efficiency and GHG emissions.

Levels of retrofit are broken into two categories:

1. State of Repair and Resilience; and
2. Deep Energy and Comprehensive Retrofits

STATE OF REPAIR (LEVELS A - D):

State of repair scenarios place focus on capital upgrades to ensure buildings remain in good service, are upgraded to meet today's expectations of life safety and accessibility, and are improved for resident health and community resilience. These measures exclude improvements toward energy efficiency which are addressed below. These measures are not cumulative but rather outline distinct scopes of work.

The degree to which buildings undergo work described in Levels A-D will largely be dependant on the existing state of the building. In some cases, enabling works will be higher in poorly maintained buildings and less in buildings that have had more routine attention.

A: BASE STATE OF REPAIR

This scenario accounts for the complete repair and replacement of all major building systems, addressing all “end of life” items in the case study building. Measures include mechanical and electrical system replacement including risers and distribution systems and related enabling works, balcony slab edge repair and balcony guard replacement, mould remediation, underground parking membrane replacement and other critical maintenance and system replacements.

The total cost for this work, excluding contingency, is \$8,706,357, or \$36,581 per unit.

B: ACCESSIBILITY

This scenario anticipates the federal targets for accessibility, providing fully barrier-free units for 20% of the building, as well as modernized elevators and entryways to enable barrier-free path of travel throughout the building.

The total cost for this work, excluding contingency, is: \$5,894,552, or \$24,767 per unit.

C: LIFE SAFETY UPGRADES:

This scenario accounts for upgrades to life safety to meet contemporary standards, including provision of sprinklers throughout the building and in each suite, a modernized fire alarm system and new back-up generator.

The total cost for this work, excluding contingency, is: \$2,845,673, or \$11,957 per unit.

D: SOCIAL RESILIENCE

This scenario engages in measures which improve social resilience, beyond those measures discussed in Levels A-C, and excluding measures captured in energy retrofit measures captured below. These include elevator replacements; modernized common areas, including community space upgrade for use as cooling room in extreme weather; the provision of in-suite thermostat controls and ceiling fans to improve summer overheating; and improved outdoor amenity for community activity.

The total value for this work, excluding contingency, is: \$2,706,325, or \$11,371 per unit.

Taken together, the total costs of Level A-D is **\$20,152,907 or \$83,970 per unit.**

DEEP ENERGY AND COMPREHENSIVE RETROFIT (LEVELS 1 - 4):

These four scenarios describe various degrees of energy retrofits. These levels are cumulative and include selective items from Levels A - D above that are required to achieve a comprehensive retrofit to the degree required for the scenario. Scope for these levels include modernizing the building envelope and mechanical and electrical systems for enhanced building performance, inclusion of in-suite thermostat controls and updated building automation systems, as well as related enabling works and other modernization measures not related to energy retrofits, such as life safety systems and elevator replacements. These levels are cumulative.

LEVEL 1: LIGHT ENERGY RETROFIT

The Light Energy Retrofit focuses on reducing water and electricity consumption, as well as like-for-like replacements of HVAC equipment for modest reductions in natural gas usage. Scope includes LED lighting retrofits, water-conservation fixtures, as well as complete replacement of mechanical air handling units and heating and domestic hot water boilers. Envelope upgrades are limited to re-caulking existing windows and exterior doors.

Level 1 retrofits achieve GHG reductions in the range of 10-20%. Due to short-term paybacks on utility costs, this level of retrofit is becoming more common in properties throughout Canada.

The total cost for this work, excluding contingency, is: \$3,688,094 or \$15,496 per unit.

LEVEL 2: MEDIUM ENERGY RETROFIT

The Medium Energy Retrofit is a combination of capital repair and energy retrofit enhancements. It includes a comprehensive HVAC system retrofit including provision of direct in-suite ventilation, the provision of window shading and ceiling fans for cooling, and window and exterior door replacement. This retrofit also includes envelope maintenance and repair items from Levels A and C, including balcony guard replacement and life safety upgrades including sprinklers. Level 2 retrofits achieve GHG reductions in the range of 35% with significant improvements to resident comfort. Currently, a select but growing number of properties across Canada have undergone or are undergoing a similar level of retrofit.

The total cost for this work, excluding contingency, is: \$12,046,343, or \$50,615 per unit.

LEVEL 3: DEEP ENERGY RETROFIT

The Deep Energy Retrofit scenario includes a comprehensive building upgrade, inclusive of building overcladding, high performance windows and the elimination of thermal bridges at balconies for the substantial reduction of heat loads, resized HVAC equipment, the installation of low-temperature radiators, as well as the provision of direct in-suite ventilation systems, and passive cooling measures. This scenario engages in life safety measures from Level B as well as elevator upgrades from Level D. This comprehensive retrofit achieves GHG reductions greater than 75% and provides significant improvements to resident health, comfort and climate resilience. Across Canada some marquee projects have undergone or are undergoing this level of retrofit.

The total cost for this work, excluding contingency, is: \$20,152,569, or \$84,675 per unit.

LEVEL 4: COMPLETE RETROFIT

The Complete Retrofit combines State of Repair Levels A - D and Energy Retrofit Levels 1 - 3. This scenario represents the transformation of a distressed asset in need of full systems replacement into state-of-the-art modernized housing. While this level of retrofit is currently rare, limited to one known example in Canada, it is used here for the purpose of comparison. This 'complete' retrofit achieves GHG reductions greater than 90% and demonstrates significant improvements to resident health, comfort and resilience, as well as comprehensive asset modernization.

The total cost for this work, excluding contingency, is: \$32,206,256, or \$135,320 per unit.

The following is a summary of the total and per unit costs of the eight levels of retrofit discussed above.

Table 1: Levels of Retrofit

Levels of Retrofit								
	Level A	Level B	Level C	Level D	Level 1	Level 2	Level 3	Level 4
Project Cost*	8,706,357	5,894,552	2,845,673	2,706,325	3,688,094	12,046,343	20,152,569	32,206,256
Cost / Unit	36,581	24,767	11,957	11,371	15,496	50,615	84,675	135,320

**Costing includes construction materials and labour costs, contractor mobilization, overhead and fees. Prices exclude construction contingency, project soft cost and applicable taxes.*

2.2 BUILDING OWNERS AND FINANCIAL CAPACITY: MOTIVATIONS FOR ENGAGING IN RETROFITS

The largest inventory of affordable rental housing is owned and operated by public trusts and companies, private companies and individuals. In gross numbers, over 30% of Canadians are tenant households, and an estimated half of these live in purpose-built multi-unit rental housing. The inventory of purpose-built rental housing is largely older stock, facing significant requirements for capital reinvestment.

Significant work has been undertaken to identify opportunities for reinvestment in multi-unit residential buildings with the objective of building performance improvements and the livability of older buildings. Building owners in certain markets in Canada have demonstrated the value and the economics of large-scale building reinvestment and improvement. However, this approach is not widespread in all urban areas, and the inventory of older multi-unit buildings remains a high contributor to GHG emissions, and in some instances contributes to poor quality of life in low income neighbourhoods.

Recapitalization of rental housing is largely driven by three factors: regulation (compliance with building code, local bylaw or other legislation), market demand (response to competition in attracting tenants) and pricing (ability to generate sufficient returns on investments made in the buildings). The decisions by owners related to re-capitalization of purpose-built rental housing vary depending on the form of ownership, past investment activity, rental housing demand and pricing as well as the tax treatment for building owners. Public policy objectives such as reductions in GHG emissions or preservation of rental housing affordability are not paramount in these decisions.

Economic motivations and financial capacity limit for-profit owners' willingness to undertake retrofits. Owner capacity can vary significantly due to rent zones, vacancy rates and maintenance needs. Pre-existing debt will also significantly hinder an owner's ability to raise money for retrofits. For most buildings, carrying pre-existing debt of 30% of their building value limits their capacity to leverage new debt toward a retrofit project by more than 50%. Some buildings have the financial capacity to engage in retrofit, while others do not. Additionally, the full use of a building's financial capacity will be limited by for-profit owner's seeking the best ROI for their investments. (ie, where capacity does exist, retrofits may not be an attractive use of capital).

In for-profit buildings, projects are evaluated not only on existing financial capacity, but for financial performance. Large scale retrofits typically do not generate returns commensurate with capital needs and project risks, particularly when not relying on rent increases. While some for-profit owners may have the ability to raise capital through debt or equity, their motivation for doing so may be limited to investments which meet ROI criteria and not public policy objectives. As a result, retrofit activity may be limited in scope and tied to increased rent profiles and work with short payback periods.

Rent increases have traditionally been used to fund repair and renewal which places pressure on affordability. Rent profiles have a significant impact on the capacity to engage in retrofits. However, using rents as the basis to finance repair and renewal would place unhealthy pressure on many Canadian households living in these buildings who are currently financially stressed by the existing rent burden. Increases to rents in these buildings would negatively impact lower income households. Encouraging the use of rent increases to support retrofit activity should be avoided.

On the other hand, non-profit owners have a motivation and mandate to use their financial capacity toward repair and renewal, however they may be limited in their financial capacity to do so. Without the need to create and grow profit, non-profit owners have a unique ability to use a significant amount of free capital funds for repair and renewal.

2.3 THE FINANCIAL GAP

The capital costs of retrofits is beyond the financial capacity of many owners, particularly for retrofit Levels 2, 3 and 4 described above. Moreover, the motivation for owners to put their financial capacity toward these types of retrofits is often evaluated by financial performance, not solely on financial capacity or public policy outcomes.

As a result, most buildings throughout Canada will not engage in retrofit without support. The TRP's financial modelling and research has demonstrated that a significant financial gap exists in most retrofit scenarios. The estimated financial gaps, as related to the cost of retrofits and owner financial capacity are demonstrated below using a 230-unit apartment building.

Table 2: Retrofit Cost Summary for a 230-Unit Apartment Building

Retrofit Level	Retrofit Costs	Owner Debt Capacity (Assuming low vacancies, low maintenance and debt level as 30% of Cap Value)	Financial Gap (Excluding all retrofit financing tools)
Level A (Base State of Repair)	\$8,706,356.92	\$8,480,500	\$225,857
Level B (Accessibility)	\$5,894,551.52	\$8,480,500	none
Level C (Life Safety)	\$2,845,673.42	\$8,480,500	none
Level D (Resident Resilience)	\$2,706,324.73	\$8,480,500	none
Level 1 (Light Energy Retrofit)	\$3,688,094.20	\$8,480,500	none
Level 2 (Medium Energy Retrofit)	\$12,046,343.00	\$8,480,500	\$3,565,843
Level 3 (Deep Energy Retrofit)	\$20,152,569.13	\$8,480,500	\$11,672,069
Level 4 (Best in Class Retrofit)	\$32,206,256.20	\$8,480,500	\$23,725,756
NHS Retrofit (Level B + Modified Level 2, owner debt capacity takes into account 30% units @ 80MMR)	14,314,786	\$7,002,200	\$7,312,586

2.4 RETROFITS AND RISK TO AFFORDABILITY

Financing repair and renewal works through rent increases alone would have substantial negative impact on affordability. For illustrative purposes, the eight retrofit levels identified in this study, have been analyzed based on the required rent increase to cover project costs (assuming use of favourable long-term financing):

Covering Debt Service for Retrofit Investment Through Rental Increases: Impact on Affordability

Financing Retrofit - Impact on Rents				
Renewal Level	Capital Investment	Debt Service Using Long Term Loans (3.8% / 25 Years)	Impact on Rents (per unit/month)	% Increase from baseline (100 MMR)
Level A	\$8,706,356.92	\$545,592.08	\$191.03	15%
Level B	\$5,894,551.52	\$369,387.64	\$129.34	10%
Level C	\$2,845,673.42	\$178,326.81	\$62.44	5%
Level D	\$2,706,324.73	\$169,594.40	\$59.38	5%
Level 1	\$3,688,094.20	\$231,117.91	\$80.92	6%
Level 2	\$12,046,343.00	\$754,895.46	\$264.32	21%
Level 3	\$20,152,569.13	\$1,262,879.78	\$442.18	34%
Level 4	\$32,206,256.20	\$2,018,235.47	\$706.67	55%

3. ENCOURAGING RETROFITS: BRIDGING THE FINANCIAL GAP

The magnitude of the financial gap points to the need for continued public investment; in many cases, substantial public investments are required to fully fund retrofits.



3.1 PRESERVATION OF RENTAL AFFORDABILITY

In most Canadian urban markets, there is upward pressure on rents. Lower migration of renters into home ownership (home ownership price barriers, inventory availability), increased demand from in-migration (larger Canadian cities) and a lack of new rental housing starts (particularly at low and moderate prices) all contribute to push rents upwards. In Toronto, it is estimated that the achievable rents increased year-over-year by 17% in 2018 on re-occupancy of vacant units. These rent increases are not apparent in average and median rent data as there continues to be a large inventory of occupied units subject to rent increase regulatory limits. In these market conditions, building owners will be motivated to invest new capital if there is a strong likelihood of gaining sufficient new revenues. The current market forces that are likely to attract new capital into existing rental housing are also likely to result in increased rents and diminished affordability. Rent regulations will have some effect on the rate of reinvestment and price increase but is unlikely to prevent rent escalation the longer term.

3.2 TAX IMPACTS FOR BUILDING OWNERS: OPTIONS ANALYSIS

As noted above, there are several factors that impact a building owner's decision to reinvest in a building. Where the assets are held in a larger corporate entity or institutional fund, the decision is most likely a straight forward economic decision related to ROI. Incentives related to reducing the cost of capital (access to low cost, long term capital at crown rates) or reducing the cost of improvements (reduction or elimination of HST/GST on building improvements) are likely to be most attractive. However, there may not be significant interest in these incentives if the policy intent is to regulate subsequent rent increases so as to ensure that the public investment in recapitalization results in sustained rental affordability (most likely time limited to the horizon of the depreciation of this investment). Typically, a building owner, institutional or small property owner, will voluntarily invest capital when there is likelihood this will result in increased revenues.

The value of incentives would have to at least be equal to the likely gain in revenue from investments at the owners' usual cost of capital, but not realized because of an agreement to limit rent increases. An institutional owner will weigh the benefit of access to low-cost capital against the opportunity cost of reduced long-term rents. In current rental markets, it is less likely the incentives of capital at crown rates can be made attractive if there is a high rate of suppression of future rent increases. This is particularly the case where there are low vacancy rates, high demand and high price increases for rental housing without significant investment of new capital in buildings.

For example, a 1-bedroom unit renting at \$1,000 per month in 2019, after 10 years at a fixed rent increase of 2.5% will have a rent of \$1,280 per month. The same unit, where rents are allowed to rise on a vacancy, will have a rent in 10 years of \$2,652 per month, assuming 10% to 15% annual rent increases. On a cash basis, the building owner accepting a fixed rent increase of 2.5% would in this scenario be forsaking the opportunity of earning an additional \$1,372 monthly by year 10. For a 100-unit building, assuming at 50% turnover, this is forsaking over \$800,000 annually in rental revenue on the 2029 balance sheet.

For non-institutional building owners, it is more likely that incentives for capital reinvestment related to current and future tax treatment will have some interest. Whereas institutional owners have a long-term interest in holding assets, and therefore are not likely to be motivated by capital gains in the short-term, smaller corporate and individual owners are more likely to be motivated by reducing any impacts on the realization of the value of their asset at sale.

At the sale of a building, non-institutional building owners face two tax consequences – repayment of any capital cost allowance that they have claimed over the course of the ownership of the building (deferral of tax impacts) and capital gains (tax on the increased value of the asset from the point of their ownership to the sale of the asset).

3.2.1 IMPACT OF CAPITAL COST ALLOWANCE RECAPTURE AND CAPITAL GAINS

Capital cost allowance (CCA) is the amount of allowed depreciation on a building that can be claimed by a building owner in any year and reduces the taxes payable on the income from the property in that year. The amount of CCA claimed is established by the CRA and is dependent on total revenues (all properties in the portfolio). It is most common for building owners to claim CCA, as the value of a dollar saved is high relative to when it is likely to be taxed at sale (often 20 or more years in the future).

Assuming that the building will have a higher value at sale than the original purchase price, taxes payable by an owner include the amount of CCA claimed (at the building owner's marginal rate or the applicable corporate tax rate). In addition to the recapture of CCA, a building owner will face a capital gains tax – a tax on the net gain in value appreciation of the property.

A simple example illustrates the taxes payable by an owner at sale. A building originally purchased for \$5 million, is sold for \$10 million. The building owner has deferred through CCA an amount of \$1.2 million in taxes. Assuming the building owner is in a 40% tax bracket, the taxes payable on sale are:

\$2.0M @ 40% = \$0.80M (recapture of CCA)

\$5.0M @ 25% = \$1.25M (approximate capital gains 50% on 50% of property gain value)

Total taxes payable \$2.15M

In this example, on the sale of a building the owner will net \$7.85 million less any debt owned on the building. For many building owners, the sale of a building creates a cash flow issue. It is usual for a building owner, and particularly one that holds multiple assets, to withdraw equity from the building (place a mortgage) in order to fund new investments. Where there is a high rate of debt, at the point of sale, there may be insufficient proceeds to pay both the CCA recapture and capital gains.

The sale value of a rental property is driven by the current net revenues and the expected ability of a new owner to increase rents and net revenues in the future. In most Canadian markets the value of purpose-built rental housing has risen due to high demand, rising rents and expected rent gains in the future. The motivation by many independent building owners to recapitalize their assets in order to gain value in their properties through rent increases is relatively low. Value gain in the property is largely driven by market forces, and tight supply ensures that product can be rented even if lower in quality or where buildings have higher than average operating costs.

3.2.2 TAX TREATMENT INCENTIVES

As encouraging retrofit activity contributes to the National Housing Strategy's goals of reducing GHG emissions, increasing housing affordability and improving housing conditions, it is important to ensure program alignment. Modelling in the following sections (3.2.2 to 3.2.5) assumes program participation minimum of 25% reduction in GHGs and \$35,000 per unit retrofit investment. This is in line with NHS programs and would ensure that projects are able to stack available funding.

Capital cost recapture and capital gains tax reductions

One possible incentive to increase current investment in building improvements is through a tax incentive - either through reduced future CCA recapture or reduced capital gains taxes. The challenge is in establishing the future value of a benefit that provides sufficient incentive for reinvestment in the current period. Unlike a grant, the effect of a tax incentive is dependent on the length of time that an owner is likely to hold the asset, their cost of capital (opportunity cost attributed to the capital that is being invested, and assumptions about future cost and price inflation.

To illustrate this concept, a 100-unit building in ownership for 20 years, was modelled. It is assumed the original purchase price of units was \$75,000 per unit, and reinvestment requirements are \$35,000 per unit and will result in an operating cost savings of 20%. The building is assumed to have been financed originally at 65% of value and no new debt placed on the property. While it is unlikely any single project will have these parameters, these are reasonable assumptions for the purposes of modelling the impact of tax incentives.

The model measures the assumed present value of future tax benefits (benefits realized at the sale or transfer of the asset) against investments made in the building to achieve GHG reduction targets and/or livability improvements while suppressing potential rent increases in order to maintain housing affordability. Put differently, the model compares the present value of a future tax benefit and the value of rent increases, assuming no agreement to hold rent increases to a modest level.

The results of the modelling indicate that there is little value in providing future tax advantages (either in the form of reduced capital cost recovery or capital gains). Even broadening the parameters of the model, there is not likely to be a scenario in which the value of future tax benefits offset the value if investments and suppression of potential rent increases in order to maintain affordability.

The challenge with this approach is whether a building owner can be incented to take advantage of the tax relief, and keep rents within a prescribed guideline. For an existing owner this calculation is relatively simple, and the level of interest in capital investment is largely driven by the likely duration of owning the asset. The longer the hold period the less the present value of a future tax advantage becomes. Where the tax treatment binds a future owner or has the effect of reducing the value of an asset because future revenues are impaired (more likely in a shorter planned hold period), this approach it is less likely to attract current owner interest. The offset to this may be to increase the capital gains tax reduction, but this creates a larger loss of future tax revenues for government, offset by the value of preservation of affordable housing and GHG reductions. A building owner will have limited direct gain from these investments and the reduction of future rents. For government, the subsidy transferred to the building owners through tax incentives must at least equal the value of the lost revenue plus a risk premium related to the uncertainty of the future tax gain in present value terms (likelihood of assumptions in discount rate and inflation being realized).

The approach of reducing future capital gains does not provide current cash flow to the building owner, and of the corollary requirement to maintain rents at current levels, there is limited additional cash flow available to service new debt. Therefore, this approach to inducing new building investment is likely to be attractive only to owners who have debt capacity and/or access to lower cost financing. There may be an opportunity to link this approach with a separate incentive of access to capital at crown borrowing rates.

Providing an incentive through reduced CCA recapture will largely have the same impacts as a reduced capital gains tax, although the impact can be greater as the likely marginal tax rate of owners is higher than the capital gains tax rate. In either case, the owner will gain more of the proceeds on a building value on sale, but the approach does not offer any cash flow assistance to support current year investments in building improvements. A building owner will have to be able to obtain and finance a loan based on the current cash flow of the business (and anticipated operating cost reductions).

Increasing the rate of CCA for building recapitalization is likely to only have a positive impact for multiple or portfolio property owners. The assumption is that where owners are taking advantage if CCA (as it is not a mandatory tax treatment) they are maximizing this benefit. Additional CCA would lead to losses, and these can only be used to offset revenues on other properties in a portfolio.

The use of capital gains tax reductions and reduced capital cost allowance recapture can be used as an incentive for building owners to reinvest and improve buildings. However, the target group of owners that are likely to use this incentive may not be significant, given it will target individual or smaller corporate owners, those that have current cash flow to support additional debt, and those with a pre-determined hold period on the assets that is not significantly longer than 10 years. The challenge in providing these incentives is that their value to a building owner is in the future and is eroded over time.

3.2.3 ANNUAL TAX CREDIT AGAINST RENTAL PROPERTY INCOME

It is likely that an annual tax credit for building owners who invest capital in improvements and GHG reductions will be more attractive than wither CCA or capital gains tax reductions. In the model scenarios developed to test the various tax treatment approaches, the value of an annual credit (minimum duration 10 years) provides a present value that is close to the same as the present value of rent increases (based on the assumptions listed above on turn over and rent increases on vacant units). The attractiveness of the tax credit approach does vary based on the form of ownership and tax treatment for the entity holding the asset, and the effectiveness will vary based on how much debt above the modelled level is actually in place for the property. In cases of high debt levels (high owner leverage) the tax credit has less value as there is less net income and less tax to offset. However, in cases where the property is part of a portfolio, and there is an ability to use the credit within the portfolio, this would increase the in-year tax credit approach for building owners.

3.2.4 SALE OF ASSETS FOR PRESERVATION OF AFFORDABILITY

A different approach, and one that avoids the impact of diminished future gains from favourable tax treatment is to provide for these advantages at the time of sale of an asset. In this approach, building owners are provided with incentives to sell their buildings to entities that will hold these in the long term and maintain the affordability of the housing, while investing in the refurbishment of the buildings. While such entities are most likely to be not-for profit organizations (NPO's) they could be institutional owners interested in a stable long-term return and not motivated by maximization of returns.

Acquisition of rental units is, in most markets, a less expensive approach to ensuring the availability of affordable units. While this approach does not result in new net units, it prevents the loss of affordable rental units. Loss of housing affordability is a critical issue in most Canadian cities, and this diminishes the impact of any new net additions of rental housing.

The proposed transfer of assets to entities that have the goal of maintaining housing affordability places the assets where there is an incentive to reduce operating costs through capital reinvestment and increasing the quality of the buildings in the long term. Indirectly, this establishes a basis for providing opportunities for large scale recapitalization of assets. Where the new owners are NPO's, there is an ability to use existing and planned government housing expenditures on rehabilitation and building performance improvements while maintaining affordability.

A model (see attached Model B) has been developed to illustrate how a transaction can be incented so that the assets are transferred to owners with a long-term interest in housing affordability. The transaction would be structured as follows:

- Assets eligible for acquisition under the terms of a tax incentive program are valued at a 5% or higher cap rate (including the cost of major repairs to achieve compliance with health and safety standards)
 - This cap rate targets modest rent buildings
 - Vendor prices must be below market averages measured over the past 12 months
 - Negotiations with vendors will reduce the price to comply with program guidelines
 - The cap rate will cause an adjustment to pricing for interested sellers
 - A minimum size of building can be set in each marketplace representative of the average size of multi-unit buildings
- Covenants will be put in place to ensure that rents will be maintained at average market rents for the area for a minimum period of 20 years
 - Sale of asset is permitted after this time
 - Assets can be re-capitalized over this period and/or be used as balance sheet support for other real estate investments
- Interested eligible property owners will have the benefit of:
 - A reduction of 80% in capital gains (increased deal cash flow)
 - Increased net gain (estimated between 10 and 13%)
- An eligible new entity (NE) has the benefit of:
 - Acquisition of properties at reduced values and affordable rents
 - The net benefit of over 60% of the tax incentive
 - Transfer of new inventory at prices below new construction

It is proposed that the rental acquisition program be established for a fixed duration (4 or 5 years) in order to assess the market impact and the success of asset acquisition. The time limits provide an incentive for owners to move more quickly on sale decisions and allow the federal government to plan for the tax impacts of these acquisitions.

3.2.5 RENOVATION CREDIT

In rental complexes with rents currently below average market rents and meeting other key qualifying criteria (over 20 years old, high GHG production, and key building code deficits), for every dollar invested in qualified improvements (GHG reducing, code compliance), the owner would receive a tax credit worth 15% of the total project rehabilitation investment (hard and soft costs related to the work) each year for five years beginning with the year the improved building with the still affordable rents is placed in service. If the owner spent \$1,000,000 on the improvements, they would receive \$150,000 in tax credits every year for 5 years. The credit would be regulated through certified tax returns. The credit can only be applied against owners' tax liability, but could be distributed to owner/investors in a partnership or limited partnership that owned the building and applied against corporate or individual tax liability related to other income producing activity so could include banks, insurance companies, and other entities with predictable long term tax liability. Users of the credit would be careful in their use of the credit since a violation of the rules (filing inaccurate tax accounting or failure to reach GHG, affordability, or other key requirements) could result in recapture of the tax credit for up to 10 years. The owner would need to agree to an affordability covenant of no less than 20 years.

Tax incentive could also take the form of increased depreciation rates, which could be calibrated to achieve a similar incentive. However, tax credits may prove a simpler and more universal incentive.

3.2.6 ACQUISITION AND RENOVATION INCENTIVE FOR HIGH IMPACT TARGETS

For buildings that meet the above criteria but also have a particularly high GHG production and good affordability profiles, an additional incentive providing for half the cost of the property's acquisition could be included in the basis for the tax credit when acquisition and renovation are done together. Including the renovations credit described in 3.2.5, if \$1,000,000 was spent on acquisition and \$1,000,000 was spent on renovations, a credit equal to 15% of \$1,500,000 or \$225,000 would be taken every year for 5 years. In this case GHG reduction outcomes should be critical to national GHG reduction planning and the affordability covenant should be for 30 years. Ideally these acquisition/renovations developments would be led by non-profit entities working with limited partnership structures resulting in an increase in community controlled affordable housing assets.

3.3 COMPLEMENTARY OPTIONS

3.3.1 LOANS & FINANCING

The following suite of options built from the tax incentive explored above to create a suite of tools to support activity toward housing Repair and Renewal.

Energy-Backed Loan Products

An energy-backed loan, which uses capital funds financed by long-term energy savings, can be used to direct additional capital toward retrofit. These loans are tied to the energy performance of retrofits, rather than the financial capacity of an individual building or owner. This tool has broad appeal among owner groups, is viewed as no cost debt, and is revenue neutral.

Low-Interest Financing

Widely accessible low-interest long-term financing can be used to stretch available debt capacity to those engaging in deep retrofits. Where debt is used to finance capital projects, low interest lending rates tied to policy objectives can help to use any available debt most effectively.

Mortgage Refinancing

A Renewal Mortgage Refinancing tool is a potential mechanism which could be used by a broad range of private and non-profit owners to undertake retrofit projects. Through reduced interest and prolonged amortization rates (2.5% over 35 years, for example) a Renewal Mortgage Refinancing tool could provide an operating incentive which frees up capital toward retrofits. This Renewal Mortgage tool could be tied to investments that support public policy goals (carbon reduction, social resilience). Further study is required to determine the terms of delivery of such a tool, to ensure ease of use, uptake, and efficacy in meeting public policy goals.



3.3.2 PUBLIC GRANTS

Performance-Based Grants

Strategically designed grants can drive policy-driven investment when tied to performance requirements. Existing CMHC grant programs limit equity contributions to 15% of project costs for private owners. Expanding this threshold, while aligning grant levels to performance, could motivate owner participation in retrofits. Grants could also be designed to support smaller owners with less financial capacity, ensuring program uptake in smaller economies and communities.

3.3.3 GROWING THE RETROFIT INDUSTRY

The tools outlined above can drive retrofits from an owner's perspective. However, the development of a capable retrofit industry ecosystem is also crucial to drive down risk and trade pricing. The public sector is best positioned to lead this market transformation through complementary initiatives, including:

- a. Support of deep and complete retrofit demonstration projects;
- b. Support of capacity development, including trades training, practice guides, research and development, and widespread awareness campaigns for design, construction and building operations professionals.

3.3.4 REGULATIONS AND STANDARDS FOR RETROFIT

Provide Guidance for Renewal Standards

The regulatory framework for altering existing buildings varies significantly across provincial and territorial building codes, resulting in inconsistent interpretations across the country. The development of a national model code, voluntary guidance documents, and case studies will help to ensure that deep retrofits are linked to new construction standards for health, safety, and resilience.

Across orders of government, regulation could be introduced that requires certain types of retrofits for aging buildings (ie, such as through Municipal Codes that govern base housing quality). This has been incrementally implemented in European jurisdictions with success, since positive incentives alone are not sufficient drivers for widespread uptake. While regulation is an effective tool, impacts on affordability and other unintended consequences must be carefully studied.

Reevaluating Criteria for ‘Above Guidelines Rent Increases’

In jurisdictions such as Ontario, existing rent increases are fixed roughly at inflation for sitting tenants. However, owners are able to increase rents beyond this value if capital investments are undertaken that meet specific criteria. Many of the improvements considered here as ‘Repair and Renewal’ may trigger an ‘Above Guidelines Increase’ under current frameworks, placing affordability pressures on tenants. As a result, it is recommended that:

1. Participation in programs considered here should be on condition of not engaging in Above Guidelines Increases; and
2. The Criteria for Above Guideline Increases should be reevaluated to not include the retrofit activity to be undertaken in achieving the housing quality and GHG reduction goals of Repair and Renewal.

4. SUMMARY FINDINGS

4.1 RECOMMENDATIONS

As noted above, taxation can be a powerful tool in incenting investment behaviour in the aging stock of rental apartment buildings throughout Canada.

The analysis conducted here found that an incentive built on forgiveness of capital gains and/or CCA recapture is not likely to attract significant interest for building owners. While the model is necessarily based on assumptions that will be quite different than the reality of many building owners, it clearly demonstrates that the future value of a tax credit does not provide a greater benefit than simply minimizing capital investment in a building and raising rents in response to market demand. While it is possible that future rent increases will be low, and market demand may drop, these are unlikely to be the scenarios that compel building owners to voluntarily suppress rent increases and maintain rental affordability in exchange for an uncertain tax credit value.

More likely for building owners is the attraction to an annual tax credit available to building owners who invest in GHG reductions and building improvements. The credit will offset current year tax liabilities, increase cash flow, and provide the benefit in current year dollars. Using this incentive, it is more likely to have an acceptance of rent suppression or voluntary control in exchange for increased net revenues. If the building investments are made on the basis of access to low cost, long term financing, then it is even more likely that this tax treatment approach will find some takers among independent building owners.

Additionally, as described above it was found that incentives at point of sale to an entity committed to preserving affordability would be attractive in shifting assets from a select group of current owners, toward owners and operators with an affordability mandate.



In summary, it is recommended that:

- 1. An affordable housing renovation tax credit be developed allowing for the value (at minimum) of 15% of the cost of renovations for each of five years, pending guarantee of affordability and building performance criteria (as described in Section 3.2.5 above);**
- 2. An affordable rental sale and acquisition capital gains tax incentive be developed (as described in Section 3.2.3 and Section 3.2.6 above);**
- 3. These measures be coordinated with existing programs such as those provided through the National Housing Strategy (NHS);**
- 4. Complementary measures as described in Section 3.3 be developed to support broader affordable housing retrofit activity**

Using such a tax credits aimed at the private sector will promote the maintenance of affordability through mitigating lost future revenue through rent increases. Though the tax credit serves to make retrofits as attractive as raising rents, it is important to note that it will not cover the full cost of forgone profit. For example, on a per unit basis, the future forgone revenue is \$40,000 and the retrofit investment is \$35,000. While the tax credit will contribute to the total cost, the full cost still requires owner contribution (which could be supported through participation in other retrofit programs).

5. ADDITIONAL CONSIDERATIONS

Preserving Affordability

As described throughout this paper, increased rents are the primary method of increasing revenue in rental buildings: these revenues are typically directed toward expanded operations, reinvestment, or profit. Investment in buildings is primarily motivated by an ability to increase rental revenue, either through rent increases at turnover, or by filling vacancies. Lobby renovations, landscape improvements, and cosmetic suite modernization are all specifically aimed at making buildings more attractive to prospective tenants, thereby securing rent or occupancy increases. In this environment, renewal projects tied to public policy goals while maintaining affordability pose a considerable challenge in the private sector environment.

Public investment is required to ensure the costs of repair and renewal are not borne by lower income tenants, resulting in the loss of affordability.

Policy Context

Through the National Housing Strategy (NHS), the federal government is investing \$40 billion toward affordable housing over the next ten years. A portion of this investment will be delivered through the National Housing Co-Investment Fund – a vehicle which provides crown rate lending and direct equity contributions for both affordable new construction and renewal. CMHC has also announced a mission statement that all Canadians be housed in appropriate and affordable housing, and to achieve this goal by 2030.

In this context, the tax treatments explored here have the potential to both generate new activity in affordable housing investment, and, importantly, augment existing spending (such as through the NHS) through increased program participation and by strengthening the not-for-profit housing sector.

Tax Treatments to Encourage Private Sector Retrofit Activity

Tax treatments to reduce the impact of CCA and capital gains taxes may encourage private sector investment activity. However, as noted above, uptake will be specific to a segment of the market and any programs which preserve affordability by restricting rent increases will likely face limited uptake. Inducing participation of some market segments may require a large public investment.



Tax Treatments to Encourage the Sale of Private Sector Assets to NPOs

Using tax treatments to incentivize the sale of for-profit assets to affordable housing providers (NPO or other) has the potential to achieve several important goals:

1. Encouraging the movement of housing assets that may be stranded due to tax penalty at sale;
2. Increasing the ability of affordable housing providers to acquire housing assets, thereby transitioning these units from 'precariously affordable' to intentionally affordable; and
3. Placing this housing in a position to benefit from existing financing and grant programs largely targeted to the NPO and affordable housing sector.

This tax treatment has the potential to shift a portion of the existing housing mix toward secure long-term affordability, while benefiting both private sector owners and affordable operators. Moreover, this strategy would support expanded participation in existing housing renewal tools, such as those offered through the NHS. This public expenditure would satisfy multiple public policy objectives while leveraging existing spending.

Applicability Across Geographies and Built Form

Rental markets in large urban centres are under considerable pressure across Canada. However, secondary and tertiary markets are experiencing less upward pressure on rents. In these conditions, owners may favour long-term stability over immediate market gain. As a result, buildings in these markets may be more amenable to the affordability requirements of any of the above tools.

The scenarios explored here are applicable to all forms of purpose-built rental housing. While the scenarios tested modelled larger buildings, the impacts are generally scalable on a per-unit basis. The cost of retrofit, however, varies based on the scope of work, size, condition and configuration of the asset, and local market conditions.

Stackable Incentives to Maximize Impact

Any program geared toward investment in housing renewal should be stackable with other incentive programs. Given the magnitude of investment required for renewal, multiple sources of capital are generally required for project viability. Access to low-cost capital, performance-based grants, and indirect financial contributions such as the regulatory environment and industry readiness (training, product availability) must all be harnessed together to create a competitive, self-sustaining, and cost-effective market environment.

