



NATIONAL ROUND TABLE ON THE ENVIRONMENT AND THE ECONOMY
TABLE RONDE NATIONALE SUR L'ENVIRONNEMENT ET L'ÉCONOMIE

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NRT-1996062

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Sustainable Development

FIRST
DRAFT

**THE RE-USE OF BUILDINGS:
TAX MEASURES FOR
SUSTAINABLE DEVELOPMENT
IN HUMAN SETTLEMENTS**

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**FOR: THE NATIONAL ROUND TABLE ON THE
ENVIRONMENT AND THE ECONOMY**

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ABSTRACT

The Government of Canada is urged to consider the following prospect:

<p>To restructure and rationalize the tax accounting of buildings:</p> <ul style="list-style-type: none"> • to allow renovators, who <i>extend the life expectancies</i> of buildings, to have a <i>clear and predictable tax treatment</i>, based upon the principles which the courts have already directed, but more <i>simply</i>; • this measure should be self-financing almost immediately; but <i>if</i> (and only if) such treatment causes a drain on the Treasury, then the government may explore compensating itself by dipping into the existing tax deductions for the premature <i>decay, destruction and removal</i> of buildings to landfill sites. 	
ESTIMATED EFFECT ON:	
JOBS	creation of thousands of jobs in the building renovation industry (at <i>twice</i> the rate of new construction)
ENVIRONMENT	"re-use and recycle" society's largest investments, and ease pressure on landfills (one third of Canada's deposits are "used construction material")
TAXPAYERS	approximate <i>neutrality</i> , for property-owners
DEFICIT	beneficial (although proposals are roughly revenue-neutral for property owners, job creation in renovation will generate many more <i>taxable salaries</i>) than the few which may be lost in demolition
HOUSING	more affordable housing saved instead of destroyed
TAX POLICY	beneficial (these proposals are not tax <i>incentives</i> ; they would remove unrealistic tax <i>anomalies</i> which <i>encourage</i> demolition)

- This is *not* about perks or favours
- The objective is a *win-win*:
 - a) FOR FINANCE
 - more taxable salaries
 - more mechanisms/motivation for owners to do *legitimate* (well-documented) repairs (thereby attacking the underground economy)
 - *no* new perks (sensitive to deficit reduction)
 - b) FOR CANADIANS
 - more *jobs* (rehab)
 - more *re-use* (of items as big as buildings)
 - less *waste* (1/3 of landfill is used construction material)
 - improved *cities* (repaired housing, dynamism etc.)

THE ISSUE

- **ORIGIN: 1940s**
- **Economic goals at that time:**
 - avoid return to Depression
 - promote industrialization, *via*
 - "new is better than old"
 - "replacing is better than fixing" ("Planned Obsolescence")
- **How this affected buildings:**

as expressed where?

*eliminate or reference + defend
Keep to defensible statements*

TOPIC	1940s ATTITUDE	1940s TAX	TAX SYSTEM TODAY	ACTION BY FINANCE CANADA
RE-USE (REHAB)	<i>Marginal</i> (at best) to national interest	Not even worth defining (i.e.) what's deductible or not)	Unchanged. Still no clear idea what work is deductible	
DESTRUCTION	Get rid of old buildings	Better deal for demolition than for donating the building to charity	Some instances where demolition still delivers tax deductions ("Terminal Losses")	Reduced in '81 for many cases, but not all.
OBSOLESCENCE	Buildings should be <i>replaced</i> ASAP	Buildings will lose \pm 3/4 of their value in a decade	Buildings lose over half their value (53% in constant dollars) in a decade — 34% tax-deductible	3/4 was excessive, and was reduced in '87 <i>somewhat</i> + 0 ?

- To its credit, Finance Canada has shown awareness of these problems: it tried to update the system (e.g. '79, '81, '87) — but *without the benefit* of a *comprehensive* review of cumulative effects.

THE BIG PICTURE

- The *combined* impact on investors, buildings and cities:
- Investors must continuously choose between

deterioration

destruction

VS.

rehab

re-use

QUESTION: IS IT TIME TO EXAMINE HOW TAX AFFECTS THIS CHOICE, IN LIGHT OF WHICH OPTION IS MORE LIKELY TO

- Reduce deficits
- Create more jobs
- Provide more levers against the underground economy
- Re-use resources
- Reduce waste
- Improve Canadian lives

The following proposed objectives are therefore submitted to the Department for its consideration:

1. Investors in the rehabilitation of buildings should know *how their investment will be treated* for tax purposes.
 - At present, rules are so confusing that a taxpayer cannot even expect an advance ruling on tax treatment — and so cannot predict return reliably.
 - To avoid *detering investment* (and burdening Revenue Canada with useless controversy), the Income Tax Act's DEFINITIONS OF "RENOVATION" AND DEDUCTIBLE "REPAIR" SHOULD BE UPDATED *CLEARLY*.
2. Subject to the principle of fiscal neutrality, that codification should follow the conclusions of the courts, namely that work is **EXPENSABLE** if it
 - *adds* nothing (physically) that was absent before, *and*
 - uses no materials or other features which are *out of character* with the value for which the building was designed, or which are required by law.
 Those principles should be *clearly* and unconditionally reflected IN THE LEGISLATION.
3. This objective is nevertheless *subject* to the overriding principle of *fiscal neutrality*:
 - it would create more *taxable wages* (in the renovation industry)...
 - ...which, because of the idiosyncratic features of this particular industry, should produce a *positive* cash flow for Treasury *almost immediately*;
 - but strictly as a contingency plan, proponents *understand* that tax officials may worry about this work being expensable...
 - ... so it is suggested that increases in deductions (IF ANY) can (IF REQUIRED) be *COUNTERBALANCED* as follows (#4 below).
4. At present, building owners can annually claim deductions for
 - doing something positive (expensable work), *and/or*
 - sending the building to landfill (deductible Terminal Loss), *or*
 - doing nothing (depreciation, i.e. Capital Cost Allowance or CCA).
 - CCA is an existing tax deduction for 34% of the building's value in a decade (53% when adjusted for inflation).
 IF THE *TOTAL TAX DEDUCTIONS* ARE TO REMAIN *ROUGHLY CONSTANT* (i.e. fiscal neutrality), then Finance Canada *may* consider dipping into Terminal Losses etc. CCA to **COVER ANY SHORTFALL** resulting from newly expensable rehab — but only if absolutely necessary. In *principle*, a clearer and better tax treatment for rehab should be self-financing.

Background

Nice layout

WHAT IS THE PROBLEM

I. INTRODUCTION

I.1 Background

Overture to the Hon. Paul Martin

In August 1995, representatives of the Alberta Historical Preservation & Re-building Society met with the Hon. Paul Martin, Minister of Finance, to open discussion on ways to improve the tax treatment of buildings. In principle, the Society suggested to the Minister that such an improvement would create renovation jobs, embellish communities (for tourism and otherwise), encourage investment in property, and keep buildings and neighbourhoods out of the dump. It wanted Finance Canada's support.

Rationale dating to 1940s

The rationale was offered by the Society, to the Department, in the following terms. The issue (of tax treatment of older buildings) has been around for some 25 years. The Society argued that when the Income Tax Act was introduced in the 1940s, it was slanted to favour "planned obsolescence" among buildings rather than their re-use. Accordingly, there was no effort to distinguish deductible repairs from non-deductible renovations, and taxpayers were left in the dark; existing buildings were presumed to be so obsolete that they lost value at a cataclysmic rate; and demolition enjoyed sizeable tax deductions.

quote from where?

Effects on competitiveness

This scenario, said the Society, hampered the competitiveness of older buildings (vs. demolition) for decades. Finance Canada had taken some corrective measures, e.g. by slowing down the rate at which buildings are presumed to lose value, and by reducing the tax deductions for demolition (but then it increased them again). The concern today, however, remains the same: any landlord who tries to plan the future of his/her building knows, on one hand, precisely how the (taxman) will treat deterioration and demolition, but, on the other hand, has no idea how to predict the tax treatment of rehab. In fact, if the owner asks how Revenue Canada will treat his/her investment, it sends a circular saying that it refuses to predict (*Information Circular 70-6R2*).

Revenue Canada

Appendix

Dampening investor confidence

One tax expert¹ wrote that this unpredictability artificially dampened the market for rehab investment; spokesmen for industry had declared that this deters job-creation in renovation; and this reputedly all had a serious effect on the competitiveness of older buildings, the rehab-oriented growth in the tax base etc. This did not look much like "sustainable development" in cities, and Mr. Paul Martin's Task Force on the greening of the tax system had told him so (*Economic Instruments and Disincentives to Sound Environmental Practices*)², in the words (p.35) of the following unanimous recommendation:

defend or omit

PROPOSED REBALANCING: WHILE KEEPING TOTAL NATIONAL DEDUCTIONS CONSTANT (ALBEIT CLEARER), TO SHIFT THE EMPHASIS TOWARD DEDUCTIONS WHICH ARE JOB-CREATING.

what does this mean

MECHANISM:

Proposal

AMENDMENT

DEFINITION:

THE TAX-DEDUCTIBLE REPAIR OF BUILDINGS [*i.e.* PROPERTY IN CLASS 1(q)] INCLUDES WORK WHICH *RESTORES* THE PROPERTY (OR ITS PARTS) TO ANY *PREVIOUS* CONDITION,

- WITHOUT IMPROVEMENT TO THAT CONDITION, EXCEPT TO THE EXTENT THAT THE IMPROVEMENT OF BUILDING PARTS...
- ...DOES NOT INCREASE THE VALUE OF THE PART *RELATIVE* TO THE WHOLE (AS COMPARED TO ITS RELATIVE VALUE IN THE PAST); AND/OR
- IS *LEGALLY REQUIRED* FOR SUCH WORK UNDER AN APPLICABLE CONSTRUCTION OR FIRE CODE.

WHAT THIS PROPOSAL IS NOT:

- This is *not* a proposal to shelter professional or business income via "losses" incurred while expensing these works.
- This is *not* a proposal to deprive taxpayers of the option to capitalize the works if they so choose.
- This is *not* a proposal to deal with any property other than buildings and structures (*i.e.* technically, property covered by par.(q) of "Class 1" for CCA purposes).

HOW THIS PROPOSAL WILL MORE THAN PAY FOR ITSELF:

A combination of the following three factors

- (In part), expenditures which are not capitalized (*i.e.* expensed) will lead to correspondingly higher CAPITAL GAINS.
- (In part), an increase in taxable WAGES AND SALARIES in the rehab sector (which has among the highest job-creation figures of any sector).
- (In part), by attracting *certain* property-owners back from the UNDERGROUND ECONOMY.

LAST RESORT:

If this proposal defies all economic predictions and (after a *wait-and-see period*) is shown to produce a negative cashflow to the Treasury, then Finance Canada may wish to explore the possibility of compensating itself via an abolition of the TAX DEDUCTIONS FOR DEMOLITION ("Terminal Losses"). If that is *still* insufficient (as increasingly *unlikely* as this may be), Finance Canada may wish to re-explore CCA. However, that is not expected to be necessary.

Task Force Recommendation

Restructure Tax Accounting of Buildings

The existing tax system could be examined to determine the extent to which it might encourage the premature demolition of buildings. If the tax system is found to encourage premature demolition, then remedial measures would need to be developed.

There has been a suggestion that the existing federal tax structure might encourage the premature demolition of buildings. Construction and demolition debris comprises a large portion (roughly 30 percent) of the Canadian solid waste stream. If the tax system does encourage premature demolition of buildings, then it could be contributing to the solid waste problem in Canada. Reform of this aspect of the tax system could, therefore, reduce the amount of solid waste generated in Canada. However, there has been very little work in Canada examining this issue. The Task Force recommends that the government work with relevant outside experts to examine this issue.

Intervention of courts

The Society also mentioned that the courts had intervened (with their own definitions of tax-deductible rehab, ^{or} for restoration). As described later in this report, Revenue Canada had replied that this jurisprudence was unrepresentative because the judges did not express themselves correctly. In truth, said spokesmen, "We cannot provide hard and fast rules as to the nature of an expenditure."³ This had confused people further.

Consensus: no perks

To deal with this confusion, ^{who are these people?} most observers agreed that buildings should not be subject to any new perks and quirks. The Treasury simply had no money to spare, and any new improvement to the tax treatment of rehab might need to be compensated elsewhere, in order to maintain the principle of fiscal neutrality. None of the major critics of the status quo, the Society argued, challenged that premise at all. Instead, the responses to the status quo appeared at two distinct levels.

Desire for predictability

There were those who believe that the current tax treatment was incomprehensible, that the parameters were vague and potentially arbitrary, and that there was too great a margin of error (and accompanying potential for re-assessment). These observers wanted to remove the uncertainties. They wanted to see a situation which is sufficiently precise that reliable predictions become available for rehab projects.

Emphasis on jobs

There were also those who believed that there should be a "rebalancing". These observers preferred a better tax treatment for rehab, involving not only a clear definition, but also unequivocal support for the deductibility of various specified rehab expenses. Although they argued that this would merely codify the status quo, this would (from Revenue Canada's perspective) cost the Treasury money; so these advocates often piggybacked the further suggestion that if any money needed to be found to compensate for these deductions (a large "if", because of the job creation arguments) it should be retrieved via a reduction in deductions for demolition or obsolescence. The rationale was to retain fiscal neutrality, but to "shift the emphasis" from a purely static concept of depreciation/deterioration to a "more dynamic" posture of job-creation in the renovation sector; but the premise was that the total national level of deductions would remain the same.

Emphasis on
balance

No major organizations, said the Society, professed to support any measure which would produce a net drain on public revenue, or a worse treatment for the embattled real estate sector.

Review of
previous
correspondence

Finally, the Society alluded to a variety of letters which had been exchanged between Non-Governmental Organizations (NGOs) and the previous government:

- A. Concern: The tax treatment of building rehabilitation is a mess. We can't even get a straight answer on what's deductible and what's not.

The previous government's response: Sorry, the law is made that way.

Suggestion: Isn't it in Finance Canada's self-interest to develop a formula which better encourages job creation in rehab?

Jurisprudence

- B. Concern: Why can't we simply codify what the Courts said, namely that subject to the principle of fiscal neutrality, that codification should follow the conclusions of the courts, namely that work is EXPENSABLE if it
- adds nothing (physically) that was absent before, and
 - replaces nothing that had disappeared for a significant time, and
 - uses no materials or other features which are out of character with the value for which the building was designed, or which are required by law.

The previous government's response: That's not Finance's issue, but Revenue Canada's. Besides, Finance approves of Revenue Canada's efforts to keep deductions from spiralling "out of proportion" with the existing revenue from the property.

Suggestion: Codification would be Finance's responsibility, not Revenue's.

Deductions for
destruction

- C. Concern: If a clearer and better tax treatment for rehab were to cost money (as yet to be determined), Finance has options at its disposal for reimbursement. For example, do people need to get the present tax deductions for destroying buildings ("terminal losses")? These deductions were *increased twice since 1987*.

The previous government's response: Depriving people of this tax deduction for demolition would have "a dampening effect on the willingness of taxpayers to invest in our economy."⁴

Suggestion: Since when is this an appropriate response for favouring demolition, but not for renovation? Which of these two (demolition or renovation) is a more appropriate way "to invest in our economy"? This discrepancy, between these two kinds of investment, could be questioned.

Codified
obsolescence

- D. Concern: *If* a better treatment of rehab costs money, and *if* Finance is still looking to compensate itself, it also has the option of looking at CCA. CCA (Capital Cost Allowance) says buildings lose 34% of value in a decade (53% when adjusted for inflation), which is unusual.

The previous government's response: Yes, CCA says buildings lose 34%, i.e. 4% a year. Michael Wilson, in his wisdom, reduced it from 5%/year, and he got it right.

Suggestion: Which is better: presuming that buildings warrant deductions (for obsolescence) of over a third of their value in a decade (over half their value, when adjusted for inflation)? Or using those deductions to encourage rehab, so that owners don't have to expect losses at all?

December 1995 meeting

These are the Society's positions which it placed on the table when it met with Finance Canada officials in Calgary on December 8th, 1995.⁵

The meeting reiterated previous themes:

Assurances to Finance

- it was stated early, that in accordance with the principle of fiscal neutrality, the participants wanted **neither a net increase in deductions for the real estate sector, nor a decrease**. The proponents merely wanted to *reorganize* the existing deductions on a revenue-neutral basis.
- The word "incentive" was never used, except once or twice in the sense of *psychological motivation*, rather than in a fiscal sense.
- Although a majority of the Calgarians were involved with "heritage" property, they were equally unanimous in explaining that their interest in **rehab referred to all property regardless of vintage**, and their income tax suggestions would be viewed accordingly.

Meeting topics

As in the invitation which the group had sent to Mr. Martin (and in the voluminous background materials that the Society had been forwarding since August), four related topics were specified:

- (a) the *unpredictability* of the status quo;
- (b) the desirability of *codifying* the treatment of rehab, in terms that favoured *more job creation*;
- (c) *if necessary, balancing* a better tax treatment for rehab (for purposes of "fiscal neutrality") via reduction in the deductions for demolition;
- (d) *again if necessary, balancing* such better tax treatment via reduction in tax deductions for *depreciation*.

These ideas were explored in turn.

Complaints on predictability

The unpredictability of the tax treatment of rehab was raised. Several people complained that it would be impossible to instill a comfort level among owners, if they couldn't even get a **reliable prediction** (e.g. an Advance Ruling) from Revenue Canada on how to do the balance sheet on a prospective rehab. Revenue Canada's documents *IT-128R* and *70-6R2* were mentioned by name.

One question was whether the situation *was all that bad in real life, i.e.* whether taxpayers were generally able to sort through it. In response, there were quotations from three judges who had called this documentation several things, e.g. "... nothing so generally *unhelpful*", etc. There was also Judge Bowman's line:⁶ "Had the Minister applied common sense, the Appellant would not be before the court." That prompted the question of whether the judge's reference to "lack of common sense" applied

- *not* to the documentation like *IT-128R*, but
- to the Department's *interpretation* of *IT-128R*

which (in turn) prompted the rhetorical question that if *Revenue Canada* didn't know how to interpret the rules, *what hope was there for the public?*

Alternative approach

On the next issue, namely that of "shifting the emphasis" in the tax system, the Calgarians asserted repeatedly that their conversations with property-owners belied any perception of a "level playing-field" in the tax treatment of rehab versus demolition. In order to "level the playing-field", it was suggested that Finance *codify* the following principles, which (it was argued) were merely a reiteration of what the *courts* already said.

Definition

Subject to the principle of fiscal neutrality, that codification should follow the conclusions of the courts, namely that work is **EXPENSABLE** if it

- *adds* nothing (physically) that was absent before, *and*
- uses no materials or other features which are *out of character* with the value for which the building was designed, or which are required by law.

Those principles should be *clearly* and unconditionally reflected IN THE LEGISLATION.

This suggestion triggered three major sets of questions.

Scope

- (a) What was the *scope* of this proposal:
- was it only for buildings?
 - was it only for *heritage*?
 - was it for "renovation"?
 - was it for "restoration"?
 - was it for something else?

Which buildings did the proponents have in mind, and what work?

The participants replied, unanimously, that they were interested in *all* investment *buildings* (rental residential, commercial, industrial) regardless of vintage (the "heritage" label was irrelevant to this proposal). They also replied, unanimously, that the focus of their interest was *restoration*, *i.e.* a straight return to the *status quo ante* — subject, however, to items like *code upgrading* when they were *required by law*.

Retaining subjectivity

- (b) Another question was whether a clarification/simplification of the tax treatment of rehab could possibly pay sufficient attention to "**the principle of intent.**" According to this theory, an expense cannot be *properly* categorized without speculating on the frame of mind of the investor: for example, it should "always" be capitalized if the owner had *the intent of undertaking it at the time of purchase*:

- the argument is that the buyer would (in his/her mind) have tended to assimilate **this eventual cost to the price of acquisition**, and (subjectively) the purchase and the future expenditure would have been treated as a *unit* — and hence be *all capitalized together* by the taxman.
- The advantage of this approach is that this is consistent with previous thinking.
- The disadvantage is that it is *extremely* amorphous (subjectivity always is), and hence reopens a **huge fiscal grey area** again.

The obvious objection is that if "intent" were retained as a criterion, the resulting uncertainties would *defeat the purpose* of clarifying the legislation. One spokesman for the Department expressed the concern, however, that

Overly attractive?

- *unless* subjective intent were a criterion,...
- ... all sorts of Canadians might *jump* on the purchase and rehab of buildings (if this rehab could be *expensed*): rehab might become analogous to a tax shelter, and this windfall could therefore cause a drain on the Treasury. In the words he

used later, "the more broadly this is worded, the more difficult it is to maintain fiscal neutrality."

- In reply, the Calgarians expressed doubt that there would be an *impending rush* toward the rehab of buildings (in fact, they said Canada might love to have that problem)...
- ... but that *if there were* — and if there were a corresponding upsurge in claims of tax deductions for rehab by recent buyers — *then* Finance could consider **compensating itself** via a reduction in deductions elsewhere (first in demolitions, and second in depreciation)... but that would be a last resort, and would be discussed a few minutes later.

Specificity

- (c) Finally, another concern was that before significant progress could take place, **more specificity** would be required — preferably in the form of written proposals.

Deductions for demolition

The next issue was that of tax deductions available at demolition ("terminal losses"). It was generally acknowledged that they do *not* apply to all situations, and are sometimes unavailable on a demolition. Nonetheless, it was observed that these deductions had been *increased twice since 1987*, and hence that there was some room to make cutbacks (if necessary) without violating precedent. In fact, some asked what public purpose these deductions served at all.

CCA

The last major issue discussed in Calgary was tax-deductible depreciation ("Capital Cost Allowance"). The current CCA presumes that investment properties lose 34% of their value in a decade (4% per year, declining balance). This represents 53% in constant dollars; historically, this does not correspond factually to how buildings evolved in value, at least during the past generation. The question, however, was whether (or how) to deal with this issue, particularly in light of the current stressed-out condition of the real estate industry:

- Some of the Calgarians viewed it as a *priority* concern;
- others preferred to view it as a *last resort* (for Finance to compensate itself for any improved treatment of rehab), for fear of aggravating current conditions in the real estate sector.
- Several people wanted CCA to be *reduced*, so that the taxman could shift those deductions over to a more overt encouragement for rehab;
- on the other hand, one lone participant suggested that CCA on certain capitalized renovation expenses may be *increased*, so that they could be amortized more quickly.

Emphasis

However, the Calgarians were unanimous that the most important issue was one of principle. "Why not take deductions that *don't* create jobs (CCA), and *shift* them to things that *do* create jobs like rehab?" All the arguments of principle were advanced: economic growth, "sustainable development", reduction in landfill deposits etc. There was also mention of the battle against the underground economy [to which it was observed that the lion's share of underground rehab was in private residences (as opposed to rental residential or commercial), and hence outside the orbit of the *Income Tax Act* anyway]; this was acknowledged — but with the observation that Canada has to **start the battle against the underground somewhere**, and although the GST is a larger factor in dealing with the underground, that subject could be discussed *afterwards*.

Finance
Minister's
concerns

There was considerable mention of the objectives of the Minister of Finance:

- he felt passionately about "levelling the playing field" in the tax system generally.
- In an ideal world, many tax measures could be considered, that *pay for themselves over the long term*. However, this is not an ideal world and the Minister is not in a policy position to consider them unless they **pay for themselves within a short timeline** (perhaps two years or less). Arguments about long-term recuperation via job creation etc. may be valid, but *currently are non-starters*, for policy reasons (as unfortunate as that may be).
- Finance Canada would be *prepared to look at the above arguments more closely*. However, the Department would therefore prefer that such proposals be researched and committed to writing before they are submitted.

Alberta
Minister's
endorsement

At that moment, the Alberta Minister of Community Development arrived. The Hon. Gary Mar is a lawyer with a commerce background. He said that he was quite familiar with the proposals being advanced at the table, and gave them his wholehearted moral support. He himself lived in an older home, and he took the subject to heart. He added that, by coincidence, he would be meeting with one of Mr. Martin's cabinet colleagues that week, and looked forward to recruiting support for any initiative Mr. Martin might make in this area.

Follow-up

At that point, the meeting with Finance concluded. There was an immediate follow-up meeting of the participants other than the Finance officials. The consensus was to produce specific proposals for the Department's consideration, and to be submitted around February-March.

Hence this report.

1.2 The Human Habitat, in an Environmental Perspective

ENVIRON: To extend around; encircle; surround.

(Funk & Wagnall's Canadian Dictionary)

"Environmental"
core

At any given time, as a result of Canada's climate,

- the overwhelming majority of Canadians are *inside a building*; and
- the majority of those buildings are in *cities, towns and villages*.
- It follows that at any given time, those buildings (and the accompanying community) constitute a more *direct part of those Canadians' immediate "environment"* than any other areas, regardless of ecological argument.

In short, at most times of the day or night, Canadians' **immediate environment is a built environment**. The administration of this built environment has some idiosyncratic features. Canada's population is mostly *urbanized*; consequently,

Basic positions

- when the Brundtland Commission⁷ called for "sustainable development", one might have expected at least some attention to be devoted to "sustainable **urban development**".
- Similarly, when the Government of Canada's *Green Plan*⁸ emphasized the principle of "*re-use, reduce and recycle*", one might have expected some allusion to the **re-use of the built environment**.

- If Canada is committed to the re-use and recycling of items as small as pop bottles and tin cans, one would expect an even larger commitment to the re-use or recycling of items as large as *entire buildings, neighbourhoods and cities*.
- If Canada is committed to bringing sustainable development to the habitat of its moose and ducks, one would expect an even larger commitment to sustainable development in the **habitat of its people**.
- Since a city is the **largest single tangible object that civilization produces**, a country which disregards the "re-use and recovery" of its cities is unlikely to generate a *credible* policy on sustainable development generally.

The "starting point" for sustainable development

In short, if it is true that

- "sustainable development *starts at home*", then
- one of the first topics which a national strategy *must* address is homes (and, by extension, human settlements).

Agenda 21

It is therefore no surprise that the international community's foremost statement on sustainable development, namely *Agenda 21* adopted by 178 countries (including Canada) at the United Nations Conference on Environment and Development⁹, reserves an entire chapter for the subject of "human settlements." *Agenda 21* even specifies "the protection and/or rehabilitation of older buildings."¹⁰ Signatory States, including Canada, were expected to prepare policies for the implementation of the various components of *Agenda 21*.

Scale

As yet, the built environment represents perhaps the largest inventory of assets on which Canada has no overt policy pertaining to use or re-use. This is so despite the fact that this environment has a substantial volume: it is estimated to include some eight million buildings¹¹, among which the pre-WWII stock alone was tentatively appraised in 1986 at \$114.9 billion¹².

Gap to be filled

Normally, one would expect that with an inventory of that economic magnitude,

- there would be a *public policy* on whether to upgrade it, replace it, or whatever;
- one would not expect that kind of inventory to be merely ignored...
- ...any more than one would expect Canada to disregard how it would deal with other major inventories such as its oil reserves, fish stocks, forestry reserves or other collections of assets. "It is like having an elephant in your garage: sooner or later you have to decide what to do with it."¹³

1.3 Planned Obsolescence for Canadian Cities

The role of tax

Although Canada has no *overt* policy on the "re-use" of its cities, that does not mean that *no* policies underline federal intervention in the urban development process. In an economically-driven system of urban development, the tax system can be a larger "form-giver" to cities than all architects and planners put together. The tax system is not neutral: there are distinctive features which it has conferred on Canadian urban development patterns. "The Canadian tax system is not neutral", said the accounting firm Arthur Andersen & Co.: "[It] provides incentives and disincentives for a variety of alternative investments, including owner-occupied and rental housing."¹⁴

A product of its time

Canada's income tax system was introduced "temporarily" in 1917 and again in 1940; the version we have today stems from the late forties, when certain ideas about urban form prevailed in the circles of power and influence. As economic strategists attempted to lay the foundation for a post-war boom, they were unavoidably influenced by the theories of the day, particularly those which sought to explain how industrialized societies could avoid a return to the Great Depression. One such theory was that of planned obsolescence.¹⁵

The call to replace cities

That prevalent theory was applied, with particular vigour, to Canada's buildings. As early as 1938, there were high-ranking statements that the **entirety of the Canadian production of buildings and cities was *already obsolete***. One official, W. Clifford Clark, declared

- that our cities reflected a *Pre-Industrial Revolution* approach, *unbefitting* the society that Canada had become;¹⁶ and
- that as a modern industrial society, Canada should move immediately to a pattern of cities composed entirely of *assembly-line prefabs*.¹⁷

The seeds of "urban renewal"

This suited the academic and architectural thinking of the day, which had announced that pre-existing buildings were "criminal", "pathological", "perverted", and a source of "shame".¹⁸ To eliminate this "eyesore", some influential professional journals even speculated that Canada might have been better off if its cities had been bombed.¹⁹ In an unfortunate but revealing phrase, the principal of McGill University, for example, labelled the Luftwaffe's failure to level Canadian cities as a "comparative misfortune",²⁰ but predicted that Canadian cities would be levelled anyway after World War II so that a new generation could start over.²¹ Wartime housing was often built without basements and furnaces precisely because it was "disposable": it was expected to be destroyed after the war, as soon as the house factories came on stream.

Intellectual climate

That thinking, which might be called "planned obsolescence" with a vengeance, prevailed in exactly the era when accounting principles were being developed to harmonize with the new tax laws. The person responsible for overseeing the new fiscal system was none other than W. Clifford Clark (the Deputy Minister of Finance), the *same person* who had expressed strong public opinions on the obsolescence of Canada's housing.

A remarkable "coincidence"

It should therefore come as no surprise that certain assumptions were entrenched in the tax system. Where the Income Tax Act was silent, the blanks would be filled in by "Generally Accepted Accounting Principles" (GAAP). It was accepted wisdom that

Initial Fiscal Approach

<i>Re-use, renovation and repair</i> would not be significant factors. For example, the words "repair" and "renovation", although fiscally crucial (the former is tax-deductible, the latter is not), did <i>not even warrant definition</i> in the Act.
Demolition was good, and would result in a significant <i>tax deduction</i> for the owner when it occurred (demolition received even better tax treatment than a donation of the building to charity).
The overwhelming majority of buildings in Canada (which are built of wood-frame construction) would lose <i>over two-thirds</i> of their real value within a decade of their purchase.
Masonry and steel-framed buildings would lose a third of their real value.

Intervention in economics	This view of GAAP was so entrenched that during the ensuing decades, countless landlords found themselves overdepreciating their property, and faced the prospect of tax penalties when they sold. One way to avoid those penalties was to demolish — and demolition entitled them to further deductions. In real estate investments, profit margins are often narrow enough that even a slight fiscal distortion is enough to tip the balance between re-use and replacement of older buildings. After forty years, the results for urban Canada were predictable: Canadian downtowns were indeed largely levelled — <i>as predicted (with the help of the taxpayers)</i> . Some other G-7 countries, ²² which refused to take this fiscal approach, found themselves with dramatically different patterns of urban development.
Modifications	This fiscal and accounting situation went through several modest modifications in the 1980s, but is still <i>almost</i> intact. For example, tax deductions for demolition were reduced, but not eliminated. The assumptions concerning cataclysmic declines in the value of buildings were adjusted (instead of losing <i>over two-thirds</i> of their value in a decade, they were presumed to lose "only" some 53% of their value when adjusted for inflation). The two questions which remain, however, are these:
Questions today	<p>a) Does this approach bear even the slightest resemblance to economic <i>reality</i>?</p> <p style="text-align: center;">and</p> <p>b) Even assuming (for the moment) that this policy served Canada well two generations ago, does it make sense in light of "sustainable development" and other policy objectives today?</p>
New policy context	The renovation boom which began in the late seventies has produced a plethora of statistics which make the case for better treatment of renovation instead. For example, renovation produces higher contributions to GDP than new construction, higher job creation, higher <i>net</i> tax base etc. However, although there have been some minor tax adjustments, the tax treatment of cities has <i>never been reviewed</i> by Ottawa in the light of the Brundtland Commission's recommendations on "sustainable development", or of the current government's agenda published in <i>Creating Opportunity</i> . ²³ Although the residential construction industry and CMHC have launched major initiatives in support of the "re-use" of buildings and cities (which are civilization's largest tangible objects), this cannot be called a "national policy" until there is a comparable commitment by tax authorities, who can control 52¢ out of every dollar earned in Canada.

1.4 Jobs and the Economic Longevity of Urban Investments

Public Policy	Job creation has been a major theme of the public policy of this government, going back to the document <i>Creating Opportunity</i> . Obviously, there are many other sectors of the economy which also claim to offer job-creation benefits, in return to a modified tax treatment. If Finance Canada agreed to them all, the Treasury would be bankrupt. However, in the case of the re-use of buildings, there is an unusual doubling-up effect which puts it in a substantially different position from other sectors. That feature is described below.
The option of "re-use"	A key component of the very notion of sustainable development has been to <i>extend the economic life expectancy</i> of investments (particularly investments of materials). Within

human settlements, that objective means *rehabilitating* (wherever possible) the existing building stock so that it has less *need of being replaced*.

Economic spin-off

This helps explain *Agenda 21's* recommendation about "protecting and/or rehabilitating older buildings"; and when one considers the **estimated value of the pre-World War II building stock alone** (\pm \$115 billion in 1986), the magnitude of this issue becomes apparent. Furthermore, this rehabilitation process is what many observers to be the **ultimate model of an industry which combines sustainability with national profitability:**

Construction industry

Tax base \$230 billion

Jobs

Tourism

- A decade ago, Canadian investments in residential renovations (called the "reno sector" by the industry) had already overtaken and surpassed investment in new housing.²⁴ The definition of "real estate development" was changing; more money is now being spent in fixing existing housing than in building new developments.²⁵
- By the year 2000, over eighty percent of all residential construction investment will expected to be in renovation, as opposed to twenty percent in new construction.²⁶
- the renovations sector is expected to generate \$230 billion of investment over the next 20 years;²⁷
- the reno sector is growing at twice the rate of new construction;²⁸
- the reno sector is creating (*dollar for dollar*) jobs at over twice the rate of new construction;²⁹
- renovation is adding to the *net* municipal tax base more quickly than new construction;³⁰
- As with their American counterparts, who have adopted renovations as their *instrument of choice* for the expansion of the municipal tax base,³¹ many Canadian municipalities are hoping to capitalize on the renovation boom. Of particular interest is the fact that although renovation *adds to the property tax base, it seldom requires new infrastructure*, unlike new construction; that means that a million dollars of renovation investment usually results in a higher *net* increase to the municipal tax base than a corresponding investment in new construction.
- The first governmental targets are usually the rehabilitation ("rehab") of heritage buildings and districts, where it is hoped that investment will serve *cultural, tourism, and economic goals simultaneously*.

However, there should be no mistake: the international community has issued calls on countries to develop strategies for the economic re-use of the *entirety* of the building stock, wherever reasonably possible. Those calls are found in documents like *The Global Strategy for Shelter*³² as well as *Agenda 21*. The above economic statistics indicate that such an economic strategy is not only good for sustainable development; it is good for the economy generally.

Timing This could not come at a more crucial time. According to a January 1996 statement from Human Resources Development Canada,³³ the current situation can be summarized as follows:

Despite its size and significance, the construction industry in Canada is highly vulnerable, with...unemployment rates running at double the Canadian labour force average, significant contractions in construction industry spending during recessionary periods, declining wage rates relative to the economy overall, and falling contributions to total economic output.

Conclusion Under the circumstances, the *combined* economic benefits of measures, to make investment in the rehab sector more straightforward, are arguably in a qualitatively different category from most other industries.

1.5 Recap of the Complaint

At the time that the tax system (and the related Generally Accepted Accounting Principles) were formulated, in the 1940s, the repair/renovation/rehabilitation of buildings was not expected to be a significant phenomenon since the overwhelming majority of buildings were considered obsolescent and expendable in the first place. This view was reflected in a most ironic feature of the *Income Tax Act*, which is otherwise an immensely detailed, specific and precise document:

No statutory definition

- despite the fact that the distinction between "repair" and "renovation" is *crucial* ("repair" on investment buildings is tax-deductible, whereas "renovation" must be capitalized),
- it was not considered necessary or appropriate to bother with *definitions* of either of these terms.

Interpretation

As a direct result of this omission, Revenue Canada was left to its own devices, to *extrapolate distinctions from the jurisprudence from time to time*. By the early 1980s, Revenue Canada had published an Interpretation Bulletin³⁴ which outlined six possible criteria or "guidelines" which might (or might not) influence whether a given rehabilitation project would be considered tax-deductible or not the subject-matter was considered so amorphous that, as described in further detail later in this report,

Surprise!

Revenue Canada published an information circular specifying that if any Canadian wanted to find out how a given rehabilitation project would be treated,³⁵ Revenue Canada would refuse to answer.³⁶ It specifies that the Department will *not* normally issue Advance Rulings on whether building rehabilitation work is capital or expensable. The investor is expected to pay his/her money, take his/her chances and find out *ex post facto* what the tax treatment is.

Jurisprudence

However, a more precise position would be taken by the courts. In one decision, the Quebec Court of Appeal dealt with a Mrs. Goyer, whose walk-up apartment building needed new doors, windows, plumbing, wiring, and balconies.³⁷ The Quebec Court of Appeal agreed unanimously that in the case of rental housing, her expenses were deductible so long as (a) they did not **add** any pieces to the building, (b) they did not replace **disappeared** items, and (c) they were not **out of character** with its normal value.

Different criteria offered

Tax authorities took exception and applied to the Supreme Court of Canada. That Court ruled, however, that the issue was sufficiently open-and-shut that it was not worth its time.³⁸ At almost the same time, the Federal Court of Canada reached a similar conclusion in an Edmonton case on the same subject.³⁹

Revenue Canada, however, refused to redraft its rules in light of the findings. That department actually informed NGOs that what the Court of Appeal and Federal Court had written could not be what the judges *meant* — and that what the Supreme Court had *meant* to say was that it had no opinion.⁴⁰

But the courts ground onward.⁴¹ One tax court judge looked at Revenue Canada's arguments on non-deductibility, and called them "wholly unreasonable and arbitrary ... Had the minister applied common sense in making the assessment here, the appellant would not be before the court."⁴² Revenue Canada's position still did not change: it told one group that the department should be entitled to "a degree of flexibility in making each determination."⁴³ Although Revenue Canada says that it has nothing against restoration or responsible property management, it continues to advise the public that such expenses are non-deductible.⁴⁴

Not surprisingly, the above situation would leave any prospective investor in a state of *total confusion*.

Review

Let's review what the tax system has done to our typical landlord:

- *The courts have told the owner that restoration work was tax-deductible, but Revenue Canada has not acknowledged that the taxpayer can follow suit.*
- *In the meantime, the owner has been invited (with tax write-offs) to depreciate the building beyond usual market realities...*
- *... Whereupon the owner faces taxable "recapture" unless he/she demolishes the building.*
- *Some owners who demolish, can claim a deduction because the remaining investment got "lost".*

This is not fiscally neutral. It is not a level playing field; and it is certainly not conducive to either job creation, or the re-use of Canada's built environment.

1.6 The Results for Canada

As a result of

- the clarity of the tax advantages of demolition and
- the lack of clarity of the tax treatment of rehabilitation,

it should come as no surprise that:

ALMOST ONE-THIRD OF ALL DEPOSITS IN CANADIAN LANDFILL SITES IS COMPOSED OF USED CONSTRUCTION MATERIAL.⁴⁵

This background analysis suggests three conclusions:

1. The principle of "sustainability" was not historically — and is not now — a feature of the Canadian economic system's approach to urban development.

2. We have the cities we paid for (and that we are still paying for).
3. If we wish to bring "sustainable development" (and the concepts of "re-use and recover") to civilization's largest products, namely *cities*, we should have no illusions about the work ahead of us.

Invitation

This is only one illustration (among many) which emerge from a system which was designed some fifty years ago, with a very different philosophy toward development compared to public goals today. It is time for Canada to *pause, reflect, and ask itself* whether there are features to its system which can be profitably reconsidered.

Our ultimate goal should be no less than to encourage an economic climate where Canadians pursue the goals of sustainable development because that is the economically reasonable thing to do; and to assure that such a scenario gets fair and even-handed tax treatment.

If we can move toward that goal, then we can reduce the adversarial relationship between the public and private sectors, and foster a planning system where partnership takes precedence.

2. IMPROVING THE STATUS OF THE RE-USE OF BUILDINGS

2.1 Introduction

Affected
properties

Via the *Income Tax Act*, the government of Canada can intervene directly in almost every decision pertaining to the use and re-use of the built environment. Most decisions which bear upon the maintenance and upgrading of that environment are affected by the Income Tax system, whenever the property is held for rental residential, commercial or industrial purposes. These instruments can change what would "normally" have occurred to this environment if governed by the laws of economics alone. The applicable tax rules represent a web of components which emerged over time for a variety of reasons, none of which were necessarily intended to promote "sustainable development" in an urban context.

Within the context of the "re-use" of buildings, some properties are affected by those rules more than others:

Basic categories

- The properties which are *least* affected are lands which are held for a taxpayer's **personal enjoyment**, namely principal and secondary residences. Broadly speaking, the re-use of those properties is usually outside the orbit of the tax system: it does not normally give rise to either tax benefits or tax liabilities pertaining to operating/carrying costs.
- The situation is quite different for properties which are not held for enjoyment, but for **investment**. Broadly speaking (and at the risk of some oversimplification of the *Income Tax Act*), properties held for short-term production of rental income, commerce or industry or longer-term speculation are referred to as "capital property". If the property produces ongoing income (e.g. commercial building, rental residential building etc.), then the net income from the property is taxable. If the property is sold for a profit, then the profit may be considered a "capital gain", and 75% of that capital gain becomes assimilated to taxable income. In the computation of the net ongoing profits of the property, routine expenses may be deductible from gross income, *i.e.* may be considered "expensable". A tax deduction is also allowed by the *Income Tax Act* for depreciation on certain kinds of property classified in the Act: this tax-deductible depreciation is called "Capital Cost Allowance".

The interplay of these provisions can be so complex as to create employment for thousands of professionals, working both for governments and for taxpayers. However, that does not mean that the Canadian tax system is beyond analysis, particularly from an industrial or environmental perspective.

Exclusion of
principle
residences etc.

As mentioned above, Canadian income tax policy has minimal impact on properties which are *not* held for investment purposes, such as a principal residence. Those properties are therefore excluded from the following discussion.

Investment

How does the *Income Tax Act* react to the management of *investment* property? The primary and most obvious distinction between management of the natural environment and management of the built environment is this:

Reaching
entropy

- the natural environment is capable of retaining its relative importance in the world, without human intervention; but
- the built environment is not; indeed, without human intervention on a regular basis, the built environment can lose its relative position very quickly: ongoing

maintenance and periodic attention to building systems are essential, *just to stay in the same relative position.*

The management of the built environment usually includes ongoing cleaning, periodic repainting and refinishing, cyclic rehabilitation work of a more substantial nature (e.g. roofs), and even occasional upgrading of certain components whose original materials no longer meet legal construction requirements (e.g. outmoded wiring and plumbing).¹

When a person owns investment property (i.e. capital property), the *Income Tax Act* recognizes *two main kinds of expenses* which can be incurred on that property:

Kinds of expense

- "capital expenditures", and
- expenses which are usually called "business expenses" or "expenses on current account".

The distinction is crucial, because:

- *capital expenditures are not tax-deductible*: they are merely depreciable (e.g. in the case of most buildings, a 4% "Capital Cost Allowance" can be deducted annually from taxable income).

Capital expenditures on buildings

This treatment is referred to in Schedule II of the *Income Tax Regulations*, where buildings are covered in **paragraph (g) of "Class 1"**.

[N.B. THIS PROPOSAL REFERS ONLY TO *BUILDINGS* OR OTHER STRUCTURES, *i.e.* PAR (q) OF CLASS 1. IT DOES NOT REFER TO OTHER FORMS OF PROPERTY IN CLASS 1 (e.g. bridges, canals, dams, railways etc.) OR IN OTHER CLASSES.]

Current expenses

- On the other hand, business expenses on current account are *100% deductible* from taxable income.

Application to works

The maintenance of the built environment is in the hands of what is loosely called the "reno industry" ("reno" being short for "renovation"): this is a euphemism for all the industries in Canada which conduct or cater to not only the maintenance and repair of buildings, but also their remodelling (i.e. change of physical appearance), rehabilitation or "rehab" (i.e. renovation without the connotation of "remodelling"), restoration (*i.e.* return to a *status quo ante*) and even additions:²

Exclusion of remodelling and additions

- Routine *maintenance* is seldom questioned as a legitimate tax deductible item.
- On the other hand, *remodelling and additions* would be difficult to treat as tax-deductible, since they usually imply a **conscious and overt departure** from the *status quo ante*.

"Rehab"

- The problematic **grey area** is therefore that of *repair, rehabilitation and restoration*. For the sake of brevity alone, these will be assimilated under the name of "rehab" in this report.

No definitions

The source of the problem of definitions is not difficult to trace:

- "Renovations" are not tax deductible, whereas
 - "Repairs" are tax deductible.
- However, the Act contains *no definition* of either of these words.

Historical context

This has been a feature of the Income Tax Act since it was introduced in the 1940s. It is a matter of historical record that W. Clifford Clark, the Deputy Minister of Finance

who supervised the introduction of the Income Tax Act at the time, believed that rehab would be an insignificant prospect, that existing buildings and cities were obsolete³, and that human settlements should be modelled on the car industry.⁴ In fairness to Clark, this view was consistent with that of the opinion-leaders of the day. The theme of Planned Obsolescence, modeled on the car industry, was so pervasive that in due course, it was predicted that houses would have annual model changes.⁵

Unexpected development

Nonetheless, building rehab activity grew progressively, and began spiralling in the late 1970s. Indeed, the "reno sector" on the residential side has exceeded new residential construction almost continuously since 1982, and is expected to continue doing so to the year 2010 and beyond. This is an upsurge which was never anticipated by the drafters of the Act; and in the absence of any statutory definitions to guide Revenue Canada, that Department has had only miscellaneous court rulings to resort to, when attempting to distinguish deductible repairs from non-deductible renovations.

By their very nature, these cases tended to be *ad hoc* determinations instead of definitive systematic rules. Indeed, Revenue Canada felt so strongly about the subject that it refused to issue Advance Rulings pertaining to rehab projects: that position was articulated at ss.14(e) and (j) the Department's *Information Circular 70-6R2*.

Resulting uncertainties

This left the building rehab industry as one of the most unpredictable in Canada, for the individual investor. Any investor who wished to plan the *pro forma* balance sheet of his/her investment was saddled with the virtual impossibility of doing so, in the absence of a reliable prognosis of tax treatment.

For good measure, Tax Court Judge Bowman described a controversy over the rehab of a century-old rental property in the following terms:

Nuisance value

"It raises a question of the allocation between revenue and capital expenditures, a matter that has been litigated in this country and in the United Kingdom with greater frequency than almost any other issue in the field of income tax."⁶

In practice, prospective investors who requested such information would receive 70-6R2 – accompanied with Revenue Canada's statement of belief concerning what might occur. This statement, however, could not be classified as anything more than a "best guess." For rehab expenses to be deductible on current account, Revenue Canada would insist that they meet a web of at least six tests. Those tests are outlined at the Department's paper entitled *Interpretation Bulletin IT-128R*. IT-128R says the decision on whether rehab work is capital or expensable depends, in part, on

IT-128R and its guidelines

- whether the work confers "enduring benefit";⁷
- whether it confers a "betterment";⁸
- whether it is stand-alone, as opposed to being an "integral part" of the structure;⁹
- whether it's "relative value" is large in comparison with the overall value of the property;¹⁰
- whether it is on newly-acquired "used property";¹¹
- whether it is "in anticipation of sale".¹²

If the answer to *any* of the above questions is affirmative, the Department *tends* to disallow the tax deductions on the work and to treat the work as capital.¹³ However, none of these factors was considered fully *conclusive* on its own; the expression used by the Department was that "each case is judged on its own merits". As reasonable as this may sound, the practical effect was to leave substantial discretion in the hands of departmental officials. Nonetheless, work like new plumbing etc.¹⁴ would usually have been classified as capital.¹⁵

Goyer case

In 1987, the Supreme Court of Canada cast new light on the issue. Upon review, it declined Leave to Appeal on a Quebec Court of Appeal decision (*SMRQ v. Goyer*)¹⁶. The latter court's unanimous decision, based upon careful review of the jurisprudence¹⁷ was that the "enduring benefit" test and the "relative value" test are "perhaps in certain cases...elements of the solution", but were inconclusive *per se*. The "essential question" was instead the following: the work constituted deductible "repairs and maintenance" if it met this three-pronged test:

- a new capital asset is not created,
- the normal value of the capital asset is not increased, and
- an asset that had ceased to exist is not replaced by a new one.¹⁸

The result was to allow *new plumbing, wiring, doors, windows and balconies* to be deductible on current account. The Court ignored the other tests in IT-128R and its Quebec counterpart.¹⁹

Gold Bar case

Essentially the same result had been reached independently by the Federal Court (Jerome J.) in *Gold Bar Developments Ltd. v. R.*²⁰ for replacement of an *entire façade* which was suffering from a material defect.

Follow-up

Revenue Quebec promptly issued a new Interpretation Bulletin to bring itself into line with the judgement.²¹ However, Revenue Quebec interpolated an extra condition: it would refuse to allow use of *Goyer* in the case of work conducted shortly after or before purchase of the property.²² Nowhere is this condition to be found in the judgement itself. Revenue Canada, for its part, has so far declined to redraft IT-128R. This has resulted in some confusion in the industry.

If the *Goyer* approach were maintained (without interpolations), then the broad effect would be to guarantee the tax-deductibility of work on investment property which does not necessarily *improve* the quality of the built environment, but at least keeps it at its current position (its "normal" value), or which brings buildings into line with the condition they were supposed to have.²³ Although that is not necessarily "progress" or even "positive" tax treatment for the maintenance of the built environment, it would appear to be consistent with an element of equilibrium.

This was greeted with enthusiasm by the residential renovation industry. Although that industry contributes some \$20 million annually to the Gross Domestic Product, it nonetheless feels hampered by the low "comfort level" among many prospective investors, because of the fiscal uncertainties which these investors face. The residential renovation industry therefor entered into communication with Revenue Canada requesting that the turn of events in jurisprudence be committed to writing, with clearer tax rules by which the industry could operate. This request was unsuccessful; indeed, Revenue Canada used the opportunity to articulate a distinctly different view of what had occurred:

SEVEN REASONS ADVANCED BY REVENUE CANADA ON WHY PREDICTABILITY IN THIS AREA IS NOT POSSIBLE

THE DISTINCTION BETWEEN CURRENT AND CAPITAL REHAB EXPENSES IS BY NATURE UNCLEAR.

THE LACK OF CLARITY IS UNAVOIDABLE

"It would not be appropriate to publish a single all-purpose test in the face of authoritative evidence that no one test can ever be determinative"²⁴

"This lack of clear judicial guidance was reiterated in the most recent Supreme Court of Canada decision on point, *Johns-Manville Canada Inc. v. The Queen*.²⁵ [Note: this case²⁶ was decided *pre-Goyer*, and addressed the deductibility of land purchased for an asbestos mine].

"The certainty that (renovators) desire is not consistent with the jurisprudence".²⁷

"Using the word 'rules' implies that these are hard and fast rules, they are not. Many factors must be considered and no one factor on its own will necessarily be conclusive".²⁸

"We cannot provide hard and fast rules as to the nature of an expenditure".²⁹

THE LACK OF CLARITY IS GOOD

"By considering each case based on its facts we ensure a degree of flexibility in making each determination."³⁰

PHILOSOPHICALLY, REVENUE CANADA OBJECTS TO THE "GANGING UP" OF REPAIRS

"The ganging up of repairs is offensive (to the Department)...(The treatment of such work as current expense at all) is a concession".³¹

"It is unfair (from a policy standpoint) for buyers of buildings to expense their restoration costs as occurred in *Goyer*, because that puts restorers of existing buildings at a competitive advantage compared to new construction."³²

"If a person's building was in bad need of repair when bought, and subsequently encountered replacement of doors, windows, plumbing or wiring, this would be capital in all circumstances, regardless of how long the property was held. Nothing is deductible as current expense unless it returns property to its condition *at time of purchase*; if that condition was deteriorated, then so be it."³³

THE "ESSENTIAL QUESTION" IN *SMRO v. GOYER* DOESN'T REPRESENT THE LAW

IT DOESN'T MEAN WHAT IT SAYS

"*Goyer* cannot be taken at face value because the judges did not express themselves correctly. Just because they said that a given point was the essential question, that does not mean that other questions were not even more important: the latter just didn't come up."³⁴

GOYER STRETCHES THE LAW

"*Goyer* cannot be taken at face value because the judgement stretched the law".³⁵

<p>GOYER IS JUST ONE CASE IN A THOUSAND <i>"Goyer is just one case in a thousand."</i>³⁶</p> <p>"There have been other (recent) judgements by the same (courts) on the current vs. capital issue that give no hint that there has been any significant change in the applicability of various tests: see <i>MCH Holdings v. The Queen</i> and <i>Firestone v. The Queen</i>."³⁷ [Note: the cases cited³⁸ dealt with whether a <i>payment in lieu of parking spaces</i> and <i>research costs</i> (respectively) are current or capital.]</p>
<p>THE SUPREME COURT'S ADJUDICATION DOESN'T COUNT "The Supreme Court of Canada refused to hear the <i>Goyer</i> case, it did not indicate any reasons for its refusal, therefore, it cannot be said that the Supreme Court of Canada was either in agreement or disagreement with the decision".³⁹ [Note: the <i>Supreme Court Act</i> specifies, at s. 2(1) that when the Court dismissed the Application for Leave to Appeal, this does indeed constitute a "judgement" of the Court; and it is published as such.]</p>

If the industry was confused by the tax treatment of rehab *before* these turns of events, it was even more confused after the above comments were received from Revenue Canada.

As the issue was studied further, the topic became even more confusing for prospective investors: this was particularly so, on review of the various judicial pronouncements on point:

IT-128R GUIDELINES INDICATING WHEN REHAB MIGHT BE CAPITAL	EXACT WORDING OF IT-128R	COMMENT FROM THE COURTS
When the work confers <i>"enduring benefit"</i> :	"When an expenditure on a tangible depreciable property is made 'with a view to bringing into existence an asset or advantage for the enduring benefit of a trade', then that expenditure normally is looked upon as being of a capital nature. Where, however, it is likely that there will be recurring expenditures for replacement or renewal of a specific item because its useful life will not exceed a relatively short time, this fact is one indication that the expenditures are of a current nature."	"The regular recurrence of the acquisition is in no way decisive." Supreme Court of Canada Justice Estey. ⁴⁰ "There is no test that I find less helpful for general application than the 'Once and for All' or enduring asset or advantage test." Federal Court Chief Justice Jackett ⁴¹ ,
When it confers a <i>"betterment"</i> :	"Where an expenditure made in respect of a property serves only to restore it to its original conditions, that fact is one indication that the expenditure is of a current nature.... Where, however, the result of the expenditure is to materially improve the property beyond its original condition, such as when a new floor or a new roof clearly is of better quality and greater durability than the replaced on, then the expenditure is regarded as capital in nature."	"In order for work to be capital, the test is not just a question of betterment, but whether "the purpose... is to replace an asset by a new one and work that involves <i>such</i> degree of improvement to an asset that it <i>becomes a new one</i> ." Tax Court Judge Proulx ⁴² .

<p>When it is stand-alone, as opposed to being an "integral part" of the structure:</p>	<p>"Another point that may have to be considered is whether the expenditure is to repair a part of a property or whether it is to acquire a property that is itself a separate asset. In the former case the expenditure is likely to be a current expense and in the latter case it is likely to be a capital outlay. For example, the cost of replacing the rudder or propeller of a ship is regarded as a current expense... but the cost of replacing a lathe in a factory is regarded as a capital expenditure... between such clear cut cases there are others where a replaced item may be an essential part of a whole property yet not an integral part of it. Where this is so, other factors such as relative values must be taken into account."</p>	
<p>When its "relative value" is large in comparison with the overall value of the property:</p>	<p>"The amount of the expenditure in relation to the value of the whole property or in relation to previous average maintenance and repair costs often may have to be weighed.... On the other hand, the relationship of the amount of the expenditure to the value of the whole property is not, in itself, necessarily decisive in other circumstances, particularly where a major repair job is done which is an accumulation of lesser jobs that would have been classified as current expense if each had been done at the time the need for it first arose; the fact that they were not done earlier does not change the nature of the work when it is done, regardless of the total cost".</p>	<p>"The more substantial the repair, the less likely it is to recur (certainly the fervent hope of the building's owner) but it remains a repair expenditure nonetheless". Federal Court Associate Chief Justice Jerome:⁴³</p> <p>"I cannot accept the view that the cost of repairs ceases to be current expenses and becomes outlays of capital merely because the repairs required are very extensive or because their cost is substantial". Mr. Justice Jackett⁴⁴.</p>
<p>When it is on newly-acquired "used property":</p>	<p>"Where used property is acquired by a taxpayer and at the time of acquisition it requires repairs or replacements to put it in suitable condition for use, the cost of such work is regarded as capital in nature even though, in other circumstances, it would be treated as current expense."</p>	<p>"I find that the premise of the assessment to be wholly unreasonable and indeed arbitrary. No basis for this extraordinary conclusion was given... Had the Minister applied common sense in making the assessment here the appellant would not be before the Court." Tax Court Judge Bowman⁴⁵.</p>
<p>When it is "in anticipation of sale".</p>	<p>"Repairs made in anticipation of the sale of a property or as a condition of a sale are regarded as capital in nature. On the other hand, where the repairs would have been made in any event and the sale was negotiated during the course of the repairs, or after their completion, the cost should be classified as though no sale was contemplated."</p>	

The cumulative effect of this confusion, in terms of dampening investor enthusiasm, was summarized by one Montreal tax expert as follows:

We will not deal with all the tax implications related to the... mechanics of such an investment but more specifically, with the uncertain fiscal results for a taxpayer who chooses to invest and operate an old building, instead of investing on a stock exchange...

Unavailability
of predictions

While the property is being held, as a taxpayer you will have to decide...whether the renovation expenses which you incur are current or capital in nature. Here again, you will have to assess the numerous administrative criteria established by tax officials, which may be different depending on the level of government. Furthermore, if you are in doubt about the nature of these expenses and you wish to obtain an advance ruling from Revenue Canada, the department will probably refuse your request because this is among the exceptions listed in Information Circular 70-6R2, concerning which Revenue Canada does not intend to issue such advance rulings.

Results on audit

So suppose that the die is cast, you have made your decisions, and you feel certain that you have discerned the true characterization of your expenditures, so as to deduct them on current account or to capitalize them if they are permanent, as based on your understanding of the interpretation bulletins issued by tax officials which outlined the criteria based (in part) on the jurisprudence. A few years go by, you believe that you have acted in accordance with the rules and numerous directives of different tax departments, and then a tax department decides to audit (or in some cases investigate) your tax returns over the previous three years. The first question that you will probably be asked pertains to the maintenance and repair expenses which have been deducted each year, and which you categorized according to your understanding of the administrative measures published by different tax authorities. However, you learn that the department disagrees with your interpretation as well as the interpretation of certain judges, and disallows certain current expenses which, according to the department, should have been capitalized. In all probability, the converse situation would not be checked. Furthermore, the disagreement may take on even more dramatic dimensions. You are told that because you incurred losses on your rental property over the last three years (or since you acquired the building), the department will disallow your loss because you did not have a reasonable expectation of profit at the time of purchase of the rental building. So after you have explained your bewilderment to tax authorities, you are advised that you are free to challenge the department's decision.

Possibility of
disagreement

Brinkmanship

Now you are before the courts, and you are convinced that you have reached the right decision when you made your investment and categorized your expenses. Will you be vindicated? In some cases, the jurisprudence may support you. On the other hand, since each case is different and the department claims that certain court judgements were incorrectly decided, it becomes more and more difficult to identify a trend in the jurisprudence.

Effects on investment

These are some of the tax problems which every property owner will face sooner or later. Is this normal? Tax officials say yes, because it is up to the taxpayer to make his/her own decisions. On the other hand, since it is impossible to offer any assurances on the tax consequences of such an investment, it becomes more and more difficult to interest potential investors in this important sector of our economy. Consequently, these investors are leaving the real estate sector in order to have recourse to other sectors where the tax treatment of their investment is foreseeable and not arbitrary, e.g. the stock market. Is there anything that can be done about this situation? Perhaps. Will various tax agencies agree with you, in view of their respective economic position?

Conclusion

We believe that this is perhaps the right moment for a joint effort by taxpayers involved in real estate investment, with the support of officials responsible for the development of old buildings, to assess the circumstances described above. Interested parties should have alternative solutions to propose, in order to eliminate the uncertainties and ambiguities, and to avoid resorting to the courts which sometimes appears contradictory according to the different cases heard.

2.2 Proposal

NOTE: ALTHOUGH VARIOUS DOCUMENTS LIKE IT-128R REFER TO REPAIR AND RENOVATION OF PROPERTY OTHER THAN BUILDINGS, THE FOLLOWING PROPOSAL APPLIES TO BUILDINGS ONLY, I.E. PROPERTY WHICH IS LISTED IN PAR (q) OF "CLASS 1" FOR CCA PURPOSES.

The following proposal is submitted for Finance Canada's consideration:

Defining repairs

- to amend tax legislation, to provide an actual definition of a "repair" (tax-deductible) on buildings held for investment purposes.
- This report expresses no opinion on *where* the amendment should be inserted, e.g. via a Regulation, a statutory amendment at s. 248(1) or elsewhere.
- To found that definition on *approximation* of the wording provided by the courts, with certain simplifications; to wit repairs *include* work which
 - *restores* the building to its *status quo ante*, i.e....
 - ...the condition and value for which the building was originally built...
 - ...without additions or improvements (i.e. beyond those which existed in the past...), or
 - ...beyond those improvements which are *required by law*, (construction standards) applicable to the property or to the work.
- *If* the above tax treatment causes a demonstrable net drain on the Treasury as compared to the status quo, *then* Finance Canada could consider reimbursing itself from among the options outlined later in this report.

Restoration

In the above scenario, "restoration" would be interpreted in a manner similar to that used by Associate Chief Justice Mr. Jerome in the *Gold Bar* case, i.e. which includes a certain amount of substitution, when

Proportionality

- the substitution is merely of a
- standard which, in relation to *today's* construction technology.
- is *proportional* to
- the *standard* of the substituted materials, in relation to the construction technology of their time.

Pragmatism

This proviso is inserted, in order to avoid an incongruous situation. In some cases a *verbatim* restoration would (paradoxically) be out of step with current construction practices. The above proviso is therefore intended to avoid driving proprietors to do unnatural things with their buildings merely in order to claim a certain tax treatment (heritage authorities remain free to direct a *verbatim* restoration if they choose, but that has no bearing on *this* proposal). By retaining the focus on the **proportionality** of the construction technology, this also fits with the theme suggested by the courts, namely of consistency of *value*.

In the above scenario, the reference to work *required by law* is *specifically* to construction standards, *i.e.*

Safety

- those requirements which are imposed by a building or fire code of a competent jurisdiction.
- The intent is again to **avoid an absurdity**: it would be absurd, for example, to suppose that in restoring a 1922 building to its *status quo ante*, one would also be restoring its plumbing and wiring system to 1922 conditions (as that would be fundamentally illegal, in light of the National Building Code and its counterparts).
- However, it is *not* proposed that this exception extend to forms of legislation other than such construction standards; it is not suggested, for example, that it extend to municipal land use controls. For instance, an owner may have a building which is a valid non-conforming use for zoning purposes; the upgrading of that building may be desirable in order to make it into a conforming use, but this is *not* the kind of work which would be targeted by this proposal.

In its most elementary format, the proposal could be summarized as follows:

Proposal

AMENDMENT
<p>DEFINITION: THE REPAIR OF BUILDINGS [<i>i.e.</i> PROPERTY IN CLASS 1(q)] INCLUDES WORK WHICH RESTORES THE PROPERTY (OR ITS PARTS) TO ANY PREVIOUS CONDITION,</p> <ul style="list-style-type: none"> ● WITHOUT IMPROVEMENT TO THAT CONDITION, EXCEPT TO THE EXTENT THAT THE IMPROVEMENT OF BUILDING PARTS... ● ...DOES NOT INCREASE THE VALUE OF THE PART <i>RELATIVE</i> TO THE WHOLE (AS COMPARED TO ITS RELATIVE VALUE IN THE PAST); OR ● IS <i>LEGALLY REQUIRED</i> FOR SUCH WORK UNDER AN APPLICABLE CONSTRUCTION OR FIRE CODE.

There is an essential corollary to this recommendation: it is that for the sake of *clarity*,

Objective test

THE CATEGORIZATION OF THE EXPENSE SHOULD BE BASED ON THE OBJECTIVE NATURE OF THE WORK.

In other words, it should be possible for either tax officials or taxpayers to be capable of identifying the likely treatment of the expense based

Departure from status quo

- upon *ascertainable* physical characteristics,
- as opposed to
- conjecture on the **state of mind** of the investor, or on other features which are difficult to *define with precision*.

For example, in a project which included a variety of features which included *both*

- items which were being restored, and
- items which were being remodelled or added to,

those various works would be categorized *according to their physical nature*, instead of according to the range of more difficult and amorphous guidelines currently in IT-128R. Ultimately, this should lead to the following ancillary goal.

Objectivity

Workability

As a matter of fundamental public policy, it is preferable to have a tax treatment which is so straightforward that it can be understood, *e.g.* by any contractor.

- Any reputable contractor is presumed to know the basics of construction technology. As such, any reputable contractor should be able to discern on an *objective* basis,
 - what the construction features of the building would have been in the past,
 - what restores the building to that condition, as opposed to what remodels or improves it,
 - what is an equivalent technology today, and
 - what is required by applicable codes.

IN SHORT, BY MOVING TO THIS SIMPLIFIED AND OBJECTIVE SYSTEM, THE DISTINCTION BETWEEN CAPITAL AND DEDUCTIBLE EXPENSES COMES WITHIN THE PURVIEW OF (AND BECOMES COMPREHENSIBLE TO)

- ANY REPUTABLE CONTRACTOR (AND, BY EXTENSION TO HIS/HER TAXPAYER CLIENTS)
- AS COMPARED TO THE FISCAL STATUS QUO, WHICH HAS SORELY TESTED THE ABILITIES OF CANADA'S FINEST (AND MOST EXPENSIVE) ACCOUNTANTS, LAWYERS, JURISTS AND CIVIL SERVANTS.

No sheltering

This is *not* incidentally, a proposal for "sheltering": there is *no* suggestion that any losses which might occur, as a result of claiming the deductions above, should be applied against other income.

Option to capitalize

Similarly, there is *no* suggestion that property owners should depart from current practice with regard to their **OPTION TO CAPITALIZE** such expenses if they so choose. In other words, no one is suggesting that this new tax treatment be "rammed down the throats" of any Canadian taxpayers who do not want it, and who would *prefer to continue capitalizing* such expenditures as they might have done in the past.

In order to assess how such a definition would play itself out in practice, one should first address the following standard questions:

● Who?	To whom would such tax treatment apply?
● What?	Which kinds of projects would be affected?
● When?	Would timing play a role in distinguishing between projects?
● Where?	Would there be limitations on this tax treatment, e.g. for heritage properties etc.?
● Why?	Would the motivation of the owner/investor be a relevant factor?

Each of these will be addressed in turn.

2.3 The Need for Simplicity

The objective of this exercise is to render the tax treatment of the re-use of buildings as straightforward as possible to Canadian taxpayers. This will mean, inevitably, that certain executive decisions will need to be made in introducing such a treatment:

Difficult executive decisions

- the most fundamental executive decisions is whether to retain certain **nuances** or not.
- If those nuances are maintained, then there will be the **least disturbance** of the conventional fiscal wisdom, going back to the 1940s.
- However, by the same token, the retention of those nuances will mean that the tax treatment continues to be **difficult for taxpayers (particularly investors) to understand**.
- On the other hand, the abolition of those nuances would represent a significant **departure** from the *status quo ante*; and more importantly, by rendering certain work tax-deductible (unambiguously) in areas which are currently capital (or at least arguably so), Finance Canada may develop concerns over a possible upsurge in investment and related **impacts on Treasury**.
- However, the **latter scenario is addressed** later in this report. Indeed, there are several options for the Department to consider in order to compensate anticipated losses in revenue (if any).

For the above reason, the next section deals exclusively with a proposed simplification of the tax treatment of the re-use of buildings.

2.4 The Proposal in Detail

QUESTION	PROPOSAL	COMMENTS
Who	<ul style="list-style-type: none"> ● investors only 	This proposal, as usual, <i>does not</i> address personal-use property, which remains outside the orbit of this entire discussion
What	<p style="text-align: center;">AMENDMENT</p> <p>DEFINITION: THE REPAIR OF BUILDINGS (I.E. PROPERTY IN CLASS 1) INCLUDES WORK WHICH RESTORES THE PROPERTY (OR ITS PARTS) TO ANY PREVIOUS CONDITION,</p> <ul style="list-style-type: none"> ● WITHOUT IMPROVEMENT TO THAT CONDITION, EXCEPT TO THE EXTENT THAT THE IMPROVEMENT OF BUILDING PARTS... ● ...DOES NOT INCREASE THE VALUE OF THE PART RELATIVE TO THE WHOLE (AS COMPARED TO ITS RELATIVE VALUE IN THE PAST); OR ● IS LEGALLY REQUIRED FOR SUCH WORK UNDER AN APPLICABLE CONSTRUCTION OR FIRE CODE. 	The test is objective based upon the nature of the works.
When	There would be no distinctions as to timing, e.g. the timespan after acquisition or before sale.	The test is objective based upon the nature of the works.
Where	There would be no distinctions as to location, e.g. on designated heritage property or elsewhere.	The question of "heritage" is a matter of primarily provincial and municipal jurisdiction, which has no direct application to the Income Tax Act under <i>this</i> proposal.
Why	There would be no distinctions as to the purported motivations of the owner/investor.	The test is objective based upon the nature of the works.

The monetary consequences are important. For example, let us suppose that \$20,000 worth of work is conducted on an existing building:

Example

- *If the work is treated as tax deductible*, then the owner can **deduct \$20,000** from his taxable income from that building. If the building was producing less than \$20,000 in net income, the resulting *loss* can be applied against the income of subsequent years, and hence be used as a tax deduction in those years (up to a maximum of five subsequent years). For example, if \$20,000 worth of tax-deductible work is done on a **building which otherwise produces net income of \$4000** per year,

		NET INCOME	REPAIR	TAX DEDUCTION	TAXABLE INCOME
Balancing against income	Year of work	4,000	20,000	4,000	0
	One year after	4,000	--	4,000	0
	Two years after	4,000	--	4,000	0
	Three years after	4,000	--	4,000	0
	Four years after	4,000	--	4,000	0
	Five years after	4,000	--	0	4,000
	Further years	4,000	--	Ineligible	4,000

Effect on
taxable capital
gains

N.B.: Since the work is "expensed" and *not* added to the capital value of property, the consequences will be significant when the property is eventually disposed of.

- If the work had been capitalized, the expense would have been *added* to the value of the property *for the purposes of computing capital gains*;
- but in this scenario, it is not.

Therefore, the capital gain on the disposition of the property will be \$20,000 higher (in this example) than if the work had been capitalized. Since 75% of capital gains are assimilated to taxable income, that will mean that when this property is eventually disposed of, there will be \$15,000 of taxable income on which taxes will need to be paid to the Treasury, which would not have occurred if the expenses had been capitalized.

- *If the work on an investment property is not tax-deductible, it is probably a "capital expenditure".* A capital expenditure is not tax-deductible, but CCA can henceforth be claimed annually on it. In the case of most investment buildings, this depreciation is typically 4% of the "declining balance". For example, if \$20,000 worth of "capital" work is done on a building which produces net income of \$4,000 per year,

	NET INCOME	CAPITAL PROJECT	TAX DEDUCTION	TAXABLE INCOME
CCA				
Year of work	4,000	20,000	800	3,200
One year after	4,000	--	768	3,232
Two years after	4,000	--	737	3,263
Three years after	4,000	--	708	3,292
Four years after	4,000	--	679	3,321
Five years after	4,000	--	652	3,348
Further years	4,000	--	626	3,374 ⁴⁶

In such a situation, the owner is usually better off when the work is treated as "tax-deductible" than when it is treated as "capital". Similarly, the owner will have more cash flow (and hence flexibility) in dealing with renovation contractors who are doing "tax-deductible" work rather than "capital" work.

Minimizing
substantive
change

In *most* respects, the proposal would not change the status quo appreciably, at least as reflected in the jurisprudence cited. Under both the fiscal status quo and under the new proposals, for example, adding a fireplace or a skylight would be capitalized because they are additions. Replacing tile with gilt would be capitalized because that is not a restoration, as understood.

Present
jurisprudential
approaches
unchanged

In other words, creating (or replacing) property, or increasing its *normal* value is likely a capital expense; repairing or maintaining property, or restoring its normal value is likely a current expense. Under cases like *Goyer*, "Restoring normal value" can include tax deductibility for work when a building is "run down", and the owner merely intends to "bring it back".

Similarly, under cases like *Gold Bar*, if a landlord replaced **flawed older materials** with new materials, that could still be a tax-deductible repair (instead of a capitalized renovation) if it did *not* improve the building beyond what it had ever been in the past. For example, although it would be more straightforward to replace plaster with plaster, it would not be considered unreasonable to replace heavily-damaged plaster with drywall, since economical access to plasterers is problematic.

An even more obvious situation arises when building codes and standards have changed over time: if the owner is *obliged* to install materials to certain specifications (because the previous ones would now be illegal), then complying with those specifications would *not* be considered as an intention to exceed the building's "normal" status. A person is not presumed to intend *improvements* to a building if his/her primary intention is to assure that the building complies with the law and can stay on the market.

Gold Bar already suggested that a similar situation should prevail when changes are imposed upon an owner by **technology or unforeseen events**. If he/she must replace materials because the originals had a latent defect, the work should not be labelled an "improvement". Similarly, if the owner installs ventilation because increased air tightness makes this both necessary and prudent (in light of responsible construction practice), he/she should again not be presumed to be intending an improvement.

Intent under
the status quo

The overriding principle throughout all of these decisions was constant: it was *business reasonableness*. If the intention of the person who undertook the work was first and foremost to assure that the building was in a state consistent with what the market would have expected from it in the past; the work should have been considered a tax-deductible repair rather than a capital renovation.

The primary effect of **this proposal**, however, is to remove the nuances which would have rendered the categorization more amorphous. For example, by defining the categorization in strictly **physical terms**,

- it becomes irrelevant to speculate on the taxpayer's *intent*, and
- it becomes equally irrelevant to develop elaborate theories on the *timeline* of the work (e.g. whether enough time separated the work from a recent acquisition or a prospective sale).
- Other factors, like relative size, become equally irrelevant (as they were in *Gold Bar*, but which was not picked up in subsequent departmental practice).

The following further examples of how this approach would be played out in practice.

QUESTION	NEW ANSWER (UNDER THE PROPOSAL)	OLD ANSWER (UNDER THE FISCAL STATUS QUO)
<p><i>Development around my building has affected the water table, and I must either redo the foundations or face a structural crisis. Is the foundation work tax-deductible?</i></p>	<p>Yes</p>	<p>Probably but not definitely. Not only does this respect the three <i>Goyer</i> rules defining repairs (no additions, no disappearances, no changes in value), but the intent is not to improve the building, but to keep it on the market. However, Revenue Canada could reach a different decision depending on "whether or not these problems were...there when the building was acquired."¹⁷</p>
<p><i>I have my eye on a building for sale: if I buy it, put up some brass lights and fake bargeboard, I can probably resell it as a Victorian classic. Is this work tax-deductible?</i></p>	<p>No</p>	<p>Most unlikely. This <i>adds</i> components to the building. Furthermore, the intent is not to return the building to what it has been, but to improve it. This appears to be a capital expenditure.</p>
<p><i>I have learned that my building's plumbing is classified as deficient, and the local building inspector thinks my wiring is downright hazardous. If I upgrade my plumbing and wiring to new code requirements, I am obliged to use new specifications and materials. Does this exclude the work from tax deductibility?</i></p>	<p>No: it is still deductible</p>	<p>This <i>might</i> still be deductible. Even if someone argued that you were adding something to the building, this is offset by your intent: if your intention is merely to do the minimum work required to keep your building "legal" and on the market in light of current codes, this would not be viewed as <i>out of character</i> with the way the building was in the past. In other words, if the building was "legal" in the past, it is reasonable to bring the building to a condition where it would still be "legal" today. This work is <i>perhaps</i> tax deductible, but in the view of the Department, the situation will vary depending on "how long buildings have been the property of the current owner", and "on their condition upon acquisition."¹⁸</p>
<p><i>I am looking to sell my apartment building. I think that if I redo the bathrooms and install whirlpools, it may be more marketable. Is this work tax-deductible?</i></p>	<p>No</p>	<p>Most unlikely. First, you are adding to the building. Furthermore, your intent is less to return the building to a previous condition than to speculate on a larger capital gain (i.e. profit) on sale. This looks like a capital expenditure.</p>

<p><i>Archival photos show that my building once had a large summer kitchen. If I rebuilt to the same dimensions with proper windows and insulation, I could add an extra apartment. If I show that I won't alter the building's appearance from a previous time, does that make my work tax-deductible?</i></p>	<p>Re-creating the shell might be deductible if it is of no higher proportional quality. Any work beyond that is capital.</p>	<p>Not deductible. Even if it <i>looks</i> like you aren't adding to the building, you are trying to replace something which disappeared for a significant lapse of time. Furthermore, an insulated apartment is not consistent with the "normal" character and value of a summer kitchen. On those two counts, this is probably a capital expenditure.</p>
<p><i>My roof is now a total loss, and needs replacing; but it is one of those old tin roofs and I can't find anyone to replace tin roofs. What happens if I use shingle?</i></p>	<p>Deductible. This is a reasonably proportional technological equivalent. However, if heritage authorities directed that tin be replaced by tin, this would also be deductible.</p>	<p>Perhaps, replacing tin with tin would be more straightforward; but the switch to shingles is not fatal. If your intent was not to improve the property, but to find a technologically reasonable equivalent, the expense is probably tax-deductible; but Revenue Canada claims that if the building "was in this condition when acquired, then any repairs are capital, whether he uses tin or shingles."</p>
<p><i>I am doing a comprehensive rehabilitation of my property. Most of the work is clearly repair; but while I am at it, I thought I would also add a couple of skylights. What should I do?</i></p>	<p>Simple: restoration work is deductible. Additions are not.</p>	<p>Try to treat the repairs and the new components separately. Repairs are tax-deductible; new elements like skylights should be treated as capital expenditures. However, in the view of Revenue Canada, "you must establish when, and in what condition the property was acquired before it can be concluded that most of the work is clearly repairs",⁴⁹ and the entire project <i>might</i> be disallowed.</p>
<p><i>I want to take out the UFFI which was sprayed into my 1920s building in 1978. Is this tax-deductible?</i></p>	<p>Yes.</p>	<p>Goyer had suggested the three rules:</p> <ul style="list-style-type: none"> ● you aren't adding to the building; ● you aren't replacing something which disappeared; ● you aren't trying to increase the "normal" value of the building. <p>Your intention here is merely to return the building to the character and value it would have had if the mistake hadn't been made. This kind of work will usually be tax-deductible, but may not be if the UFFI was already in the building at the time of purchase.</p>

3. BALANCING COSTS

3.1 Existing Method for the Treasury to Recoup Cost

Increased
capital gains

The *Income Tax Act* already includes a mechanism whereby the Treasury can recoup, *in part*, its cost in converting certain building expenditures from capital to deductible in nature. For every dollar which becomes expensable instead of being capitalized, that means the following: in technical parlance, the "Adjusted Cost Base" of the building will *not* increase by that capital amount, when it comes to computing capital gains tax. In other words,

- a *capital* expenditure would *reduce the margin of profit* on eventual disposition of the property, *i.e.* reduce the amount of taxable capital gains.
- If that spending is *not* capitalized, then the capital gains are **correspondingly higher**.

To return to the example offered earlier in this report, let us consider an expenditure of \$20,000. Let us further assume that the expenditure is successful in raising the fair market value of the property by a corresponding amount:

- if the expenditure is capitalized and the property indeed sells for \$20,000 more than it was worth before, then the capital gain is zero.
- However, if the expenditure is deductible, then the Adjusted Cost Base does not increase, and the \$20,000 **premium on disposition of the property is treated as a capital gain**. Since 75% of that gain is assimilated in taxable income, this adds \$15,000 to the taxpayer's taxable income and taxes are charged thereon accordingly.

Theoretical
losses
nonetheless

Under the above scenario, the Treasury nonetheless still loses a certain amount of income, in two ways:

- capital gains are *taxed at a rate which is the equivalent of one-quarter lower* than business income, and a certain amount of "seepage" is predictable accordingly; and
- the Treasury loses certain amount of income *now* and only regains them *later*, even in times of low inflation, this means a *net loss approximately equal to the interest* which would have been receivable or payable on that amount.

It is therefore obvious that by converting certain expenditures (which are now arguably capital) to deductible status, there will be **questions as to cost**. However, that does *not* necessarily mean a negative cashflow for the Treasury; that issue is explored further below.

3.2 More Immediate Effects

No windfall

Another factor in assessing cost/benefit is the likely **take-up rate**, *i.e.* the rate at which taxpayers undertake projects which were previously capital, and which would now be deductible. Clearly, it would not be in the Treasury's interest to allow a situation where countless Canadians stampeded toward a fiscal windfall: that would not only be **expensive**, but it would also be **unfair**. This proposed treatment, however, is no windfall:

- in the overwhelming majority of instances, it does **not change the substantive tax treatment at all** (as understood in the jurisprudence): it only makes it *clearer*, thereby reducing the administrative risks for the taxpayer — and a certain amount of the tedium which Revenue Canada itself must face because of the same existing complexities.

- Even where the tax treatment would unquestionably change, there is an *automatic* way to recoup it (at least in part) via the capital gains system, as described above.
- The remaining balance of net cost to the Treasury is therefore a more modest figure.

Take up

In attempting to quantify that more modest figure, certain technical difficulties arise. For instance, no survey results currently exist, to indicate the likely take-up rates by taxpayers, in the event that the tax treatment of building rehab were improved. The question of cost to the Treasury, therefore, is still relatively conjectural. However, the following preliminary observations can nonetheless be made.

It has been argued that even if a new tax treatment of building rehab (as proposed) produced a rush of investment in this sector (tax-deductible), there would still be a positive cashflow for the Treasury. The rationale for that argument is as follows.

3.3 Job Creation

Competition for attention

The question of cashflow (arising from taxable wages etc.) is obviously central to any cost/benefit analysis. It is immediately acknowledged that such discussions may sometimes appear tedious — almost *every* proponent, for any tax change, invariably argues that the Treasury will recoup its costs via an upsurge in taxable wages. Some of these claims border on the miraculous. In addressing this question, therefore, it is essential to assemble reliable data on the position of building rehab *relative to other sectors*.

Desirability of data

The task of identifying the employment multipliers, associated with the rehab of older buildings, is hampered by the lack of a proper "Employment Generation Model" for the sector. Indeed, one report which is currently going to the Minister of Human Resources Development strongly urges the preparation of such a model, at least in the residential renovation field.⁹⁴

DRI approach

In the meantime, observers must therefore resort to employment generation models which are *as close as possible* (in terms of sector and date) to today's rehab industry. At this point in time, according to the Canadian Housing Information Centre,⁹⁵ it would appear that the closest relevant indicator is the one provided in a 1993 analysis done for Canada Mortgage and Housing Corp.(CMHC). This report, entitled *Economic Impacts of Residential Construction*,⁹⁶ covered "alterations and improvements" as of 1992, but its focus was on the *residential* side of the industry only. Although the non-residential and institutional side would appear to be ripe for further research, it is arguable that the figures from these sectors would likely be comparable, and that for the time being, the following figures nonetheless convey a reasonable general profile.

CMHC/CHBA approach

The consultants (DRI Canada) used a methodology which was different from the one used by other organizations, and this gives rise to another caveat. Organizations like CMHC and the Canadian Home Builders' Association (CHBA) often refer to "the reno sector" as including

- (a) "alterations",
- (b) "additions", and
- (c) "maintenance and repair".

Caveat

DRI did its calculations based on (a) and (b), but there was **no apparent reference to (c)**. Furthermore, unlike the computations at Statistics Canada, the DRI figures do not include "self-supply". This would automatically mean a different set of figures for

Superiority of
rehab

contributions to GDP (Gross Domestic Product) — and a different point of departure for employment figures.

Nonetheless, DRI demonstrated that *its* chosen component of the reno sector (residential alterations and improvements) had a **higher multiplier than the new construction sector**: roughly 1.6 versus 1.5.⁹⁷ In other words, a given expenditure on rehab would have a greater domino effect on the *economy as a whole* than an identical expenditure on new construction. However, since there were significant discrepancies in definitions of the industries surveyed,⁹⁸ such figures must be approached with caution. In particular, one may note that the DRI findings are fundamentally different (in both methodology and outcome) from those of the previous leading report, published by CMHC in 1986. That report entitled *The Canadian Renovation Market*⁹⁹ had calculated that *direct* renovation employment generated by a given amount of investment was **over twice the direct employment provided by an identical investment in new construction**; and that the *total* employment (direct, indirect via suppliers, and induced through related economic activity) was still substantially higher, in the case of reno as opposed to new construction.

CMHC figures

With a figure of almost 60 jobs per million dollar investment (1986) the CMHC findings indicated that reno's job spin-offs were not only better than manufacturing and new construction, but also **BETTER THAN ALMOST ANY OTHER INDUSTRY IN CANADA.**

Comparison

The DRI figures, however, point in a more conservative direction because of the different definitions. According to DRI, new construction and renovation wind up in virtually a dead heat: for each million dollar expenditure (in 1986 dollars, \$1,339,000 in current dollars), new construction produces 29.88 jobs whereas reno produces 29.74. In other words, if one disregards any discrepancies emanating from the use of the base year of 1992 for employment data and the base year for dollars of 1995, one could reach the following *approximate* estimate: **in the case of both new construction and rehab, the DRI figures would suggest that a full-time job is created in Canada with each investment of slightly less than \$45,000.**

There are, however, some dramatically important qualifiers which must be imposed on the above: by omitting maintenance, repair and self-supply from the calculations,

- DRI left out factors which would have *significantly improved the relative figures for the renovation sector*; and
- in the case of the rehab sector, *the total employment generated tends to be far more local than in the case of new construction*, where indirect and induced job creation (notably building materials) are concentrated in only a handful of locations. This has implications for the equitable distribution of economic opportunity.

In other words, if these other factors are taken into consideration, the overall picture looks much closer to what had been predicted in the earlier employment generation models, *i.e.* a **distinct advantage to the reno sector**, at least as it relates to the local economy.

The above situation has therefore led various organizations to posit the following:

Conclusion

because of the relatively high multiplier effects associated with building rehab and the *immediacy* with which investment is translated into taxable wages and salaries (because of the labour-intensity of the industry), the *rate* at which any improvement in tax treatment is offset by rising tax revenues is expected to be preferable to that of almost any other industry. In short, any perceived tax expenditure would be recouped at an unusually advantageous rate.

There is a further unusual dimension to this particular industry, which must be born in mind in any tax discussion: under the status quo, this industry has one of the highest levels of underground activity anywhere in the Canadian economy. This leads to additional features concerning the payback of any new tax treatment, as described next.

3.4 The Underground Dimension

The problem

One problem which has mushroomed in Canada, particularly within the last five years, has been the phenomenon of rehab activities which have occurred outside *any* legal parameters: the owner and the contractor would deliberately avoid any paper trail including permits, approvals etc., as part of an overall intent to cheat on taxes and fees. This phenomenon has been referred to as "the underground economy" in renovation (or, as it is called by legitimate contractors, the competition of the Fly-By-Nighters or "FBNs").

Side effects

The pernicious effects, however, run deeper than that. Although there are some FBNs who may be qualified workers, there are many others with more dubious credentials, and whose work may do more harm than good; furthermore, in the event of customer dissatisfaction, there is no recourse to a callback.¹⁰⁰ Perhaps more important still, the important market share of FBNs stands as an ongoing obstacle to the overall professionalization of the rehab industry, with everything that this entails.¹⁰¹ This has led to demands for action on the policy front. According to a January 1996 statement from Human Resources Development Canada,¹⁰² the situation can be summarized as follows:

While the incidence of underground employment is not a new phenomenon, it is perceived by the industry to be on the increase and to represent a further threat to the viability of the industry. These concerns have led various constituents in the construction industry to request that concrete actions be taken to reduce the amount of unreported construction activity. Business managers and independent contractors are concerned that legitimate businesses are placed at a competitive disadvantage vis-a-vis those business individuals operating in the underground economy.

Losses in the millions/billions?

There are currently no reliable figures on how much money is being diverted from the Treasury by the underground economy and renovation. There have been published estimates in the hundreds of millions of dollars, and even in the billions of dollars; but in the absence of methodologically reliable figures, the subject remains one of conjecture. One published report estimated that in Ontario alone, "the underground renovation market has become a \$4.25 billion industry"¹⁰³; if that is even *remotely* close to the truth, then the *national* losses to the Treasury would indeed be into the billions. The one consensus is that the figure is *very large*.¹⁰⁴

Weakness of
conventional
wisdom

By the same token, Canada has no reliable figures on the proportion of the underground economy which is fed by **owners of investment property**. The *assumption* is that this proportion is *relatively* small, and that the lion's share of the activity is in **personal-use property instead**. In the case of commercial property, for example, it has been argued that commercial landlords would probably prefer to deal with legitimate contractors, so that they may claim their Input Tax Credit. With all possible respect, that assertion may be glib; for contractors who are *utterly* entrenched in the underground economy (*i.e.* who are cheating not only on Goods & Services Tax, but also on income tax, unemployment insurance, workmen's compensation etc.), the proffered "discount" for cash deals could easily eclipse any Input Tax Credit.

Indeed, of all the areas where the underground may be tempted to cheat, **income tax** is the one that is the most mathematically significant. For the contractor, undisclosed income (and the tax saving attached thereto) may be worth up to 53¢ on every dollar of profit, and may therefore provide the contractor with the leeway to offer dramatic "discounts".

These "discounts" may look very attractive — *including to landlords* — particularly if they believe that it is relatively **pointless (at least in the short term)** to monitor the receipts because these will not be expensable anyway (or at least they are not *thought to be*).

Attraction to
landlords

The argument about how imprudent this strategy may be, in the long term, may be misunderstood, or simply ignored by various landlords. Although the hard data on the scale of this phenomenon is almost non-existent, **the anecdotal evidence suggests that it is happening on a massive scale**. This is not to suggest that a revised tax treatment for rehab, among the owners of investment property, would wipe out the underground economy in renovation. Such an amendment would directly affect only a modest proportion of the overall underground market, and hence would provide Revenue Canada with only the *beginnings* of a window on this dangerous sector. However, that still leaves the following question:

Conclusion

**IN THE NATIONAL BATTLE TO OBTAIN LEVERAGE AGAINST
THE UNDERGROUND ECONOMY IN RENOVATION, HAS ANYONE
SUGGESTED A BETTER PLACE TO START?**

Landlords already have a motive to document their rehab work: some is already expensable under the jurisprudence, and even capitalized works are important for eventual savings on capital gains. The problem is that landlords may not *see* things that way. However, if certain work is **clearly expensable now**, the psychological impact could be important in drawing such people back into the legitimate economy. Given the *scale* of the issue, which is (according to unanimous opinion) at a disturbing level, **even modest leverage (and a relatively low *proportional* payback) still translates into a multi-million dollar improvement over the Treasury's current position**. One can also hope, at least, that the *window* which it opens on that sector will provide Revenue Canada with *further opportunities* to enforce existing legislation. The resulting benefit to the Treasury may not currently be *quantifiable*; but it is *certain* and *non-negligible*.

3.5 Proposed Position on Payback

The above three features, namely

- (a) existing payback systems,
- (b) size and speed of **multiplier effects**, and
- (c) leverage against the **underground economy**

are expected, in principle, to combine to **eliminate any anticipated costs** of an improved tax treatment to this sector. Indeed, in light of the foregoing observations, it is submitted that

Positive
cashflow likely

IN VIEW OF THE FACTORS WHICH MITIGATE GROSS COST OF THIS MEASURE, AND OF THE FACTORS WHICH SUGGEST AN UNUSUALLY HIGH BENEFIT (AS COMPARED TO OTHER SECTORS), THEN ON THE BALANCE OF PROBABILITIES, IT IS EXPECTED THAT RESULTING CASH FLOW TO THE TREASURY WILL BE POSITIVE, AND BY A SIGNIFICANT MARGIN.

However, there may still be observers who would prefer an overabundance of caution. For example, it is readily admitted that this conclusion may not be sufficient to remove all of Finance Canada's concerns:

Difficulties in
policy
forecasting

- because of the shortage of statistical data in several key areas, it may be allegedly difficult to reach an accurate prognosis of the true cost-benefit: the existing analysis may still be allegedly theoretical.
- **Even if** there is an immediate payback which reduces or eliminates the cost to the Treasury, that may be allegedly insufficient: for reasons of state, it is essential not only that Finance Canada takes a hard line on tax expenditures, but that it be *perceived* to be taking a hard line, and there is a risk that any improvement in the tax treatment of rehab would be *mistaken* (in Parliament or in the international financial press) for a "softening" of that line.
- By the same token, it may not be sufficient that the payback be massive, if it is staggered over a long timespan: for reasons of state, the payback might allegedly need to be highly *visible*, and occur within a shortened timeframe (2—2½ years).

This creates a dilemma. If, out of an overabundance of caution, one still insists on a fall-back position or contingency plan in the *unlikely* event of negative cash flow,

Concerns about
fall-back

- the glib way to assure an immediate payback would be to introduce an immediate "compensating" series of amendments to reduce tax deductions elsewhere, e.g. among terminal losses for demolition or in CCA.
- However, that would be on a **collision course with the real estate industry**, which has already complained bitterly about tax amendments over the past decade.

Embattled real
estate sector

The current situation, in the Canadian real estate industry, needs little elaboration. The decline of commercial values, and the stagnation of rental residential construction (and what that signifies in the economy) have been well-known throughout most of Canada for the past five years, with no significant relief in sight. There are, of course, many members of the real estate community who blame the tax system for exacerbating their problem, e.g. when capital gains exemptions were removed. They would argue that neither Finance Canada nor the real estate community would be well-served by still a further confrontation over something as dramatic as CCA.

Contingency
plan

The possible solution to the above dilemma is relatively straightforward. If indeed the "cost-benefit" of an improved tax treatment is difficult to predict, then Finance Canada may wish to consider the following:

- **Step 1:** to introduce the proposed amendments to the tax treatment of rehab.
- **Step 2:** to announce (truthfully) that it expects the measure to be revenue-positive or revenue-neutral, but that it has a contingency plan (unspecified) to deal with any eventualities (e.g. if that there is an unanticipated drain on the Treasury).
- **Step 3:** To adopt a wait-and-see posture, concerning take-up and payback, for a period of \pm 18 months.
- **Step 4:** In the event that either the take-up rate is low, or that the payback is high, and that the measure actually produces positive cashflow to the Treasury (which is what many observers would expect), then the Department can close its books on the subject.
- **Step 5:** If, for various unexpected reasons, the cashflow is not entirely satisfactory, then the Department can announce that it is following through on its contingency plan as predicted and consider the options outlined later in this reports.

In short, the proposed position can be summarized as possible (and with apologies to Mackenzie King): compensation if necessary, but not necessarily compensation.

Status: last
resort

If the cashflow for the Treasury is not positive after the wait-and-see period has given it a chance to work, then Finance Canada may wish to resort to its contingency plan, and consider other options. This report outlines two possible options:

- first, review of terminal losses for demolition, and
- later, review of capital cost allowance.

It should be immeasurably clear, however, that these prospects (particularly as related to CCA) are measures of last resort.

3.6. Tax Treatment of the Destruction of the Built Environment

Background

Demolition is the consummate refusal to "re-use" a component of the built environment; and the voluminous materials from the wreckage can strain waste disposal sites. Nonetheless, this waste enjoys positive treatment from the taxman. Prior to 1981, demolition enjoyed favourable tax treatment¹⁰⁴ even preferable to donation of a building to charity.¹⁰⁵ That was because of the size of the "terminal loss" claimable, i.e. the tax deduction which occurs under the *Income Tax Act*:

Mechanics

- when the last item in a given class of capital property is disposed of or
- disappears from inventory, special rules apply.
- Until 1981, demolition was treated as a disposition at \$0 (i.e. a better tax treatment than donation);
- so if depreciable property had been depreciated down to a certain figure (called the undepreciated capital cost or "UCC"), what happened to that entry in the books?
- The *Income Tax Act* replied that when this item on inventory disappeared, the remaining value listed on the owner's books (i.e. its depreciated value or "UCC") should be removed from the books by treating that entire figure as a "loss".

Original system Since this "loss" was the last item in that class of property, it was called a "terminal loss". The *amount* of that loss was the difference between

- the depreciated value at the time (UCC) and
- the "proceeds of disposition" which, in the case of demolition, were \$0;
- in other words, the entire depreciated book value (UCC) became a tax deduction.

1981 Amendment It is a matter of historical record, as mentioned before, that W. Clifford Clark (the man who supervised the introduction of the Income Tax Act) believed that Canadian cities were obsolete and destined to be replaced. With the passage of time, however, different views prevailed at Finance Canada. Since 1981, the Act no longer treats demolition¹⁰⁶ as a disposition at \$0. However, the amendment did not produce a simpler tax system, (e.g. by treating this form of disposition in the same way as donations¹⁰⁷ but instead, it produced a more complicated formula. The Act now distinguishes between two scenarios:

- (a) where demolition occurs in **anticipation of sale**, or
- (b) where demolition occurs but the owner **keeps the land**.

Demolition before sale Where the land is also disposed of in the same year, the Act "will treat the vendor as if he had sold the building for its fair market value".¹⁰⁸ It follows that a tax deduction arises if fair market value (FMV) is lower than UCC (*i.e.* depreciated value, as it appears on the books); the tax deduction would be equal to the *difference*.

Demolition on retained property The case of buildings whose land is retained by the owner is more complicated:

- Until 1988, when the building was demolished the Act allowed a **terminal loss equal to half the difference** between FMV and UCC;
- but pursuant to amendments introduced by Michael Wilson, the tax treatment of demolition was made **significantly more generous** for 1988 and 1989, this was **increased to two thirds**; and
- for 1990 and onward, this has been **increased again to three quarters**.¹⁰⁹

Wilson amendments

THE QUESTION IS WHETHER ANY TAX DEDUCTION SHOULD REMAIN AT ALL. WHY DOES THE TAX SYSTEM PROVIDE DEDUCTIONS TO PEOPLE FOR DESTROYING THEIR OWN PROPERTY?

In answer to that question, a rationale was offered in the letters which had been sent out by the previous government.¹¹⁰ The argument was that the deduction of "terminal losses" on demolition is a question of entitlement: it is consistent with generally acceptable accounting principles, and is **fully anticipated by the property-owner** throughout the time that the property-owner owned and amortized the building. By that reasoning, the property owner factored in the terminal loss as part of his/her equation pertaining to amortization and saleability of the property; to deprive the owner of that tax treatment constitutes a imposition of an unanticipated hardship.

"Entitlement"?

The counter-argument is simple: the government has right to modify the tax treatment of real estate periodically — and has indeed done so repeatedly over the past 25 years — taxpayers have a right to **fairness**; but to say that a given deduction can never be changed (even in a sector which is receiving new deductions, as in rehab) is absurd. A given tax treatment is never a "right" and that it is the Act which dictates generally accepted accounting principles, and not vice versa.¹¹¹ Furthermore, tax deductions associated with destruction of property arguably constitute:

- (a) *quid pro quo* for an activity which is **self-inflicted**; and

- (b) *quid pro quo* for an activity which is inconsistent with the re-use of property foreseen by "sustainable development" and the *Green Plan*.

Conclusion

In short, if an asset still has a market value at all, the reasoning of the *Green Plan* suggests that the value should be capitalized upon. If taxpayers choose to wipe out that value, that is their decision - but it is not normally up to the tax system to assist them, directly or indirectly, in that purpose.

Recommendation

The following proposal is therefore offered:

- If Finance Canada is still concerned about the cost (to the Treasury) of an improved tax treatment of rehab, then*
- it may choose to compensate itself by abolishing these terminal losses for demolition.
 - No preference is expressed in this report, as to the exact format of that abolition. It could, for example, take the form of a...
 - ...simple *amendment to the deemed disposition formula*
 - or otherwise, at the Department's option.

3.7 Tax Institutionalization of the Degradation of the Built Environment

Caveat

By this point, it should be unnecessary to be in search of still *further* methods to "compensate" the Treasury for any "losses" which might accrue from the proposed tax treatment of rehab. Indeed, it is arguable that any further discussion along these lines would be *moot*. Nonetheless, out of an overabundance of caution, the following observations are offered, if only as a footnote.

Background

For decades, there has been a basic tax assumption that just as the universe moved toward entropy, buildings *must* deteriorate. This assumption about degradation of the built environment was the original rationale for *depreciation*: with each passing year, the market value of buildings was presumed to decline numerically, and this deterioration would be reflected in both "generally accepted accounting principles" and the *Income Tax Act*. Accordingly, the *Income Tax Act* identifies a wide variety of "classes" of capital property, and gives the owner the option of claiming a tax deduction for depreciation, called "Capital Cost Allowance" ("CCA"). In the case of most investment buildings, this CCA is 4% per year.

This approach is also founded on a second rationale. Generally accepted accounting principles usually allow investors to amortize (*i.e. write off*) their investments *on their books*.¹¹²

Practical complexity

However, when these principles were applied to real estate, a dichotomy occurred: depreciation (for accounting purposes and CCA) was accepted for *buildings*, but not for *land*. To this day,

- land itself is not depreciable;
- it is not subject to CCA;
- and its purchase is not written off over time for tax purposes.
- This compels real estate investors to enter purchases of land and buildings separately in their books, with ensuing complications.

Mathematical
relationship to
inflation

Some observers have argued that CCA on buildings has outlived its economic and philosophical usefulness.¹¹³ That is the view, for example, in the United Kingdom. Economically, for buildings undergoing routine maintenance and repair, the *true decline in value should rarely exceed the rate of inflation*. If there is enough parity between inflation and the decline in value, then the two figures will **cancel each other out**, and *numerically* the figure listed in the books will continue to be reasonably accurate. For example,

- if a building is listed at \$100,000 in a given year,
- and 2% inflation drives its value up to \$102,000
- but 2% deterioration drives its value back down again
- then its value according to the books should logically stay at \$100,000 where it started.

Relationship to
the market

However, CCA ignores inflation: so

- if the value of money declines by 2% annually and CCA allows the value of a building to be written down by a further 4%,
- the *cumulative* effect is to say that the value of *that real estate has declined by 6% in constant dollars*.
- For example, the current system would allow buildings to be devalued by 53% (in constant dollars) during the past decade.¹¹⁴
- In *most* Canadian real estate, that objectively makes no sense,¹¹⁵ even despite the downturn of 1991; and when compared to the long-term evolution of real estate values over the last generation or two, it is absurd.

Effect of new
approach

If the tax system is amended to acknowledge (clearly) the re-use of buildings, then one would expect a correspondingly lower need to account for obsolescence, *i.e.* a correspondingly lower CCA. However, that is not the approach recommended *at this time*, for pragmatic reasons: the real estate sector simply needs more time to recover, and is in a poor position to absorb or withstand any further deterioration in tax treatment, regardless of the "logic" of the situation.

Pragmatic
realities

Conclusion

The concept of revisiting CCA, in light of new tax treatment for rehab, is therefore submitted to Finance Canada as one that can be kept in abeyance until such time as different circumstances occur.

PART 4. SUMMARY OF RECOMMENDATIONS

Proposal

AMENDMENT

DEFINITION:

THE REPAIR OF BUILDINGS [*i.e.* PROPERTY IN CLASS 1(q)] INCLUDES WORK WHICH *RESTORES* THE PROPERTY (OR ITS PARTS) TO ANY *PREVIOUS* CONDITION,

- WITHOUT IMPROVEMENT TO THAT CONDITION, EXCEPT TO THE EXTENT THAT THE IMPROVEMENT OF BUILDING PARTS...
- ...DOES NOT INCREASE THE VALUE OF THE PART *RELATIVE* TO THE WHOLE (AS COMPARED TO ITS RELATIVE VALUE IN THE PAST); OR
- IS *LEGALLY REQUIRED* FOR SUCH WORK UNDER AN APPLICABLE CONSTRUCTION OR FIRE CODE.

WHAT THIS PROPOSAL IS *NOT*:

- This is *not* a proposal to shelter professional or business income via "losses" incurred while expensing these works.
- This is *not* a proposal to deprive taxpayers of the option to capitalize the works if they so choose.
- This is *not* a proposal to deal with any property other than buildings and structures (*i.e.* technically, property covered by par.(q) of "Class 1" for CCA purposes).

HOW THIS PROPOSAL WILL MORE THAN PAY FOR ITSELF:

A combination of the following three factors

- (In part), expenditures which are not capitalized (*i.e.* expensed) will lead to correspondingly higher CAPITAL GAINS.
- (In part), an increase in taxable WAGES AND SALARIES in the rehab sector (which has among the highest job-creation figures of any sector).
- (In part), by attracting *certain* property-owners back from the UNDERGROUND ECONOMY.

LAST RESORT:

If this proposal defies all economic predictions and (after a *wait-and-see period*) is shown to produce a negative cashflow to the Treasury, then Finance Canada may wish to explore the possibility of compensating itself via an abolition of the TAX DEDUCTIONS FOR DEMOLITION ("Terminal Losses"). If that is *still* insufficient (as increasingly *unlikely* as this may be), Finance Canada may wish to re-explore CCA. However, that is not expected to be necessary.

