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Cost of removing the tax exemptions for Real Estate Investment Trusts

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The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

This report provides an estimate of the additional revenues that could be collected by the federal government if tax exemptions for Real Estate Investment Trusts (REITs) are removed, and REITs are subjected to the statutory corporate income tax rate of 38 per cent.

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Summary

This report is in response to a request by Member of Parliament Mike Morrice (Kitchener–Centre) to estimate the additional revenues that could be collected by the federal government if tax exemptions for Real Estate Investment Trusts (REITs) are removed, and REITs are subjected to the statutory corporate income tax rate of 38 per cent.

The additional revenues collected by the government if tax exemptions for REITs are removed, and REITs are taxed at the basic corporate income tax rate of 38 per cent, which we identify as Scenario 1, are estimated to be $285.8 million over the 2023 to 2027 tax years (Table ES-1). With the introduction of this legislation, REITs are expected to incorporate.

Table ES-1 Cost estimates of federal government revenues

Tax year	Additional revenues ($M)
2023	53.6
2024	55.3
2025	57.1
2026	59.0
2027	60.8
Total additional revenues ($M)	285.8

Sources: Canada Revenue Agency, Statistics Canada and Office of the Parliamentary Budget Officer.

Note: Data are in tax years.

Over 2023-2027, $95.5 million additional revenues would be collected indirectly on income distributed to non-residents and $242.6 million on income distributed to non-taxable residents.[1] On the other hand, revenues collected directly and indirectly on income distributed to taxable residents would be reduced by $52.3 million. Total additional revenues are estimated at $285.8 million (Table ES-2).

Sensitivity analyses to assess the impact on additional revenues of a potential 5, 10 and 15 percentage points increase in the proportions of income distributed to non-residents and non-taxable residents is shown in table ES-2.[2]

Government revenues are not assumed to be affected by any behavioural response, other than trusts incorporation, after the proposed legislation comes into force.

Table ES-2 Total additional revenues resulting from an increase in the proportions of income distributed to non-residents and non-taxable residents ($M), 2023-2027

Additional revenues from income distributed to *	Scenario 1	Scenario 5%	Scenario 10%	Scenario 15%
	Non-residents			
Non-residents	95.5	186.3	277.1	367.8
Non-taxable residents	242.6	242.6	242.6	242.6
Taxable residents	-52.3	-49.6	-47.0	-44.4
Total additional revenues	285.8	379.2	472.6	566.0
	Non-taxable residents			
Non-residents	95.5	95.5	95.5	95.5
Non-taxable residents	242.6	368.1	493.6	619.1
Taxable residents	-52.3	-49.6	-47.0	-44.4
Total additional revenues	285.8	413.9	542.1	670.2

Sources: Canada Revenue Agency, Statistics Canada and Office of the Parliamentary Budget Officer.

Notes: Data are in tax years.

* Additional revenues are collected directly and indirectly on income distributed to taxable residents and only indirectly collected on incomes distributed to non-residents and non-taxable residents.

Totals may not add due to rounding.

1. Introduction

This report is in response to a request by Member of Parliament Mike Morrice (Kitchener–Centre) to estimate the additional revenues that could be collected by the federal government if tax exemptions for Real Estate Investment Trusts (REITs) are removed, and REITs are subjected to the statutory corporate income tax rate of 38 per cent.

Additional revenues are estimated as the difference between the federal government revenues under the following two scenarios:

- The revenues collected by the government under existing rules (baseline scenario); and
- The revenues collected by the government if tax exemptions for REITs are removed, and REITs are taxed at the basic corporate income tax rate of 38 per cent. Under this legislation, REITs are expected to incorporate (Scenario 1).

The report also assesses the impact on the additional revenues of a potential 5, 10 and 15 percentage points increase in the proportions of income distributed to non-residents and non-taxable residents.

Unlike most Canadian income trusts, which were subjected to entity-level taxation since the legislative change of 2011, REITs are allowed to flow through their income to their unitholders and pay taxes only on the non distributed portion of their income. These tax advantages have benefited REITs' investors, particularly non-resident investors and non-taxable Canadian investors.

The following section of this report provides an overview of REITs. Section 3 describes the methodology, the assumptions and the two scenarios used to estimate the additional revenues that could be collected by the federal government if tax exemptions for REITs are removed, and REITs are subjected to the statutory corporate income tax rate of 38 per cent. Section 4 presents the results.

2. Real estate investment trusts

The REIT market began to develop in Canada in early 1990s and the first REIT was traded on the Toronto Stock Exchange in 1993 (Meretsky, J. (1995), Perkins, T. (2013), and August, M. (2020)). REITs invest in income-producing real estate. They buy, hold, maintain, improve, lease, and manage properties using money from investors and distribute income generated to the investors as dividends. REITs offer to their investors the opportunity to invest in real estate without the risk of owning investment properties or the need to manage them.

Since the legislative change of 2011, tax exemption of REITs at the entity level has made them more and more popular among Canadian investors seeking a regular income stream and sustainable growth prospects. The number of REITs increased steadily in the first decade of the century and jumped further from 15 in 2010 to 110 in 2021 - an average annual increase of 19.9 per cent (Figure 2.1).[3]

In order to maintain their exemption status, REITs are required to be resident in Canada throughout the year and to meet certain revenues and property conditions, including the followings:

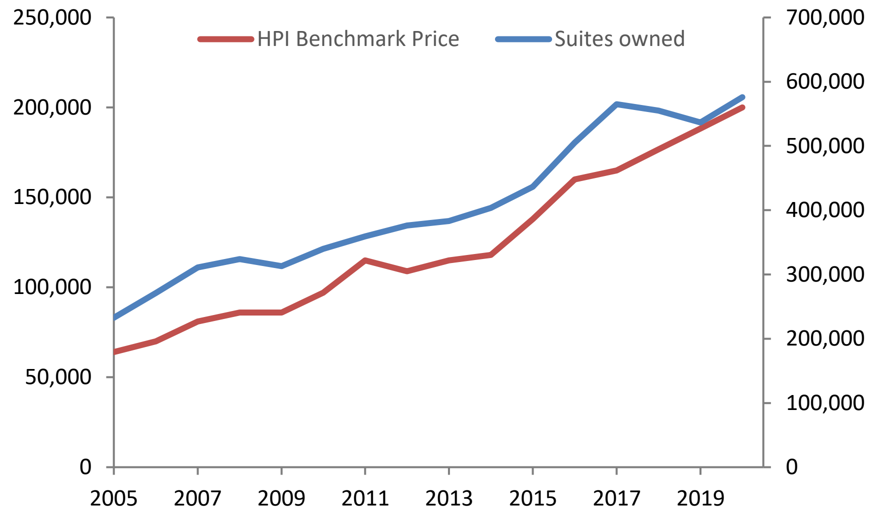
- At least 90% of the REITs' non-portfolio properties must be qualified REIT properties,
- At least 90% of the REITs' gross revenues for the tax year must come from: rent or mortgage interest from real properties, dividends, royalties, capital gains resulting from the sale of real capital properties, and dispositions of eligible resale properties,
- At least 75% of the REITs' gross revenues for the tax year must come from rent or mortgage interest from real properties and capital gains from the sale of real capital properties in Canada.

Canadian REITs assets and holdings have seen a spectacular growth since the late 1990s. Total REITs assets grew from $80 million in 1993 (Londerville, J., 2002) to $76 billion in 2021[4] and the number of rental suites (units in apartment buildings) owned by REITs increased from zero in 1996 to nearly 200,000 in 2021 (August, M., 2020, 2021).

The number of suites owned by financialized landlords (including REITs, and other financial investors) has increased continuously since the late 1990s. They owned almost 20 per cent of the country's private purpose-built stock of rental apartments in 2021 (August, M., 2020, 2021). The Canadian Housing Statistics Program (CHSP) data show that more than one in five of Canadian residential real estate properties are owned by investors and the proportion varies from 20.2 per cent in Ontario to 31.5 per cent in Nova Scotia (Fontaine, J. and Gordon, J., 2023).

Real estate prices have risen with the increase in the number of real estate properties owned by financial firms (REITs, among others) and the concentration of their ownership during the last two decades. Figure 2.1 shows that the home price index has increased in tandem with the number of rental suites owned by REITs over 2005-2020.

Figure 2-1 The home price index and the number of suites owned by REITs ($).



Sources: The Canadian Real Estate Association (CREA), August, M (2020, 2021) and Office of the Parliamentary Budget Officer.

Note: The number of suites owned in 2018 and 2019 were interpolated using the August, M. (2020, 2021) data over 2005-2020.

3. Methodology and Data

To estimate the additional revenues collected by the federal government if tax exemptions for REITs are removed, and REITs are subjected to the statutory corporate income tax rate of 38 per cent, we estimate:

- The revenues collected by the government under existing rules (baseline scenario).
- The revenues collected by the government if tax exemptions for REITs are removed, and REITs are taxed at the basic corporate income tax rate of 38 per cent. With the introduction of this legislation, REITs are expected to incorporate (Scenario 1).

We use Capital IQ data, administrative data provided to PBO by Canada Revenue Agency (CRA), Statistics Canada's Social Policy Simulation Database and Model (SPSD/M) and Statistics Canada data.[5]

First, we employ a combination of linear and nonlinear regressions to project the total amount of net income before allocations, excluding deductions,[6] (income hereafter) of REITs over 2023-2027, using capital IQ data over 2013-2021 and data obtained from CRA. Second, we estimate the projected income of Canadian Controlled Private Real Estate Investment Corporations (CCP-REICs), non CCP-REICs and public REICs (as trusts will be expected to incorporate in response to the changes), using the CRA and Statistics Canada data over 2016-2020.

After their incorporation, public REICs and non CCP-REICs would pay a tax rate of 15 per cent and CCP-REICs would pay a tax rate of 8 per cent on distributed income and 38.67 per cent on non-distributed income.[7]

The federal government revenues under both scenarios are estimated as follows.

3.1. Baseline scenario

The federal government's revenues are calculated as the sum of taxes collected on income non distributed by trusts, taxes withheld on income distributed to non-residents and taxes collected on income distributed to taxable residents.

Taxes collected on income non distributed by trusts are calculated as the trusts' projected amount of income multiplied by the proportion of income non-distributed and by the top marginal personal income tax rate (33 per cent).

The amount of withholding taxes is calculated as the trusts' projected amount of income multiplied by the proportion of income distributed to non-residents and by a tax rate of 15 per cent.[8]

The amount of taxes collected on income distributed to taxable residents is equal to trusts' projected amount of income multiplied by the proportion of income distributed to residents and by the personal income tax (PIT) rate, which is estimated at 32.8 per cent using SPSD/M.

The proportion of income non-distributed by trusts, and the proportion of income distributed by trusts to non-residents and to taxable residents are all estimated as a percentage of trusts' income using the CRA data over 2016-2020.

3.2. Scenario 1

Under Scenario 1, tax exemptions for REITs are removed, and REITs are taxed at the basic corporate income tax rate of 38 per cent. The federal government's revenues are calculated as the sum of federal corporate taxes collected on the proportions of income distributed and non-distributed by REICs, taxes withheld on income distributed to non-residents, and taxes net of dividends tax credits (DTC) collected on income distributed to taxable residents.[9]

The proportion of income non distributed, and the proportion of income distributed by REICs to non-residents and to taxable residents are all estimated as a percentage of trusts' income, using the CRA and Statistics Canada data over 2016-2020.

4. Results

The first subsection below provides our estimates of additional revenues collected by the federal government under the new legislation. The second subsection presents a sensitivity analysis of government additional revenues to an increase in the proportions of income distributed to non-residents and non-taxable residents. The third subsection discusses behavioural response.

4.1. Cost estimates of federal government revenues

We estimate that the revenues collected by the federal government from REITs after removing their tax exemptions and subjecting them to the statutory corporate income tax rate of 38 per cent (scenario 1) would be $285.8 million higher than the projected revenue of the government under existing rules (baseline scenario) over the 2023 to 2027 tax years (Table 4-1).

Table 4-1 Cost estimates of federal government revenues

Tax year	Revenues in the baseline scenario ($M)	Revenues in scenario 1 (M$)	Additional revenues (M$)
2023	969.4	1,023.0	53.6
2024	1,001.2	1,056.6	55.3
2025	1,033.8	1,090.9	57.1
2026	1,067.1	1,126.0	59.0
2027	1,101.1	1,161.9	60.8
Total additional revenues ($M)	–	–	285.8

Sources: Canada Revenue Agency, Statistics Canada and Office of the parliamentary budget officer.

Notes: Data are in tax years. Totals may not add due to rounding.

Additional revenues would come from corporate income tax ($2,510.3 million) paid directly by trusts after their incorporation and before distribution. This would offset any revenue losses incurred because of the decrease in the withholding taxes collected on income distributed to non-residents (-$35.5 million) and taxes received from taxable residents (- $2189.0 million) (Table 4-2).[10]

Withholding taxes on income distributed to non-residents would decrease because the tax base will be reduced by the federal and provincial corporate income tax imposed at the corporate level compared to the baseline scenario. Taxes on income distributed to taxable residents and grossed up will be reduced by dividends tax credits.

Table 4-2 Additional revenues by source

Additional revenues ($M)	2023	2024	2025	2026	2027	Total ($M)
Federal corporate/trust income tax	470.5	485.9	501.7	517.9	534.4	2510.3
Withholding taxes on income distributed to non-residents	-6.6	-6.9	-7.1	-7.3	-7.6	-35.5
Federal PIT net of DTC received from taxable residents	-410.2	-423.7	-437.5	-451.6	-466.0	-2189.0
Total additional revenues	53.6	55.3	57.1	59.0	60.8	285.8

Sources: Canada Revenue Agency, Statistics Canada and Office of the parliamentary budget officer.

Notes: Data are in tax years. Totals may not add due to rounding.

Over 2023-2027, additional revenues would be collected indirectly on incomes distributed to non-residents ($95.5 million) and non-taxable residents (242.6 million). Additional revenues would be partially offset by losses of $52.3 million in revenues collected directly and indirectly on income distributed to taxable residents (Table 4-3).

It is worth mentioning that additional revenues collected on incomes distributed to non-residents and non-taxable residents could only be positive because non-residents and non-taxable residents do not receive dividends tax credits.

Table 4-3 Additional revenues by individual group ($M)

Additional revenues from income distributed to	2023	2024	2025	2026	2027	Total
Non-residents	17.9	18.5	19.1	19.7	20.3	95.5
Non-taxable residents	45.5	47.0	48.5	50.0	51.6	242.6
Taxable residents	-9.8	-10.1	-10.4	-10.8	-11.1	-52.3
Total additional revenues	53.6	55.3	57.1	59.0	60.8	285.8

Sources: Canada Revenue Agency, Statistics Canada and Office of the parliamentary budget officer.

Notes: Data are in tax years. Totals may not add due to rounding.

4.2. Sensitivity analysis of additional revenues

Government additional revenues depend ultimately on the proportions of REITs' income distributed to non-residents and non-taxable residents because they don't pay the full PIT paid by Canadian taxable residents. These proportions can vary easily from year to year following changes in local and foreign legislations, tax policies, investment opportunities and investors' profiles.

In this subsection, we simulate the impact on government revenues of a 5, 10 and 15 percentage points increase in the proportions of income distributed to non-residents and non-taxable residents.[11]

The average proportions of trusts' income distributed to non-residents, non-taxable residents and taxable residents calculated as a percentage of their distributed income are estimated at 4.6 per cent, 9.8 per cent and 85.6 per cent respectively, using the CRA data.

Table 4-4 below shows that each 5 percentage points increase in the proportion of income distributed to non-residents increases, on average, the additional revenues by $93.4 million over 2023-2027. As a result, an increase from 4.6 per cent to 19.6 per cent in the proportion of income distributed to non-residents would increase additional revenues by $280.2 million (from $285.8 million to $566 million) over 2023-2027.

Table 4-4 Total additional revenues following an increase in the proportion of income distributed to non-residents ($M), 2023-2027

Additional revenues from income distributed to	Scenario 1	Scenario 5%	Scenario 10%	Scenario 15%
Non-residents	95.5	186.3	277.1	367.8
Non-taxable residents	242.6	242.6	242.6	242.6
Taxable residents	-52.3	-49.6	-47.0	-44.4
Total additional revenues	285.8	379.2	472.6	566.0

Sources: Canada Revenue Agency, Statistics Canada and Office of the parliamentary budget officer.

Notes: Data are in tax years. Totals may not add due to rounding.

Table 4-5 shows that additional revenues would increase, on average, by $128.1 million over 2023-2027 following each 5 percentage points increase in the proportion of income distributed to non-taxable residents; that's 37.2 per cent higher than the impact of a similar increase in the proportion of income distributed to non-residents.

We estimate that an increase from 9.8 per cent to 19.8 per cent in the proportion of income distributed to non taxable residents would increase the additional revenues by $384.4 million (from $285.8 million to $670.2 million) over 2023-2027.

Table 4-5 Total additional revenues following an increase in the proportion of income distributed to non taxable residents ($M), 2023-2027

Additional revenues from income distributed to	Scenario 1	Scenario 5%	Scenario 10%	Scenario 15%
Non-residents	95.5	95.5	95.5	95.5
Non-taxable residents	242.6	368.1	493.6	619.1
Taxable residents	-52.3	-49.6	-47.0	-44.4
Total additional revenues	285.8	413.9	542.1	670.2

Sources: Canada Revenue Agency, Statistics Canada and Office of the parliamentary budget officer.

Notes: Data are in tax years. Totals may not add due to rounding.

An increase in the proportion of income distributed to non-residents or non-taxable residents, which decreases the proportion of income distributed to taxable residents by the same amount, reduces the amount of DTC and increases government revenues. This is because more taxes are collected on income distributed to non-residents and non-taxable residents, and no DTC are paid, since non-residents and non-taxable residents do not receive dividends tax credits.

4.3. Behavioural response

Government revenues are not assumed to be impacted by any behavioural response, other than trusts incorporation, after the proposed legislation comes into force for a number of reasons.

Many individuals may remain satisfied by trusts' returns under the new legislation and will choose to keep their shares. In this case, additional revenues of the government will not be affected.

Individuals no longer satisfied by trust's returns under the new legislation may decide to sell their shares. Given the fact that more than 80 per cent of trusts' income is generated by trusts whose units are publicly traded on the stock market, shareholders who decide to sell will find buyers, although it may be at a lower price. The decision to sell will have no impact on trusts' overall holdings,[12] and therefore no substantial impact on government revenues.

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Notes

[1] Indirectly means collected through CIT and not PIT. Additional revenues collected on CIT are, in reality, collected indirectly on the income of individuals who receive them in the baseline scenario and lose them in scenario 1 because they are collected as taxes by the government from corporations' income before distribution. It's worth mentioning that additional revenues are collected indirectly on income distributed to all individuals but collected directly only on income distributed to taxable residents.

[2] This includes all amounts invested by Canadian investors in REITs and held in registered accounts, such as: Tax-Free Savings Account (TFSA), Registered Education Savings Plan (RESP), Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF) and Registered Disability Savings Plan (RDSP).

[3] This includes both private and public trusts. Data were obtained from CRA and Finance Canada.

[4] Data obtained from Capital IQ.

[5] The assumptions and calculations underlying the SPSD/M simulation results were prepared by the PBO and the responsibility for the use and interpretation of these data is entirely that of the PBO.

[6] All deductions, including those between line 50 and line 56 of T3, are excluded, except 'total deductible income allocations' (line 47 of T3).

[7] After their incorporation, CCP-REICs would pay the statutory corporate income tax rate of 38 per cent minus the federal tax abatement of 10 per cent plus the additional Part I tax rate on CCPCs' investment income of 10.67 per cent, that is a federal tax rate of 38.67 per cent, plus provincial taxes, on non distributed income. CCP-REICs would pay this federal tax rate of 38.67 per cent minus the refundable portion of Part I tax of 30.67 per cent, that is 8 per cent, plus provincial taxes, on distributed income.

[8] The withholding tax is estimated at 15%. For more details about rates and countries with which Canada has tax treaties, see: https://taxsummaries.pwc.com/canada/corporate/withholding-taxes, and https://www.canada.ca/en/department-finance/programs/tax-policy/tax-treaties.html#status.

[9] Incomes distributed to non-residents and taxable residents are net of federal and provincial taxes. Provincial taxes are calculated using the average provincial tax rate weighted by the federal taxable income allocated by province.

[10] Additional revenues include revenues collected on income non distributed by trusts/corporations. Because of the small amount of this income, we added its tax revenues to those of income distributed after distributing it among unitholders/shareholders according to their shares.

[11] To gauge the impact of an increase in the proportion of income distributed to non-residents or non-taxable residents on government

revenues, we will simulate their impact separately. That is, an increase in the proportion of income distributed to non-residents will reduce the proportion of income distributed to taxable residents and keep constant the proportion of income distributed to non taxable residents, and vice versa.

[12] Trusts' overall holdings are not expected to be impacted over our horizon of projection.