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Assistant Secretary
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Treasury
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via email: btr@treasury.gov.au

Dear Sir/madam

Build to Rent Managed Investment Trust Withholding Tax (BTR MT WHT) and Capital Works Deductions

Thank you for the time of the entire Treasury team on Friday to discuss the BTR MIT WHT initiative and the capital works deductions. We feel that we were able to make progress on finessing the policy.

As discussed, we appreciate your efforts to marry the policy imperatives with the hard commercial realities of Build to Rent.

The halving of MIT WHT for BTR developments is a welcome initiative however, there will need to be a number of amendments otherwise the proposal will not attract international investors.

At present there are many criteria that need to be met to be eligible for 15% MIT WHT (on income only, not capital gains relief).

Critically, some of the criteria undermine the BTR measures because they either:

1) Erode project viability – there will be less projects as a result.
2) Complicate investment risk rather than simply investing in MIT assets like sheds.
3) Create risks of downstream ineligibility that cannot be reasonably controlled by an investor much less the BTR manager. or
4) Create punitive clawbacks and penalties that present too much risk for adoption.

The net impact is once an international investor weighs up the risks and compares it to the relatively uncomplicated investment in other MIT property assets, they will be dissuaded from investment.

The Rationale for Reducing BTR WHT to 15%

The fundamental purpose for reducing WHT from 30% to 15% for BTR is to allow Australian BTR projects to compete for international capital on a level playing field with other MIT investments.

The BTR WHT discount's entire job is to improve the after tax return for an investor.

As expected, the BTR WHT discount cannot favourably impact project viability because it does not alter the cost/revenue equation – it cannot make unviable projects more viable nor can it generate more projects.

It is designed to attract international investors towards already viable projects by ensuring they have a competitive after-tax return compared to other investable asset classes.

It is necessary because BTR requires large scale investment that is only possible with super funds, mutual funds and overseas managed fund investors.

Australian Super Funds and at-scale investors largely regard the Australian BTR market as immature and will not invest until it has deepened.

International investors however have experience with overseas BTR - they have sufficient funding to take a risk on an immature market and incur manageable early losses in anticipation of building a portfolio that will become profitable in the long term.

International investors however, also have global mandates for investment in property – Australia's share of that mandate is circa 3% of the investable capital (based on global investment data).

For BTR to attract some or all of the 3% of international capital earmarked for Australia, the BTR projects must be as easy to invest in as other Australian MIT assets with comparable returns.

International investors are effectively making the choice over whether to invest in (say) Australian sheds that have a 15% WHT, no special terms or conditions on operation and a comparable if not superior return.

This means, **the more stipulations put on the eligibility criteria of BTR MIT WHT, the less attractive it becomes.**

If those eligibility criteria also materially increase the cost of the BTR project against revenue, it will further harm its ability to attract international capital ("too hard, not enough return, I'll invest in sheds").

The Proposed BTR MIT WHT criteria - Overview

Critically **we acknowledge and appreciate positive features being included** in the proposal following our earlier engagement, including the flexibility around management of the BTR properties rather than stipulating a specific management category which would exclude a number of BTR models.

We also appreciate the positive effect of an increased building allowance to contributing to the attractiveness of the package for BTR projects.

Importantly however, **there are several criteria that complicate eligibility or undermine viability of BTR projects** including:

- **10% affordable housing at a 25.1% discount to market for 15 years with 3 year leases.**

  We appreciate that this proposal is significantly less than the numbers mooted previously and the affordability discount is mercifully simple.

  Unfortunately, the impact of the criteria will be increased costs and eroded viability of projects over and above the complexity of criteria in place for the 15% WHT.

We note our previous discussions that mature International investors would "eat" a small loss of revenue from affordability mandates and we had suggested 5% affordable housing.

As noted in discussions, where a project has not yet received planning approval, a 10% affordable housing component may be less of a hurdle since some states have incentive bonuses in place for 10% or more affordable housing which will counter the costs. However, projects that already have approvals in place (but not yet commenced), or in states without similar bonuses will be more materially commercially impacted by a 10% component and 5% will ensure investors are not discouraged It is however a net drain to MIT project viability irrespective, that is not faced by other MIT assets.

While we support the provision of affordable key worker housing as part of BTR projects, it will be a material drag on projects that do not have an accompanying incentive to offset loss of rental income. The impact on projects without an offset incentive under the current draft legislation is a 50-60% reduction in the accretion gained by the reduced WHT.

As a further issue, the requirement of three year leases assumes everyone wants a 3 year lease. There should be room for renters to opt for a shorter time – this also means it should not be a criteria for penalising the MIT if it is requested by the renter.

- **The one for one matching of housing mix for at-market and affordable housing.**

  This measure can lead to odd outcomes where you may have affordable penthouse offerings which effectively undermine the purpose of affordable housing and also impact viability of projects.

  Equally, it will skew offerings into other housing types (like four bedroom dwellings), which are not sought or affordable for eligible affordable tenants.

  This also (along with the affordability criteria generally), create a complexity that does not exist in other MIT property asset offerings, making it less attractive than commercial, industrial or retail MIT assets.

- **The MIT WHT of 15% only applies to income and does not apply to capital gains relief.**

  While a key feature of widely held MITs are that the assets must be held for the primary purpose of deriving rent, the assets need to be sold at some point and the after tax position is commercially important. It simply isn't the investment purpose of the vehicle.

  Equally important, without 15% WHT for capital gains relief, BTR MITs will again be adversely differentiated from other MITs – BTR MITs will be less attractive to global investment. The inclusion of capital gains in the internal rate of return (IRR) for BTR projects is the same approach as any other passive asset class (office, retail, industrial etc) and consistent with the industry standard approach to valuation.

- **Failure of any housing eligibility criteria at one point in time "poisons" the project.**

  The consequences of even minor mistakes in housing eligibility are dire and push the risk profile of BTR MIT out of contention for international investors.

  Specifically, even a straightforward mistake like a tenant becoming ineligible for the dwelling they are renting will result in the BTR project:

- ➢ losing BTR MIT WHT status – effectively destroying the reputation of the Trustee.
- ➢ clawback of all revenues including all allowance deductions and x10 BTR withholding amount at a tax rate of 1.5%.

This is a very serious clawback that ends the project for a mistake in any of the housing eligibility criteria. This is made all the more serious because the potential errors may not be in the sole control of the investor or BTR manager including:

- ➢ Tenant eligibility and income criteria.
- ➢ Interrupted 3 year leases over a 15 year period.
- ➢ Movement in markets that disrupt the 25.1% discount to market for rents.

The Potential Changes in Detail

a) The MIT criteria - should more appropriately match existing MIT assets.

Specifically, the MIT provisions are built around an underlying concept of long term investment and exclude any material trading activity.

The creation of a further, prescriptive and punitive, set of rules which go well beyond those that apply for any other category of commercial real estate investment, simply means that BTR investment is not an attractive option. Included in this context are:

- **the 15 year holding period** – Some investors will want to hold for 5 years others 15 years and still others want to hold BTR for 30 or more years.

  The rules should be clear that so long as the asset remains BTR for a period, the constituent investors are able to divest or hold as long as needed.

  A further specific complication of the 15 year hold period is that all other MIT assets maintain 15% WHT irrespective of time – effectively in perpetuity of the asset. Limiting the 15% WHT to 15 years means the BTR product has a mandatory shelf life.

  Solution: A more appropriate rule would be to specify that while underlying investors are free to divest at any time, the 15% WHT will apply for the entire time the BTR project maintains its eligibility but not less than 15 years.

  This will mean rethinking the penalties significantly, as there should be no clawback or penalty after the designated period.

  The exposure draft should be amended so the 15 percent rate is made available on an ongoing basis and not limited to 15 years.

- **the lack of any CGT relief** - As noted above, while rent is the primary purpose of a MIT, CGT is still important at divestment and to be competitively in line with other MITs.

  Solution: MIT WHT of 15% should be applicable to income and capital gains relief like all other MIT assets. Specifically, CGT relief should apply to the disposal of the BTR facility after this holding period. CGT relief should also be available for the qualifying disposal of an interest in an entity which holds an active BTR development. This would include a situation where a holding trust disposed of units in a sub-trust which owns such a facility.

- **the prescriptive and punitive reporting and penalty outcomes –** the punitive penalties will actively discourage investment and should be removed. There should be no loss of BTR MIT status for errors – Trustee fiduciary duties are strict and well respected by Trustees. The loss of MIT status will result in investors abandoning the Trustee and Trust – they should not be invoked for trivial issues and there are already extensive rules around maintaining Trust status. Trustees do not commercially recover from a loss of MIT status.

  Solution: the mis-use tax should be aligned with the general MIT outcomes so that it only applies in respect of a year in which the conditions are not satisfied and be subject to sensible limitations in terms of the trustee having sought to meet the required conditions.

  In particular, the application of any mis-use tax should be specifically limited to the years in which the BTR facility fails to qualify as an active BTR development and should not apply in respect of any years when it met the relevant qualifications. In addition to the fact that this is an unreasonably severe penalty, it will become unmanageable where there are changes in unitholders in the holding entity such that the later unitholders become liable for tax attributable to periods when they were not unitholders.

In any event, all of these outcomes should be reset to more standard MIT outcomes.

As noted previously, could you please explain why the mis-use tax in relation to MIT withholding is calculated as 10 times the BTR withholding amount at a tax rate of 1.5% rather than simply the difference between tax the income at 30% less the amount withheld at 15%.

b) Affordable Housing – reset the rules to remove complexity and minimise impact on viability:

The inclusion of a requirement for an affordable housing component is a more understandable addition to MIT qualification but this should be restated as follows:

- **10% Component** – while affordable housing bonuses in some states may make the component less of a burden, it is still divergent from all other MITs and has a commercial impact on any BTR MITs that already have planning approval/unable to access a state bonus.

  Solution: Ideally make the affordable housing component no more than 5% of the apartments.

- **One of one apartment matching for affordable housing –** If Government want to safeguard the quality of apartments, it is important to note BTR generally standardise all apartments so there is no differentiation between at-market and affordable. The current rule needs to be amended to avoid absurd outcomes noted previously.

  Solution: state all affordable apartments must be of similar quality and standard as the other BTR apartments and specify 10% of net residential floor area as affordable housing rather than a number of apartments. That means you either end up with more smaller apartments or less larger apartments but never inappropriate penthouses for people on low income.

- **Complexity of eligibility for affordable apartments** – significant risk comes from the fact that eligible renters must be tested for income and status across the entire life of the BTR apartments. Removing people who become ineligible also cuts across “security of tenure” and encourages suboptimal behaviour to stay under income thresholds etc. There is also a strict narrow definition of ineligibility with no period for taking remedial action to rectify.

Solution: the tenant should be tested at the time of entering the apartment lease and then should not be relevant after that (and this will not require constant monitoring by the lessor).

c) GST – the Commercial Residential restriction is unnecessary and limits future flexibility for BTR.

Whilst we understand that the required GST relief is not going to be provided, it is not necessary to go a step further and exclude the possibility that a BTR facility could qualify as commercial residential premises.

It potentially knocks out future possibilities including the option for commercial residential premises (which are not capable of being sold as individual apartments), from being a more advantageous "BTR in perpetuity". If government were to implement this, it would be a major component in improving the viability of projects and will allow more BTR projects to reach viability.

d) BTR projects have strong ESG credentials - Align initiatives for increased energy performance of Australian buildings, with the need to increase the supply of rental housing.

The government's recently released National Energy Performance Strategy which will *'Expand the Clean Building Managed Investment Trusts withholding tax concession to more types of green buildings*.[2]'

This 10% clean building MIT regime is currently limited to offices, hotels, shopping centres and warehouses. It should be modernised to include all buildings held for rental purposes, including living sectors such as:

1) BTR,
2) purpose-built student accommodation and
3) retirement living

Please do not hesitate to contact the UDIA National Head of Policy and Government Relations - Andrew Mihno on 0406 454 549 to discuss this further.

Col Dutton
UDIA National President