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Dear Dr Turner

Build to Rent Managed Investment Trust Withholding Tax (BTR MIT WHT) & Capital Works Deductions

Thank you for the opportunity to provide our comments back to the BTR MIT WHT initiative and the capital works deductions inquiry.

UDIA National has been a long standing champion of levelling the playing field for BTR and lowering the MIT WHT threshold.

The halving of MIT WHT for BTR developments is a welcome initiative however, the proposal needs several amendments, to be able to attract international investors.

We have appreciated working with Treasury to try and overcome the adverse issues however, the current proposal does not significantly improve the competitive position of BTR.

We note material changes to extend the holding period beyond 15 years and the extension of CGT relief on disposal. However, the complexity of the interaction of provisions, make normal commercial transactions very difficult.

As currently drafted, the proposed legislation is still overloaded with reporting and integrity provisions which make it unworkable as an incentive to drive BTR investment.

The UDIA fully supports transparent reporting and sensibly crafted integrity rules in service of the intended incentive outcome. Unfortunately, the domination of the legislative package with these issues means that it will not encourage projects which were already marginal given the prevailing economic conditions.

There are many criteria, reporting requirements and integrity provisions that need to be satisfied in order for a project to be eligible for 15% MIT WHT.

Critically, some of the criteria undermine the BTR measures. The combined impact of these provisions:

- 1) Erodes project viability – there will be less projects as a result;
- 2) Complicates investment risk rather than simply investing in other MIT assets like industrial assets;
- 3) Creates risks of downstream ineligibility that cannot be reasonably controlled by an investor much less the trustee of the vehicle or the project manager; and
- 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 discouraged 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.

The BTR WHT discount will not 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 sovereign funds, pension funds, mutual funds and other offshore 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 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 industrial assets 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

In summary, **there are several aspects of the proposed legislative package that complicate eligibility or undermine viability of BTR projects** including:

- **10% affordable housing at a 25.1% discount to market for 15 years**

We appreciate that this proposal is significantly less than was originally proposed and that the affordability discount is mercifully simple.

Unfortunately, the impact of this requirement will be increased costs and eroded viability of projects.

We note our previous discussions with Treasury in which we indicated that mature international investors would “eat” a small loss of revenue from affordability mandates, and we had suggested 5% affordable housing.

As noted in those 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 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.

- **The application of MIT WHT of 15% to capital gains is complex and appears to disqualify many common investment structures**

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.

Accordingly, without a properly formulated 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.

- **Notwithstanding the Commissioner having a saving discretion in some circumstances, the failure of an eligibility criteria at a point in time “poisons” the project and triggers a claw-back plus penalty that applies to prior periods when if there was no failure in those periods**

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 can result in the BTR project:

- losing BTR MIT WHT status.
- clawback of all revenues including all allowance deductions and a penalty.

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 control of the investor, the trustee or the project manager and the choice of outcome in this situation sits with the Commissioner with a multi-year penalty outcome if he chooses not to exercise the discretion. It is not viable to have such a significant outcome hang on a discretion exercisable by the Revenue

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 difficult CGT relief** - As noted above, while rent is the primary purpose of a MIT, capital gains are still important at divestment and to be competitively in line with other MITs. There is a need to properly align the misuse tax, the BTR project and the relevant MIT. It otherwise results in outcomes which disqualify normal commercial holding structures from the CGT relief. The complexity of the CGT relief and in particular its interaction with the misuse tax, makes normal commercial transactions unworkable and problematic.

Solution: MIT WHT of 15% should be applicable to income and capital gains relief like all other MIT assets. It is difficult to see how this can be achieved given the design of the mis-use penalties which, as we stated elsewhere, are simply not sustainable in the context of designing an incentive. Further thought needs to be given to an integrity provision which does not unreasonably curtail the choice of ordinary commercial investment structures.

- **the prescriptive and punitive reporting and penalty outcomes** - the punitive penalties will actively discourage investment and should be removed or at least substantially reduced to a more manageable set of outcomes consistent with the incentive nature of the provisions and the usual MIT outcomes. There should be no loss of BTR MIT status for errors or. Commercial glitches without the need to seek the exercise of a discretion by the Commissioner - trustee fiduciary duties are strict and well understood and the investors, managers and other participants in the investment chain are not looking to take advantage of errors and commercial glitches to obtain unreasonable tax benefits.

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. It should also be limited to 30% rather than 45% which is an unreasonable rate in the context of MIT outcomes and in the context of a set of provisions designed to act as an incentive to long-term, scaleable, foreign capital.

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.

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.

- **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.

Yours sincerely



Col Dutton
UDIA National President