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Director
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22 April 2024

EY Submission
Built-to-rent tax concessions

Dear Director

EY welcomes the opportunity to provide comments in response to the exposure draft law (ED) for the proposed build-to-rent (BTR) provisions (in draft *Treasury Laws Amendment Bill 2024: Build to rent developments* and *Capital Works (Build to Rent Misuse Tax) Bill 2024)*, and accompanying explanatory materials, that were released for consultation on 9 April 2024.

It is broadly proposed that for eligible BTR developments to:

- Increase the capital works deduction rate from 2.5 per cent to 4 per cent; and
- Reduce the final withholding tax (WHT) rate on fund payments from eligible managed investment trust (MIT) investments from 30 per cent to 15 per cent.

We welcome the policy intent of the proposed BTR concessions to provide incentives for investment in the construction of BTR developments as part of the government's policy to increase the supply of stable and secure residential and affordable housing in Australia.

However, we are concerned that the current design of the proposals may not achieve the desired response by investors in the BTR sector due to a number of key restrictions in the design of the law which will impact negatively on the commercial analysis of those participants in their investment making decisions to invest in BTR in Australia.

In particular:

(i) EY modelling in our BTR White Paper illustrates that the proposed rules will reduce the levered post-tax project IRR by 34 bps when compared to the status quo (i.e. no BTR incentives).

(ii) The restriction of the 15% MIT WHT tax to rental income and over a 15 year period is inconsistent with the tax treatment of other investment in real estate assets held primarily to derive rental income e.g. commercial, retail and industrial assets.

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(iii) The BTR conditions and integrity rules create additional risks, uncertainty and complexities with compliance. They introduce additional barriers to investment in this asset class.

(iv) The lack of grandfathering of pre-9 May 2023 assets adversely impacts the value of pre-9 May 2023 assets and impedes the creation of a strong investment track record to encourage future investments.

This may also result in a reallocation of foreign capital to other core asset classes or BTR investments offshore (e.g. USA, UK and Japan). This will impede Australia's ability to significantly increase housing and affordable housing supply in the near term.

We set out in Appendix A our comments and recommendations in respect of the ED in relation to:

1. Limitation of 15% WHT rate to rent and not capital gains
2. Limitation of 15% WHT rate on rental income to 15 years only
3. Exclusion of assets where construction commenced prior to 2023 Budget announcement
4. Affordable housing recommendations – commerciality, complexity and uncertainty
5. Other issues.

Through this consultation window, along with other industry stakeholders, we have engaged with Treasury and government in conjunction with the Property Council of Australia (PCA). We agree with the comments made in the PCA submission. We note that the PCA submission includes a BTR White Paper prepared by EY that includes modelling to help demonstrate the impact of the BTR ED on the feasibility of a hypothetical BTR project.

* * * * *

Should you have any questions in relation to the attached or wish to discuss these matters in further detail, please do not hesitate to contact Daryl Choo (+61 2 9248 4472, daryl.choo@au.ey.com) or Luke Mackintosh (+61 3 9288 8411, luke.mackintosh@au.ey.com).

Yours sincerely

EY

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Appendix A

A.1 Limitation of 15% WHT rate to rent and not capital gains

A key objective of the government's BTR policy is that it attracts long term investment to support the development of stable and secure housing for the people of Australia. We support this policy.

We understand that the choice to exclude capital gains from the 15% MIT WHT concession is a deliberate feature designed to encourage longer term holding by single investors and to discourage short-term build to sell operators from participating in the regime.

However, for the reasons discussed below, it is our strong view that this limitation be removed so that the legislation is not ineffectual.

A.1.1 Commercial feasibility

Exit considerations are a standard inclusion in feasibility modelling for all asset classes, including low risk, long-term holding asset classes. The factoring in of exit considerations does not necessarily change the primary purpose of the investment to derive rental income over the long term. However, if the modelling shows a poor return after factoring in exit results, then this can lead to a decision to not proceed.

As demonstrated in the EY modelling, the current draft legislation with this limitation results in a worse overall commercial return when compared against the base case of the legislation not existing. In other words, the draft legislation currently acts as a disincentive for investors to participate in the BTR sector.

This could result in investors choosing to invest in other asset classes in Australian property outside the BTR or in BTR assets in other jurisdictions with consequences including the elimination of any acceleration in residential construction and reduced supply of affordable housing.

A report prepared by EY on commission from the PCA[1] concludes there is the potential for more than 150,000 new BTR homes that could come to market over the next 10 years if establishment of the BTR sector is accelerated through leadership from all levels of government. In its current form, the draft legislation could inadvertently risk this much needed increase in residential supply.

We also do not consider this limitation is necessary for the BTR to achieve its policy objectives of dissuading short-term selling of dwellings. For instance:

- The trading trust rules protect against inappropriate access to the MIT regime concessions consistent with other asset classes.

[1] Titled, '*A new form of housing supply for Australia: Build to rent housing*' dated 4 April 2024

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- As a more established sector overseas, the experience has been that BTR attracts institutional investors such as sovereign wealth funds and offshore pension funds that are looking for low risk, long term hold assets.

A.1.2 Competition with other asset classes

Another key issue with this limitation is that it puts BTR at a disadvantage compared to other Australian property asset classes including commercial, industrial, office and retail property that do not have this limitation on capital gains.

Foreign investors also tend to choose asset classes in a jurisdiction that are perceived to have strong government support. This inconsistency could signal to foreign investors that the Australian government favours these other more concessionally taxed asset classes over BTR that could impact the flow of investment to this sector. This would defeat the policy objective of encouraging more investment into BTR.

The Australian BTR sector will also be competing against more established BTR markets with proven commercial models. Other regimes also have less restrictions and higher modelled returns (such as in Canada). This makes removing this limitation critical to attract foreign investment.

Institutional investor feedback

Below is a sample of the concerns received from our clients on this limitation in support of the above:

- *"Given that the feasibility does not benefit from 15% tax on CGT, and there is the impost of the 10% affordable component, the cost may outweigh the overall benefit and developers will chose to not seek MIT status thereby lowering the supply of affordable housing."*

- *"When institutional investors consider the various real estate asset classes in Australia and overseas, Australian BTR will continue to be seen as an inferior asset class due to the proposed MIT taxation outcome. The differing taxation rates between income and capital gain effectively results in a circa 20% reduction in net after tax investment returns for BTR compared to all other forms of real estate investment in Australia."*

- *"If BTR concession is not aligned with other qualifying MIT asset classes, capital allocation to Australia will be diverted to other asset classes in Australia."*

A.2 Limitation of 15% WHT rate on rental income to 15 years only

We ask that Treasury provide further detail on the policy intention of this limitation. If a development ceases to be an active BTR development after 15 years, then this would result in the affordable housing component of that development ceasing at this time (unless there

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are measures that permit the compliance period to restart). We anticipate the need for affordable housing is only going to increase, not decrease into the future, and we would like to better understand the concern this limitation is seeking to address.

This limitation reduces the value of BTR properties as they approach the end of the 15-year compliance period. It also creates unusual complexity where a purchaser will be invited to acquire a long-term asset that only has tax concessions for a limited period.

This limitation is also unique to the BTR sector, meaning BTR will not be operating on a level playing field with other property asset classes that do not have this limitation. As discussed above, this would negatively impact the flow of capital into the BTR sector which requires rapid acceleration to achieve it targeted aims.

Industry feedback

- *"Where the 15% rate is only applicable for the first 15 years from construction commencement, the BTR would be of limited value to a secondary buyer."*

A.3 Exclusion of assets where construction commenced prior to 2023 Budget announcement

The draft legislation only applies to developments where construction commenced after 7.30pm (AEST) on 9 May 2023. At this time there were already first movers who commenced investing in the sector in the anticipation that future government policy would apply to these projects. We understand the size of the BTR sector at the time of the Budget announcement to be comprised of 12 BTR operating projects, with the majority funded by foreign capital. The estimated sector value was around $17 billion comprising over 23,000 apartments of which half were still in the planning phase.

We recommend the following on behalf of these investors.

A.3.1 Clarification of the term "construction"

First, we invite the Treasury to provide further explanation in the explanatory materials on the meaning of construction in this context. For example, does it include projects that are in the planning phase or those that have planning permission? Alternatively, does it only relate to those projects where the 'shovel has hit the dirt' or those at a later stage of development?

A.3.2 An equitable outcome for early movers by allowing these pre-commencement BTR assets to opt into the regime

The feedback from these investors is that by being excluded from the draft legislation their BTR assets are at risk of becoming stranded assets, held at a depressed value compared to later projects. This is considered unfair given it was their investments and expertise that helped to established a BTR market in Australia from which this legislation was able to build upon.

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The negative impact on value of the draft legislation is also expected to incentivise these investors to sell their BTR projects early, reducing the availability of rentals and affordable housing supply.

Further, the early stage of an asset class is important for establishing a positive reputation and support for valuations. A dual BTR market with devalued initial returns could negatively impact the reputation of the Australian BTR sector, deterring future investment and leading to a less active and ultimately more uncertain BTR market.

Institutional investors feedback

- *"If grandfathering rules are not made available, it puts early adopters of the BTR model in a worse off situation and impacts investors' confidence in the Australian tax regime."*
- *"It is clearly an inequitable position that there are two tiers to this regime."*
- *"As global investors evaluate investment opportunities around the world, having differential tax treatments for assets in the same sector (with the only difference on the date of completion of the development) appears to penalize those investors that backed the sector that had an expectation that the tax treatment would be the same."*
- *"A key barrier to entry, which has been consistently raised by institutional investors, is the uncertainty surrounding asset values and the availability of an actively traded market to support valuations. The first movers in this sector, which commenced construction prior to 9 May 2023 are excluded from the proposed MIT legislation, and their values will forever be negatively impacted compared to assets that may comply with the MIT legislation. However, these assets would otherwise have been likely to be the first assets that will be actively traded in the institutional investment market and their compromised values will negatively impact the view of institutional investors in this market, thereby creating greater uncertainty for investment markets and deterring future investment."*
- "*The success of the BTR sector (with capital to fund the housing shortage) is dependent on investors generating good returns from their investments in the sector that will be driven by those investors that generate attractive realized returns. If the existing BTR assets are excluded from the regime, the new buyer will attribute a lower valuation for the asset on sale (as they need to load in a higher tax leakage) with the realized returns being lower than what could be achieved otherwise. As Australia is competing for global capital relative to other markets, the opportunity to invest into Australian BTR is likely to be significantly less attractive*."

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A.4 Affordable housing recommendations – commerciality, complexity and uncertainty

We support the inclusion of affordable housing as an important component to achieve the social objectives of the BTR. However, to ensure this initiative is sustainable, it is important that it is implemented in a manner that appropriately manages the commerciality, complexity and uncertainty concerns of investors. For example, to maintain levels of commercial returns that are acceptable to institutional investors, the inclusion of 10% affordable housing may be balanced by the lowering of the MIT WHT tax rate to 10% as illustrated in the BTR White Paper.

A.4.1 Commerciality

Pursuant to EY modelling, the current requirement to include 10% dwellings as affordable tenancies will erode over half the advantage of shifting to a lower WHT of 15%.

Our view is that the best way to encourage affordable housing is through a differentiated MIT WHT incentive of 10% to offset the loss on rental income. This would send a strong signal of government support and help accelerate investment.

A.4.2 Uncertainty and complexity of interaction with existing state and territory government requirements

It remains unclear how the different state and territory affordable housing measures will interact with the federal measures. This makes it difficult to obtain a full picture of the true return and cost of making a BTR investment in different locations. Significant questions remain around the practical interaction of requirements in this draft legislation with state government initiatives that require delivery of affordable housing to access land tax and other concessions. We seek further clarity around how this is proposed to be dealt with, especially where the requirements at a state level differ from requirements in this legislation.

A.4.3 Income thresholds

The Policy Fact Sheet states that in addition to the eligibility criteria contained in the exposure draft legislation, income limits will apply in determining if tenants are eligible to occupy affordable BTR dwellings. Details on current limits for singles, couples and families are also shown in the Policy Fact Sheet.

We welcome further information to address practicalities associated with this requirement, including:

- Will the income threshold be indexed? If so, what basis will be used?
- Will the income threshold be the same in all locations across Australia?
- What happens when an individual's circumstances change? For example, is the individual required to vacate the affordable housing dwelling if they no longer meet the income thresholds? Alternatively, does the property simply cease to meet the

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affordability criteria, potentially forcing the owner to offer a new affordable housing dwelling to continue to meet the BTR conditions?

Industry has also requested protections from penalties for BTR asset owners where non-compliance is outside their control (e.g., where tenants provide false information on their status, or their status changes and tenants do not advise the owners). This could be in the form of a grace period for unintended breaches (such as is permitted for clean building MITs) plus specific provisions that allow BTR owners to rely on representations of tenants.

A.4.4 Ministerial determination

We refer to proposed subsection 43-152(4) that provides the Minister with the power to determine the requirements relating to the income of the tenants for the purpose of affordable housing.

We appreciate from a social policy perspective that it is important the Minister have a discretion. However, from an investor perspective too much perceived discretion can make the BTR regime less attractive.

It is therefore recommended that the parameters on income threshold be less arbitrary in the first instance. There should be rules on how the Minister will adjust income bands in the context of inflation, versus allowing income bands to freeze. Limits on the amount income bands can be reduced should also be included to protect investors. A concern is that if income bands are adjusted too aggressively down, then it may be challenging for BTR owners to keep their BTR assets compliant and hence risk being subject to the misuse tax.

A.4.5 Type of apartment or dwelling

A condition to qualify as an active BTR development is that at least one of each type of apartment or dwelling be made available as an affordable dwelling. Whilst Section 1.35 of the explanatory materials provides an illustrative example, we welcome further guidance on what will constitute the same type of apartment or dwelling, especially given the punitive misuse tax measures that apply if the affordability requirements are not met. In particular, we would welcome an additional example or further guidance on how to categorise dwelling types where floorspace size is not standardised based on the number of bedrooms and bathrooms. For example, we are aware of a development with over 60 different floor plates across 297 units and grouping these would be difficult and uncertain based on current guidance.

We would also welcome further clarification on what is intended to be included and excluded from the term ‘amenities’. The explanatory memorandum refers to amenities as including bedrooms and bathrooms etc. However, we ask for confirmation that it is not intended to be broader than this and include other dwelling features such as car parks, balconies, studies etc.

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Industry/institutional investor feedback

Other comments / ideas we have received from industry on the affordable housing condition include:

- *"Affordability criteria should be reviewed and tailored based on differences in cost of living across various states, development sizes, unit mix, etc."*
- *"The rules currently do not consider non-compliance beyond our control (e.g. change in income level of tenants). This should be rectified."*
- *"There continues to be inconsistency between the federal affordable housing criteria and those that are in place at the respective State levels. Some states have already imbedded stamp duty and land tax concessions, which may be inconsistent, and more onerous, with the federal level criteria. It would be preferable for the MIT legislation to allow the adoption of State-based affordability rules, where available, and if none are in place, to adopt the federal MIT legislation (or potentially allow flexibility to choose the relevant affordably housing requirement to work with)."*
- *"The requirement that affordable rents must be no more than 74.9% of the market rent for similar apartments does not support innovation in housing design and construction which might otherwise be able to provide apartments at an affordable rent for households at or below the required income thresholds. The affordability test should allow flexibility for properties to offer rents at 30% of the relevant income threshold (even if this rent is higher than 74.9% of the equivalent apartment market rent) to satisfy the affordable housing requirement, rather than mandate that the rent must be no more than 74.9% of the equivalent apartment market rent."*

A.5 Other issues

A.5.1 Misuse tax creates risk for prospective seller and purchaser within a 15-yr compliance period

Whilst we understand the need for integrity rules to encourage compliance with the policy objectives, the clawback mechanism is punitive and could create unintended consequences and complexities for BTR assets that are sold during the 15-year compliance period.

The draft legislation exposes purchasers of BTR assets to historical vendor and tenant behaviour that could be complex and challenging to protect against with warranties and indemnities etc, making the asset class less attractive.

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BTR investments through US and UK REIT regimes do not result in a permanent exit from the REIT regime but with grace periods to rectify non-compliances with REIT conditions.

Institutional investor feedback

- "*The ongoing uncertainty around the MIT taxation rules for BTR continues to weigh against investment in the Australian BTR sector. The draft legislation adds greater risks to consider (punitive penalties) and concern for investors as to the ability to exit (either in whole or via partial sell-down) in the future. These risks and uncertainties associated with the taxation position for BTR assets in Australia are a further barrier for institutional investors in this sector*."

A.5.2 Level the BTR with Build to Sell investments from a GST perspective

BTR developers are unable to claim the GST input tax credits for land, construction, consultant costs and operations. This effectively makes BTR projects 10% more expensive to construct and operate than Build to Sell projects (in which input tax credits can be claimed). Furthermore, the extra cost can result in a competitive disadvantage against Build to Sell developers when bidding for development sites. This cost burden is not seen in other countries with an active BTR market.

A.5.3 Administrative compliance

Compliance simplicity is another important way to attract investment in the Australian BTR sector. However, the feedback we are receiving is the level of ATO notifications, monitoring, approvals, etc is currently excessive.

Careful consideration should be had to each administrative requirement and whether it is necessary to protect the integrity of the BTR system. For example, could the creation of a BTR asset register be an alternative way to simplify compliance?

A.5.4 Short stay accommodation

Paragraph 1.31 of the explanatory materials provides examples of dwelling types that are commercial residential premises and hence outside the scope of a qualifying BTR investment with hostels, boarding houses, hotels, motels and inns being specifically excluded.

Could Treasury please confirm that dwellings that otherwise meet the BTR conditions but are used by tenants for short term stays (such as Airbnb) are not considered a commercial residential premises. If there are intended to be limitations on properties used in this way, it would be important to clearly articulate this to avoid unexpected breaches that expose the BTR owner to misuse penalties.

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A.5.5 Exceptions for tenants in common and indirect leasing

An issue that has been raised relates to the definition of 'single entity' that would preclude tenants in common, which is important when different types of investors partner with each other e.g., a private (who might want a higher debt) partnering with a pension fund who may want lower debt. Ownership by tenants in common allows for different levels of debt and each party to deal with their interests more seamlessly. We believe this kind of ownership is not in conflict with the policy intent and should be provided for.

Another question relates to clarifying if the provisions allow for indirect leasing models where properties are held by a land trust, which is then leased to an operating trust which is then leased to the general public.