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23 April 2024

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Build-to-rent tax concessions - Exposure draft legislation - Submission

We refer to the exposure draft legislation in respect of certain build-to-rent (**BTR**) tax concessions published on 9 April 2024 (**EDL**).

We are grateful for the opportunity to provide submissions in respect of the EDL. Whilst we make this submission independently of any of our clients, we act for a number of clients with potential interest in the BTR sector, and it is important that the tax policy settings appropriately encourage BTR in order to address the known housing shortages in Australia.

We have set out submissions in respect of the EDL in **Schedule 1**.

K&L Gates is a global law firm headquartered in the United States acting for a range of clients, including relevantly both a significant number of global investors and a number of real estate industry participants. Our firm has experience with BTR (or multifamily as it is often referred to internationally) in other jurisdictions, and in particular in the United Kingdom and the United States, and we have leveraged this international experience in making submissions on the EDL. In Australia, our tax practice regularly acts for a range of clients in real estate transactions, including acting for developers / sponsors and both foreign and domestic capital and debt investors. The authors of this submission are partners in the tax group of K&L Gates in Australia with extensive experience in advising on the tax aspects of real estate transactions.

Yours faithfully

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Schedule 1 - Submissions

As a general matter, there are two key themes to the submissions (as follows). We then discuss below a number of more detailed matters relevant to each theme:

- the **first broad theme** relates to making access for foreign investors to the 15% withholding tax on distributions of rent from a managed investment trust (**MIT**) holding an **Active BTR Development** (**Reduced WHT**) consistent with investments in other asset classes. That is important as BTR in Australia will compete for capital against other real estate investments in Australia that have accessed to 15% MIT withholding tax and from BTR and other real estate investments globally. Further foreign capital is necessary to make BTR feasible and successful in Australia, as is clearly recognised by the proposal to introduce Reduced WHT for BTR and also the reported market transactions in BTR assets involving foreign capital since the announcement of that proposal. In this regard, we also submit that access to the Reduced WHT needs to considered separately from any *additional incentives* to deliver BTR, and/or any requirements / additional incentives to deliver affordable housing. **The EDL does not achieve this, because it imposes a significant number of onerous additional requirements (including in relation to claw back, time periods and affordable housing) that making it inconsistent with the treatment of investments in other similar asset classes**. We submit generally that the EDL should instead align the Reduced WHT requirements more closely with existing requirements (and with any additional requirements for the MIT withholding tax measure limited in scope). Otherwise, the current inconsistency reflected in the EDL effectively acts as a *relative* disincentive to foreign capital to invest in BTR in Australia and a relative disincentive to other foreign investments.

- the **second broad theme** is that for the *separate aims* of (i) incentivising domestic capital investment into BTR and (ii) incentivising affordable housing delivery as part of BTR, only the **accelerated capital works deductions** of 4% per annum provides such an incentive currently (as the Reduced WHT *at best* operates only to make the investment in BTR consistent with other types of investment, and as outlined above the EDL proposal does not achieve that). On that basis, it may be appropriate to apply certain additional requirements (such as in relation to affordable housing standards and levels) to access the accelerated capital works deductions. However, the additional requirements in the EDL currently have a number of likely technical issues that may prevent this incentive functioning appropriately. Further:

    - for completeness, the technical issues referred are to equally relevant to the extent those same additional requirements need to be satisfied to access the Reduced WHT. However, as set out in the first broad theme, we submit that those additional requirements should not apply to the Reduced WHT in any case; and

    - given the importance of foreign capital (as already discussed), an accelerated capital works deduction may not operate as an effective incentive for such foreign capital (as currently proposed it would be a deferral of tax *at best* given the non-application of Reduced WHT to gains on exit), Accordingly, we submit that consideration should be given to instead permitting a further reduction in MIT withholding tax where the additional requirements are met. This is consistent with overseas experience that affordable housing delivery requires ***additional*** incentives.

Detailed submissions

We set out below some further detailed submissions consistent with the above themes. These are the principal issues that have been identified, and there may be additional issues that arise.

Issue	Description	Proposed solution
First theme - Reduced WHT		
Divergence with existing MIT withholding tax requirements	The requirements to access Reduced WHT in BTR are materially more onerous than the requirements for comparable investments (i.e. almost none for commercial / industrial real estate beyond the core MIT requirements). In particular, the affordable housing related measures, the 15 year hold period / limit (as implemented) and the claw back are onerous (and the latter two points are addressed further below). This is despite our understanding that generally BTR developments are often *less* (rather than more) financially marginal than other commercial / industrial real estate. Those measure therefore are a relative disincentive to investment in BTR, comparative to other asset classes which do not have onerous requirements to access the 15% rate. To the extent additional requirements have been imposed, this has been to obtain access to a further reduced rate of say 10% (in the case of clean buildings). There are also a more general disincentive, given that the current 30% rate is not internationally competitive and onerous additional proposed requirements to access Reduced WHT are onerous and likely have an impact on financial viability.	The Reduced WHT access conditions should be limited to those in subsections 43-152(1)/(2) and (3)(a)-(c), being substantially: • 50 or more dwellings; • requirement to offer 3 year lease terms; • not commercial residential premises; • owned by single entity; and • with no clawback or compliance period, as these are sufficient to promote the policy aim of large scale (i.e. professional, commercial-style) residential offerings. That is, they are already sufficient to ensure the BTR development is not a small scale play for sale.

Issue	Description	Proposed solution
Claw back - Reduced WHT	As a policy measure, it is unclear why a claw back is appropriate to Reduced WHT that applies only to rental income from an active BTR development. This is inconsistent with all other MIT withholding tax concessions (and therefore puts BTR at a comparative disadvantage). Further, the nature of the Reduced WHT on rental income already ensure the benefit only applies where the relevant conditions are met (i.e. it is self-policing) - there is no future / outsized benefit obtained from the Reduced WHT if the Active BTR Development subsequently ceases to be active in the future, and likewise if it ceases to qualify, it would lose the benefit of Reduced WHT. There is no need to also claw back the Reduced WHT from periods where the conditions were satisfied. Whilst the claw back is at least understandable in the context of accelerated depreciation as an additional incentive, we submit it should not apply in respect of Reduced WHT on BTR rental income (or at least only apply to Reduced WHT paid during the period the conditions are not satisfied). However, any claw back may still be problematic, given it operates as a barrier to flexibility for different types of capital to invest (as discussed below in the context of applying Reduced WHT to gains).	The claw back should not apply to the Reduced WHT on rental income from an Active BTR Development. The appropriate remedy is for the Reduced WHT to cease to apply. Proposed Sub-division 44-B should omit all Reduced WHT provisions (e.g. sections 44-20(2)(b), 44-30 should be omitted, with consequential changes). Alternatively, the Reduced WHT would only be clawed back if payments were from rental income derived during the period the appropriate conditions have not been satisfied (rather than the whole period).

Issue	Description	Proposed solution
15 year period - Reduced WHT	The requirement for an active BTR development to be held for 15 years to access Reduced WHT, and the cessation for Reduced WHT after that 15 year period, are both again inconsistent with other MIT withholding tax provisions. Further, for the same reasons set out in respect of the application of the claw back to Reduced WHT, it is not clear why these additional requirements are needed for Reduced WHT (in that the benefit is self-limiting, and that ongoing supply of housing stock even if the development ceases to be an active BTR development and loses the Reduced WHT benefit prospectively). However, to the extent there is some policy justification for the minimum holding period in the context of Reduced WHT not otherwise apparent, the length of time is we submit *too long* in that context and is disproportionate to any end to be achieved. For Reduced WHT purposes, it should be a much shorter period of time so as not to dissuade capital from investing by imposing the significant risk that Reduced WHT will need to be recovered for an extended period of time. In any case, the 15 year period holding requirement is inconsistent with the initial Government policy announcement (which was 10 years).	The access requirements for Reduced WHT should not include the requirement in proposed section 43-152(7) of the *Income Tax Assessment Act 1997* (Cth) (**ITAA1997**) and proposed section 12-450(5)(b) of Schedule 1 of the *Taxation Administration Act 1953* (Cth) (**TAA**). Alternatively, at a minimum a shorter time period (e.g. 10 years) should apply in proposed section 43-152(7) of the ITAA1997 and proposed section 12-450(5)(b) of Schedule 1 of the TAA should not apply. To the extent that the limit of 15 years on the Reduced WHT under proposed section 12-450(5)(b) of Schedule 1 of the TAA is intended to promote capital recycling, this should at least be accompanied by allowing Reduced WHT on gains on disposal of the active BTR development. This would also be important to addressing a situation where financial reasons, changes in law, changes in geopolitical dynamics etc. require an asset to be divested (any gain from which should be subject to the Reduced WHT to the extent the project is required to remain an active BTR development).

Issue	Description	Proposed solution
Failure to apply Reduced WHT to gains on disposals	Gains on the disposal of an active BTR development (whether by the single entity owning it, or by underlying investors) appear potentially not to be eligible for Reduced WHT (due to section 12-453 of Schedule 1 to the TAA, and both the lack of clarity as to whether proposed section 12-450 in Schedule to the TAA (item 10 of the EDL) means that section 12-453(1)(a) is satisfied or not and that proposed section 12-450 referring only to rental income and not gains). This is inconsistent with other MIT withholding tax provisions. More importantly, one of the key issues that arises from client feedback is the need to cater for different investor timeframe / risk requirements to enable delivery of BTR (for example, investors with higher risk but shorter timeframes may be suitable to get a BTR development constructed and to operating status, but then need to exit for more patient but lower risk appetite capital (e.g. superannuation / pension funds). Whilst a significant benefit of the EDL is the apparent acceptance of this by allowing disposal between one single entity and another, and allowing changes in underlying investors, the potential lack of Reduced WHT extending to any gain attributable to an active BTR development hinders the necessary capital flexibility to deliver BTR.	Reduced WHT should apply to gains to the extent attributable to a disposal of an active BTR development, or a membership interest in an entity to the extent attributable to an active BTR development, and section 12-453 and proposed section 12-450 should be amended to clarify this. It may be that Reduced WHT in that context requires appropriate mechanisms to ensure that the active BTR development remains as such for a period post-sale (and does not convert into a for-sale development).

Issue	Description	Proposed solution
Second Theme - Further technical issues		
Affordable housing requirements are difficult to apply	Whilst the apparent policy behind the requirement in section 43-152(3)(e) in ensuring any affordable homes are of a consistent standard is understood, the requirement for an affordable dwelling of the exact same size and amenities as each non-affordable dwelling is impracticable and limits flexibility, and will result in significant uncertainty in applying the EDL. Small differences in unit sizing, location or availability of storage, car parking etc. because of the floorplate of developments etc. should not be treated as a separate type of unit requiring a corresponding affordable dwelling, and would potentially lead to only very standardised developments being feasible without focusing on tenant amenity. Similarly, the requirements in section 43-152(3)(d) are expressed in absolute terms without a safe harbour or concession for inadvertent breaches (such as where the income limits expected to be satisfied on lease but a change in circumstances resulted in them being breached) and are also not clearly limited to the position that applies at the *start* of each lease (rather than at any time throughout the lease), leaving the significant potential for inadvertent breaches or breaches that cannot be remedied by the single entity owner.	This requirement in relation to comparability of affordable dwellings should at least be revised to refer to *reasonably substantive* similarity in relation to certain specific listed matters in the legislation and within clearly specified limits, such as allowing a variance of say 10% in size and with the requirement only applicable to having the same number of bedrooms / bathrooms and a reasonably substantially similar internal fit out and with parking or without parking (without requiring exactly the same number of car parking bays or storage etc.). However, it remains unclear whether this requirement is best addressed through tax legislation in any case (given the uncertainty with any such concepts and the difficulty in applying the EDL). Section 43-152(3)(d) should also be modified to be clear its requirements are tested only at the *commencement* of each lease (or each time a new offer is made), and provide for appropriate safe harbours around market rent and income limits to ensure inadvertent breaches are not captured when reasonable efforts have been made to comply.

Issue	Description	Proposed solution
Ease of ceasing to be an Active BTR Development	As drafted, proposed sub-section 43-152(6) is inflexible and liable to be triggered inadvertently too easily (with the disproportionate consequence that a claw back applies for ***all*** concessions). For example, as drafted if there is a BTR development with 60 dwellings, and for economic reasons it is necessary to sell 1 or 2 dwellings (whilst still meeting the 50 dwelling minimum and other requirements), then the whole development would cease to be an active BTR development with the claw back applying to all incentives (not just the proportion applicable to that sold apartment). Equally, if an active BTR development that may be mixed use wishes to try to expand the BTR component to test the market / consider feasibility, but then subsequently wished to scale it back due to changes in the market (whilst still meeting the 50 dwelling minimum, or even scaling back to the original numbers of dwellings), the expansion rule in sub-section 43-152(5) would mean that this would cause the **whole development** to cease to be an active BTR development and all incentives from the commencement of the development clawed back. Further, as currently drafted and as discussed above, if the income requirements, or the 74.9% market rent requirement, were not met at any point in a tenancy, again the whole development would cease to be an active BTR development (even though it may be unintentional or minor) with a claw back applying to all of the incentives.	The cessation rules in proposed sub-section 43-152(6) should refer to only (3)(a) not being satisfied for 50 or more dwellings; to (3)(d) not only not being satisfied where both it is the start of a new lease and where reasonable efforts were not taken to ascertain market rent/satisfy the requirements (or where a safe harbour for (3)(d) is introduced, where that the safe harbour is not satisfied). To the extent any claw back applies because of a change in a dwelling (rather than the development failing to meet the overall requirements), that claw back should be limited to the particular dwelling that no longer meets the requirement (e.g. that apartment's proportion of the accelerated capital works would be recovered). As already stated, it appears unnecessary to claw back the Reduced WHT (beyond any period where it was not eligible).

Issue	Description	Proposed solution
Lack of clarity - 'adjacent land'	Proposed section 43-152(8) allowing for buildings on "adjacent" land to be included in a single development is a positive measure that potentially enhances flexibility to deliver BTR projects. However, there is little clarity on the meaning of adjacent land, and we submit the cross-reference to the CGT provisions (really dealing with single dwellings) is not appropriate or adapted to the purpose.	Express clarity specific to BTR rules should be provided on adjacent land, and confirm that a development over multiple contiguous sites (or sites separated only by roads, easements etc. within a single development) are eligible to be a single active BTR development.
Common area requirements	The requirement in proposed section 43-151 that common areas be included in the single entity may prevent / hinder mixed use developments. The common areas for an active BTR development in section 43-151 are defined as any areas the use (rather than the *sole use*) of those dwellings, which would capture common areas used for mixed use developments and subject them to the ownership of the single entity. This would then impose economic burdens on the single entity, which would need to maintain those common areas, without any recognition of the ability to licence out or have cost recovery for those areas (such as treating such income as rental income). Mixed use developments are important to BTR feasibility, as they allow investment risk to be spread amongst different asset classes and make for more interesting developments (due to the ability to have co-located complementary tenancies, whether in the form of workspaces or retail / food / convenience offerings.	• Any use of common areas by other tenants in the same building or in buildings on adjacent land should expressly be permitted (provided the BTR dwellings have access as well) • Mixed common areas should be excluded from the common area definition in proposed section 43-151 (it should be areas *solely* used for dwellings, whether BTR or not) • Any licence fees / cost recovery in respect of areas that are held as part of the Active BTR Development but for mixed use should be treated as rental income for the single owner. • To the extent necessary, accelerated capital works could be pro-rated (for example, limited to the pro-rata portion of the shared common areas cost based on the overall BTR dwellings as a proportion of the building(s) sharing the common areas).

Issue	Description	Proposed solution
Clarity on eligible investment business	For the purposes of Reduced WHT and the MIT rules, there is no clarity provided that an active BTR development is an eligible investment business under the trading trust rules in Division 6C of the 1936 Act.	Section 102MB should be expanded to include an active BTR development as an eligible investment business (i.e. an investment in land primarily for the purposes of deriving rent).
Clarity on ability to provide ancillary services	The EDL does not expressly facilitate the provision of complementary / ancillary services to BTR tenants, despite this being able to potentially materially improve amenity of BTR (as experienced overseas).	Section 102MB should potentially be expanded so that a safe harbour is provided where ancillary income from providing services to tenants in an active BTR development (provided it is less than say 25% of total BTR rental income) should be an eligible investment business. The Reduced WHT should also apply on the basis that such income is rent.