MinterEllison.

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Director
Corporate Tax Policy Unit
Corporate and International Tax Division
Treasury
Langton Cres
PARKES ACT 2600

BY EMAIL: btr@treasury.gov.au

Dear Sir/Madam

MinterEllison submission: Build-to-rent tax concessions

MinterEllison welcomes the opportunity to make a submission to Treasury in relation to the build-to-rent exposure draft legislation issued on 9 April 2024, including a draft of the 'Treasury Law Amendment Bill 2024: Build to rent developments' (**BTR Bill**) and the 'Capital Works (Build to Rent Misuse Tax) Bill 2024' (**Misuse Tax Bill**) and accompanying Exposure Draft Explanatory Material (**EM**) and Policy Fact Sheet: Build-to-Rent Tax Concessions – Income Limits (**Fact Sheet**).

Having reviewed the draft materials provided, we are concerned that the BTR Bill may not achieve its stated policy goal of incentivising investment in new BTR developments in order to increase housing supply.

As a general observation, the nature of a number of qualification requirements pose a significant level of risk and uncertainty for investors. As currently drafted, the provisions continue to result in BTR developments being significantly less attractive as compared to other commercial asset classes and operate to entrench these disadvantages within the asset class.

At a high level, it is not clear why the treatment of BTR assets is not aligned with the treatment of commercial and industrial property held by managed investment trusts (**MITs**) if the policy intention is to attract investment to the sector. Doing so would simplify the rules, remove the uncertainty inherent in the current draft BTR Bill and promote the attractiveness of BTR investment.

We offer more detailed comments and recommendations in relation to our observations below.

Limitations on the reduced MIT withholding rate concession put BTR investment at a significant economic disadvantage compared to other asset classes

1. As currently drafted, the MIT withholding concession only applies in respect of eligible rental income derived from a qualifying BTR development. Capital gains derived from the disposal of a BTR development will not be eligible for the 15% withholding rate.

2. The inability to access the reduced MIT withholding rate in respect of capital gains derived from the sale of land on which a BTR project is situated puts these investments at a significant disadvantage as compared to other commercial asset classes (which allow concessional treatment for capital gains).

3. Further, the 15 year limit on the application of the reduced MIT withholding rate for rental income significantly reduces the value of a BTR investment. For example:

   (a) a BTR development is likely to be loss making in the early years of operation due to high levels of capital expenditure and debt funding, meaning cash returns to investors may not be available until part way through the 15 year period. Accordingly, as a practical matter, it is likely that investors will only benefit from the reduced MIT withholding rate for a shorter period than 15 years, notwithstanding that the 15 years compliance period essentially begins on practical completion of the dwellings;

   (b) a key factor in any investment decision is the return generated on disposal of the investment. Existing investors will find it hard to attract new investors particularly as the development nears the end of the 15 year period, given a foreign resident new investor will not benefit from the reduced MIT withholding rate once the 15 year period ends and the disposal at the asset level is not subject to the reduced withholding rate in any event. This significantly limits the market for a future sale, thereby negatively affecting the sale price; and

   (c) in order to achieve financial viability for BTR projects, investors may look to increase rents as they look to offset the lower returns they will receive on disposal of the investment due to the inability of future foreign investors to access these withholding concessions.

4. These features of the regime will have a significant adverse impact on investment decisions, and are inconsistent with the policy objective of promoting investment in the Australian BTR sector.

5. If Government is committed to a timeline for the concession, we recommend that Government engage with industry and commission modelling, which is shared with the public, to show a reasonable period for economic return on the asset class.

Significant administrative burden where multiple compliance periods are running concurrently

6. We highlight the lack of guidance in the EM around the income tracing exercise that would be required for a BTR development where it has multiple 15 year compliance periods running for dwellings (due to being developed in stages) and one of those compliance periods has ended.

7. In this case, fund payments derived from rental income from some dwellings (still within a 15 year compliance period) will be taxable at the concessional 15% rate while others will be taxable at the 30% rate (for income derived from dwellings after the 15 year period has ended).

8. The EM should provide guidance on whether investors can trace rental income from particular dwellings to specific fund payments (if achievable) or whether they will be expected to undertake an apportionment exercise.

9. If an apportionment is required, guidance on how that apportionment is to be undertaken should be included in the EM.

Commencement of construction

Drafting of the commencement date provisions

10. A clear policy intent of the provisions is that the BTR tax concessions will only be accessible in respect of a BTR development where construction of that BTR development commenced after 7:30PM (AEST) on 9 May 2023. This is reflected in the EM.

11. As a technical matter, we are not convinced that the current drafting in the BTR Bill is adequate to properly incorporate this as a requirement in respect of the MIT withholding concession.

12. Item 16 of the BTR Bill indicates that the amendments made by the BTR Bill apply to capital works begun after 7.30pm, by legal time in the Australian Capital Territory, on 9 May 2023.

13. While this provision should be effective in ensuring that only fund payments made by a trustee of a MIT after that time will benefit from the reduced MIT withholding rate, it seems open to interpretation that a BTR development could qualify as an 'active build to rent development' even if construction had commenced prior to that date.

14. To access the MIT withholding concession, the requirement is that there be a payment of rental income under a lease of a dwelling that is part of an 'active build to rent development' and for which the 'build to rent compliance period' has not ended (see proposed new subsection 12-450(5) of Schedule 1 to the *Taxation Administration Act 1953* (Cth) at Item 10 of the BTR Bill).

15. Neither the definition of 'active build to rent development' nor the conditions in proposed new section 43-152 of the *Income Tax Assessment Act 1997* (Cth) refer to construction of the BTR development needing to commence post 9 May 2023, nor do these provisions refer to the concept of 'capital works', being the term used in Item 16 of the BTR Bill that purports to introduce the construction date requirement.

16. In our view, a clearer and more consistent approach would be to adopt similar drafting to that used for the clean building reduced MIT withholding rate.

17. For example, the clean building reduced MIT withholding rate only applies where construction of the relevant building commenced on or after 1 July 2012, and wording to this effect is included in subsection 12-430(1) of Schedule 1 to the *Taxation Administration Act 1953* (Cth). Similar wording should be incorporated in proposed new subsection 12-450(5) of Schedule 1 to the *Taxation Administration Act 1953* (Cth).

18. Alternatively, the construction date requirement should be expressly included in section 43-152, being the proposed new provision which sets out the requirements to be met in order for a development to qualify as an 'active build to rent development' for the purposes of the accelerated capital works deductions.

When does construction begin?

19. Leaving aside the technical issue with the construction requirement we outline above, there remains a degree of uncertainty around when 'capital works' will be considered to have begun.

20. We assume the tax concessions will be available to investors who have, for example, carried out feasibility studies, undertaken geological surveys or obtained development approvals prior to 9 May 2023 given these activities would not ordinarily be considered 'capital works'. However, the position is less clear when it comes to demolition of existing structures or certain site preparation works. There is also no clarification about whether existing section 43-80 of the *Income Tax Assessment Act 1997* (**ITAA97**) is relevant in determining when capital works begin in this context.

21. The EM should address this uncertainty and provide guidance and examples of circumstances in which capital works will be considered to have begun and not yet begun.

Existing BTR Developments

22. Notwithstanding the above, we reiterate the concerns expressed by industry around the tax concessions being unavailable for early adopters of the BTR model who have existing BTR developments either under construction or in the early stages of operation.

23. Failing to provide existing operators and investors with access to the concessions creates a two tiered market and unfairly penalises early adopters with a devaluation of their investment.

24. It is also unclear whether existing BTR developments can add new stock to their developments and be able to qualify for the concessions. For example, could an existing development with 45 dwellings construct another 5 dwellings and be able to qualify for the concessions? Could an existing development with 60 dwellings add another 5 to its stock? Based on the current drafting of the provisions, the former scenario would appear to qualify for the concessions whereas the latter scenario would not. It is not clear why each circumstance would lead to a different outcome given both scenarios have the same net effect of increasing housing stock by 5 dwellings.

Safe Harbour should be included if failure of 'active BTR development' condition is immaterial or out of the holder's control

25. The way in which the concept of an 'active build to rent development' is defined in section 43-152 of the BTR Bill means that a development that has commenced being an 'active build to rent development' and then ceases to qualify can no longer requalify for the tax concessions if that non-compliance is rectified.

26. We submit that this is an unduly harsh outcome, and may be of concern to some operators and investors, particularly given the lack of control and degree of subjectivity associated with some of the requirements around 'affordable dwellings'.

27. For example, rent payable in relation to an affordable dwelling must be 74.9% or less of the market rate. Reasonable minds may differ on precisely what constitutes the market rate. Further, the market rate may continually fluctuate in response to external economic factors, which cannot always be accurately predicted.

28. There is a risk that, despite the best efforts of the BTR development operator, the market rate may momentarily fall below the rate which was used by the operator to calculate and set the rent payable for a particular affordable dwelling. If this occurs for multiple dwellings at the same time, this may result in the condition in sub-paragraph 43-152(3)(d)(i) not being met.

29. The Fact Sheet on income limits (provided by Treasury) states that the BTR operator will be required to 'assess initial *and ongoing* tenant eligibility' on the basis of certain income limits.

30. We understand that the full requirements which relate to eligible tenants will be contained in a legislative instrument which has not yet been made available in draft form. However, the information currently available provides no guidance on what would happen if an eligible tenant exceeds the income limit in a later income year once a lease has already been entered into. It will be impossible for a BTR operator to predict whether a tenant will unexpectedly exceed an income limit.

31. We also refer to our comments below around the term 'amenities' and the subjective nature of what could be characterised as an 'amenity' in assessing whether a dwelling that is not an affordable dwelling has the same amenities as at least one of the affordable dwellings.

32. In the circumstances such as those highlighted above, it is unreasonable for the BTR development to permanently lose access to all BTR tax concessions.

33. We submit that the BTR Bill should include some form of safe harbour provision to protect against temporary non-compliance with the conditions, particularly in circumstances where the non-compliance is due to circumstances outside of the control of the BTR operator and the BTR operator takes reasonable steps to rectify that non-compliance.

34. Inclusion of a safe harbour provision is neither unreasonable nor unusual given existing provisions around MITs already include various safe harbours to provide some level of comfort to investors in circumstances involving temporary or unintentional non-compliance (e.g. 2% safe harbour for non-trading income under the eligible investment business provisions; 180 day compliance rectification period for clean building MITs in 12-430(5) of Schedule 1 to the *Taxation Administration Act 1953* (Cth)).

Tenants in common

35. The requirement for *single ownership* of all dwellings and common areas prevents multiple investors from holding a direct interest in the project (as tenants in common).

36. The EM justifies this requirement on the basis that it ensures that the 'owner' has control over the BTR development and is responsible for maintaining its eligibility for the concessions.

37. The policy basis for this limitation is not clear.

38. The provisions clearly anticipate that a BTR development may have multiple investors. It is not clear to us how a requirement that each investor hold an interest in the BTR development indirectly via a single entity as compared to holding a direct interest in the underlying land will result in a higher level of compliance with the qualifying requirements than might otherwise be the case.

39. Being able to hold a direct interest in a project will be important for some investors who may wish to hold their interest in an existing fund with other investments, or who may be co-investing with another party that does not wish to structure their investment as a MIT. Holding a direct interest as tenant in common would facilitate investors being able to source and manage debt independently of each other, which will be particularly important for investors with different risk appetites who may want to gear their investment at different levels.

40. This requirement seems unnecessary and if the Government is trying to address a particular concern, that concern should be clearly articulated.

41. Again, we note that this feature puts BTR investments at a significant disadvantage as compared to other commercial asset classes (which allow direct investment as tenants in common). For this reason, it is inconsistent with achieving the policy objective of promoting investment in the Australian BTR sector.

Clarification of meaning of 'amenities' and de minimis rule

42. The requirement that each dwelling that is not an affordable dwelling must be of the same size and have the same amenities as at least one of the affordable dwellings adds considerable uncertainty and risk for BTR developers. It is our view that the *quality* of the affordable housing included in the development should be a matter for regulation as part of the relevant planning scheme, having regard to the local amenity, rather than a matter to be included at a very broad level in tax legislation. The minimalist drafting approach adopted in the BTR Bill creates a number of difficulties and uncertainties which undermines the concession. These are discussed below. On this basis, our view is that the amenities test in proposed paragraph 43-152(3)(e) should be removed.

What are 'amenities'?

43. The concept of 'amenities' as used in the provisions is not defined, which leaves considerable uncertainty for operators and investors.

44. 'Amenities' are generally understood to be desirable or useful features or facilities, which is a particularly broad concept. The EM identifies that 'amenities' includes factors such as the number of bedrooms and bathrooms. However, the wording in the EM suggests that these are not the only criteria that would be used to determine whether the same 'amenities' are offered.

45. In our view, the legislation should provide a more detailed (and preferably an exhaustive) description of features that are characterised as 'amenities' for this purpose.

46. For example, it is unclear whether the current definition of the term 'amenities' is intended to capture features such as car parks, storage units, being on the same floor level, having the same layout, the quality of views, fittings and décor, having access to a concierge, gymnasium or separate laundry.

47. The broad definition of the term 'amenities' without any significant clarification in the EM will be problematic and pose concerns for prospective investors.

48. This is especially in light of the fact that the provisions as currently drafted do not include any safe harbour or ability to rectify any non-compliance with the requirements. A mistaken understanding of what constitutes an 'amenity' could result in the investors in that development being permanently disqualified from accessing the BTR tax concessions.

49. In the absence of further clarification, at the very least, a misunderstanding relating to which characteristics are included within the definition of 'amenities' should be protected by a safe harbour provision as proposed above.

Same amenity requirement should not apply to classes of dwelling with a small number of members

50. We also recommend that a *de minimis* provision be included in relation to the same size same amenities requirement where, for example, there are only a small number of dwellings of a particular nature. The de minimis will apply to switch off any 'same amenity' requirement.

51. The same size same amenities requirement will be particularly problematic at the premium end of the BTR market, and may result in underutilised stock, which again detracts from the value of the investment.

52. For example, the provisions as currently drafted would seem to require that where a BTR development has a single penthouse, it must be an affordable dwelling. Given the income threshold limits for prospective tenants, it seems possible that qualifying tenants may not be able to afford to rent on a penthouse even where it is offered at a 25% discount to market. The dwelling may therefore remain untenanted.

'Same' amenity should be replaced with 'similar' amenity

53. We also submit that if this provision is retained, at the very least, the word 'same' is replaced with 'similar'.

54. It is not appropriate for there to be uncertainty, for example, whether a 49.9sqm dwelling is the 'same' size as a 50sqm dwelling for these purposes, where they clearly should be the 'same', even though they are not exactly the same size. The difference between 'same' and 'similar' has been recognised in other aspects of the tax law, including the tax loss recoupment rules in Division 165 of the *Income Tax Assessment Act 1997* (Cth) and we consider the policy reasons for the amendments to those tests would be equally applicable in these circumstances.

Misuse tax

55. The way in which the misuse tax operates means there is a risk that new investors coming into the structure partway through the 15 year compliance period could be exposed to misuse tax referable to the period prior to their investment if a BTR development ceases to meet the requirements. This is inappropriate.

Misuse tax for accelerated capital works deductions

56. In relation to accelerated capital works deductions, we assume that the entity that would be assessed for misuse tax would be the trustee of the 'single entity' which holds the direct interest in the BTR development.

57. In the event of a direct ownership change (i.e. where the 'single entity' disposes of the BTR development to a new 'single entity'), the new 'single entity' should only be liable for misuse tax in relation to the time it owned or leased the BTR development and used it in the 4% manner (see the definition of 'days used' in step 2 of proposed section 44-25). We consider this to be an appropriate outcome.

58. A different outcome arises where there is an indirect ownership change (i.e. where a new investor acquires an upstream interest, including an interest in the 'single entity' of the BTR development).

59. If the BTR development ceases to qualify for the concessions after such an indirect ownership change, the new investor will bear part of the economic burden of any misuse tax imposed on the 'single entity' relating to accelerated capital works deductions claimed before that new investor entered the structure (given the single entity will have owned or leased the BTR development from the commencement of the 15 year period). This is because they would be a unitholder of the 'single entity' which incurs the misuse tax for its entire ownership period.

60. The absence of a mechanism to take upstream ownership changes into account when assessing the misuse tax may result in it being less attractive for indirect ownership changes during the 15 year compliance period.

Misuse tax for reduced MIT withholding rate

61. A similar outcome in respect of misuse tax in relation to the claiming of the reduced 15% withholding rate could arise where each investor invests into a single upstream Australian MIT. This is because the trustee of that MIT would be liable in respect of all previous fund payments.

Clarification of meaning of 'adjacent land'

62. We note that the term 'building' as used in proposed sections 43-151, 43-152 and 43-153 of the BTR Bill may include a building which is on the 'same or adjacent land'.

63. While we welcome the increased flexibility allowed by this provision, we submit that the meaning of this phrase (and in particular the concept of 'adjacent land') is not entirely clear.

64. The legislation could be enhanced by defining the concept of 'adjacent land' or at least including some practical examples of what would qualify as 'adjacent land' in the EM.

65. For example, if two buildings are on separate land parcels which are separated by a road, will those buildings qualify as being on 'adjacent land'?

Please contact Adrian Varrasso on 0414 600 915 or Jason Hawe on 0481 462 357 if you would like to discuss this submission in any further detail.

Yours faithfully

MinterEllison