PSP Investissements Investments

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Submitted via email: btr@treasury.gov.au

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Dear Sir or Madam,

Treasury Laws Amendment Bill 2024: Build to rent developments Submission by Public Sector Pension Investment Board

We thank you for the opportunity to provide a submission in respect of the Government's Exposure Draft Legislation on the proposed Built-to-Rent (**BTR**) concessions that was released on 9 April 2024 (*Treasury Laws Amendment Bill 2024: Build to rent developments* and the *Capital Works (Build to Rent Misuse Tax) Bill 2024* - collectively **the Exposure Draft Legislation**).

This submission is made by Public Sector Pension Investment Board (**PSPIB**), a Canadian Crown corporation that invests amounts transferred to it by the Government of Canada for the pension plans of the Canadian Public Service, the Canadian Forces, the Royal Canadian Mounted Police and the Reserve Force. PSPIB has C$243.7 billion of net assets under management as at 31 March 2023 and invests globally in a variety of asset classes, including natural resources, public markets, private equity, real estate, infrastructure, and credit investments.

We recognize and support the Government's overarching policy objective to increase housing supply in Australia through investment in the construction of new BTR dwellings with an affordable component. BTR developments are becoming integral parts of housing delivery globally and are expected to make up a significant portion of housing stock in coming years. Institutional investors invest in a variety of real estate assets, including residential real estate assets.

We value the opportunity to make this submission in relation to the Exposure Draft Legislation, the accompanying Explanatory Memorandum (**EM**) and Policy Fact Sheet. We understand that Treasury is seeking feedback on the effectiveness of the Exposure Draft Legislation and the accompanying EM, together with interested parties' views on the following requirements:

- a minimum proportion of dwellings to be made available as affordable tenancies; and
- a minimum period of 15 years during which dwellings must be retained under single ownership (compared to a 10-year period in the original announcement of the policy changes in the 2023/24 Federal Budget).

We are writing to you to share our principal comments and concerns in respect of the Exposure Draft Legislation and to provide suggested changes which we consider to be both constructive and within the policy objectives of the proposed measures. We have limited our submission to aspects of the Exposure Draft Legislation where we believe the proposed rules materially depart from the desired policy objective.

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Opening remarks

PSPIB acknowledges and supports the overall intent of the Exposure Draft Legislation and the EM to increase housing supply in Australia by increasing institutional investment in BTR as an alternative housing product in the Australian market. The proposal for minimum 10% of BTR dwellings to be made available as affordable tenancies is reasonable for the Australian market – however greater flexibility is required in how this threshold is satisfied by owners and operators.

PSPIB's main concern in respect of the Exposure Draft Legislation is the 30% tax rate that applies to BTR rental income outside the 15-year compliance period and on capital gains. Taking into consideration the tax settings proposed by the Exposure Draft Legislation, the overall tax rates on BTR assets in Australia would be materially higher than other institutional asset classes. This places BTR projects at a competitive disadvantage to investments in commercial property where foreign investors can access the 15% tax rate on both income and capital gains. Consequently, the after-tax returns on certain commercial property assets remain competitive when institutional investors are allocating capital to other real estate asset classes or strategies. The Government could narrow this gap and improve the competitiveness of BTR investments where the tax outcomes for BTR developments during the holding period and on exit are the same as commercial property.

Simplicity in the tax system is important to institutional investors such as PSPIB. The Exposure Draft Legislation puts forward a complicated regime that creates a number of commercial, compliance, and valuation issues for institutional investors. Taken together, the complexity of the rules creates uncertainty which makes it difficult for investors to underwrite projects on the basis of the proposed BTR tax concession – which risks undermining the policy intent.

Lastly, BTR developments are often competing with Build-To-Sell (**BTS**) developments for land. Where the tax concessions offered to BTR investors are limited and the regime itself is too complex to access, there will be limited change in the value of BTR developments, which is likely to result in land being principally used for BTS developments. The competition for land will impact the supply of BTR developments in the market and further impede the Government's policy objective of increasing BTR accommodation as an alternative and affordable option in the Australian market.

Summary of submissions

Having regard to the Government's stated policy objectives for this measure and our opening remarks above, we have made the following submissions on the Exposure Draft Legislation:

1. The concessional 15% withholding tax rate should be available for BTR developments for the entirety of the ownership period by a Managed Investment Trust (**MIT**). Practically speaking, the proposal to limit the concession to a 15-year compliance period reduces the effective benefit to an even shorter period as the BTR developments often take a number of years to generate net taxable income to which the concessional tax rate can be applied.

2. The concessional 15% withholding tax rate should be available for capital gains derived by a MIT in respect of BTR developments. The proposal to exclude capital gains from the concessional withholding tax rate materially impacts the incentive for foreign institutional investors to underwrite additional projects as a result of the proposed BTR concessions.

3. The proposed BTR development misuse tax creates significant commercial complexity and trailing liabilities for institutional investors – this should be replaced with more targeted and appropriate integrity measures.

4. The 'same' size and 'same' amenity requirement for affordable housing is too rigid and the rule should be replaced with a simpler, more flexible requirement that continues to support the desired policy objective (e.g., 'similar' dwellings to be offered at affordable rates).

5. The minimum lease period and associated requirements should be clarified as the wording in the Exposure Draft Legislation creates uncertainty.

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6. The reporting requirements in respect of the BTR concessions should be simplified and streamlined so as to not impose a significant compliance burden, particularly given the risk for material 'failure to lodge' penalties for institutional investors – which are often Significant Global Entities - due to reliance on third party managers to operate the BTR assets.

Please refer to our detailed submissions below in respect of these items.

Submission 1: The concessional 15% withholding tax rate should not be limited to a 15-year BTR compliance period

The original announcement in the 2023-2024 Budget regarding the reduced withholding tax rate for BTR developments did not include any reference to the concession only being available for a limited time.[1] However, our interpretation of the Exposure Draft Legislation is that the concessional MIT withholding tax rate will only be available for a 15-year period.

This is on the basis that:

- The proposed subsection 43-152(7) provides that for new dwellings the BTR compliance period of an active BTR development is 15 years beginning on the day after the development commences to be an active BTR development. Practically we understand that the 15-year BTR compliance period will begin on and after the first day a building has 50 or more dwellings that satisfy all of the requirements in subsection 43-152(3).

- The proposed amendment to section 12-450 in Schedule 1 of the *Tax Administration Act 1953* prescribes that the reduced withholding tax rate of 15% will only be available provided that the BTR compliance period has not ended. Specifically, the Exposure Draft Legislation provides that:

  *"The amount is not MIT residential housing income of the *managed investment trust under subsection (2) to the extent it is attributable to a payment of rental income under a lease of a *dwelling:*

  *(a) that is part of an *active build to rent development; and*
  (b) ***for which the *build to rent compliance period <u>has not ended</u>."***

  [Emphasis added]

Based on the proposed drafting, the concessional 15% MIT withholding tax rate will only be available for a 15-year period upon the BTR development becoming operational.

In our experience with BTR projects in the Australian market, it takes a number of years after the construction of a BTR facility before the project generates net taxable income which is subject to withholding tax on the distribution to foreign investors. This is due to a combination of the relevant property trust:

- incurring significant costs during the construction phase that are deductible for Australian tax purposes (e.g., establishment costs, interest expense and borrowing costs, etc);

- the lease and stabilisation of the BTR dwellings taking a number of months (for example up to 12 months) after the construction completes; and

- being entitled to capital allowance and capital works deductions.

Practically speaking the proposed 15-year BTR compliance period for the MIT withholding tax concession would mean that investors obtain a shorter period of actual benefits. As a consequence, the incentive for institutional investors is materially diminished – particularly when

[1] https://budget.gov.au/content/bp2/download/bp2_2023-24.pdf

viewed in the light of the proposed additional affordable housing requirements, complexity associated with the BTR misuse tax and ongoing compliance obligations.

Additionally, limiting the concession to the proposed 15-year period means that the concessional withholding tax rate cannot be priced into the value of the building by a foreign purchaser on resale of the asset once the 15-year period has expired. This impacts the liquidity of the asset and further diminishes the incentive for investors to develop BTR dwellings.

Submission:
The 15% withholding tax rate should not be subject to a capped 15-year period from when the BTR development becomes operational. Instead, the 15% MIT withholding tax rate should be available throughout the entire holding period provided the relevant eligibility criteria are satisfied.

Submission 2: The concessional 15% withholding tax rate should apply to capital gains derived on BTR developments

The Exposure Draft Legislation provides that the reduced 15% withholding tax rate is only available in respect of 'rental income' derived by the MIT. As a result, any capital gain derived by the MIT in respect of BTR development is not subject to the concessional 15% withholding tax rate and instead will be taxed at the 30% withholding tax rate (i.e., as MIT residential housing income).

As noted above, institutional investors invest in a variety of real estate assets, including both commercial and residential real estate assets. Under Australia's current policy settings, capital gains on office, retail, industrial, and commercial residential property in Australia qualify for the concessional 15% withholding tax rate for foreign investors. Given the policy intent is to encourage further institutional investment in BTR developments, the concessional 15% withholding tax rate should also be available to the capital gains derived from eligible BTR developments.

It is important to also highlight that allowing foreign institutional investors to access the concessional 15% withholding tax rate for capital gains on an eligible BTR development would still put these investors at a relative disadvantage as compared to Australian Superannuation Funds (who have invested in the Australian BTR sector[2]). Australian Superannuation Funds are subject to a 15% tax rate on income and are also able to access a 33.33% discount on capital gains[3], which results in an effective tax rate of 10%.

Submission:

The reduced 15% withholding tax should be available for capital gains attributable to BTR developments, provided that the relevant eligibility criteria are satisfied.

[2] AustralianSuper to fund $920 million build-to-rent Melbourne portfolio: https://www.afr.com/property/commercial/australiansuper-to-fund-920-million-build-to-rent-melbourne-portfolio-20230302-p5cp00#
[3] Subsection 115-100(b) of the *Income Tax Assessment Act 1997*.

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Submission 3: The BTR development misuse tax should be replaced with more targeted and appropriate integrity measures

The BTR development misuse tax applies to neutralise tax concessions which were obtained prior to the BTR development ceasing to be active BTR developments. The BTR development misuse tax appears to have been drafted to prevent abuse of the system (i.e., inappropriate access to the BTR concessions) where one or more of the requirements to claim the BTR concessions – reduced withholding tax rate and increased capital works deduction rate – are not continuously satisfied.

Whilst PSPIB acknowledges Treasury's position regarding preventing abuse of these concessions, the proposed approach creates significant complexity and risk for institutional investors – particularly where the ownership of the BTR facility changes during the 15-year compliance period. The proposed requirements also appear to apply significant penalties for inadvertent errors as temporary non-compliance could result in the BTR concessions no longer being available and the BTR development misuse tax applying (for example institutional investors could be severely impacted where a property manager causes a temporary failure of the conditions outside the control of the institutional investor). We believe the following points are relevant to highlight.

A) Vendor and purchaser complexity relating to the BTR development misuse tax

To the extent a BTR development that applied the concessional MIT withholding tax rate and capital works deductions is acquired, the acquirer will need to undertake significant due diligence to confirm that the active BTR development requirements have been satisfied throughout the 15-year period to ensure that no BTR development misuse tax would arise for the acquirer.

Commercially, purchasers of an active BTR dwelling in these scenarios are likely to require an indemnity for any non-satisfaction of any of the BTR concession eligibility requirements. The requirement to provide significantly long dated indemnities (e.g., up to 15 years) will prevent institutional investors from accessing a commercially desirable 'clean exit' from the investment. This, in turn, will make the utilisation of the proposed incentive unattractive for investors.

To address these commercial issues, in the case of MITs, we submit that where the requirements to be classified as an active BTR development are not satisfied in an income year, the reduced withholding tax rate and accelerated capital works deduction rate should not be available for that income year and the ordinary amendment period for income tax assessments should be applied (i.e., 4 years). This is on the basis that MITs aggregate institutional investor capital and operate with a high degree of compliance from both a regulation and reputational perspective.

Additionally, to the extent that the requirements to be classified as an active BTR development are not satisfied in an income year, but are subsequently satisfied in a future income year, the BTR concessions should be made available in future income years.

B) Temporary errors outside the control of the investor

The proposed requirements will also apply significant penalties for inadvertent errors that lead to non-compliance with the BTR conditions. These could include, for example, a third party BTR operator inadvertently failing to offer a three-year lease term or failing to maintain the affordable housing requirement across each type of dwelling and/or the BTR facility for a short period.

In such circumstances we believe it would be more appropriate to disregard such temporary breaches outside the control of the trustee of the MIT. Such an approach would also be consistent with other provisions currently in force under the MIT rules, such as section 275-55 of the *Income Tax Assessment Act 1997* (Extended definition of managed investment trust – temporary circumstances outside the control of the trustee).

Submission:
The BTR development misuse tax should be replaced with more targeted and appropriate integrity measures such as:

- For Managed Investment Trusts the reduced withholding tax rate and accelerated capital works deduction rate should not be available for that income year and the ordinary amendment period for income tax assessments should be applied (i.e., 4 years).
- The BTR concessions should be made unavailable only in the income year in which the active BTR development requirements are not satisfied;
- The BTR concessions should be made available if the MIT is able to rectify the non-compliance with the active BTR development requirements within a reasonable period; and
- There should be a safe harbour introduced whereby the BTR concessions are not made unavailable due to a circumstance outside the control of the MIT, provided that any non-compliance is appropriately rectified within a reasonable period.

Submission 4: The requirement for at least one affordable dwelling to be the 'same' size and have the 'same' amenities should be replaced with a more general and less rigid requirement

One of the requirements that must be met to obtain the BTR concessions is that each of the dwellings that is not an affordable dwelling is the same size and has the same amenities as at least one of the affordable dwellings (refer to the proposed condition in paragraph 43-152(3)(e)).

The condition, as drafted, requires that the dwellings are the "same" (rather than 'similar' or 'reasonably comparable'). The term "same" is not defined in the Australian tax legislation but is defined in the Cambridge Dictionary to mean "exactly like another or each other".[4] Additionally, Australian Courts have interpretated the term "same as", in the context of the same business test loss recoupment rules to "import identity and not merely similarity" and in that context, the natural reading of "same business" was to mean "the identical business".[5] Additionally, an "amenity" is understood to be a desirable or useful feature or facility of a building or place.[6]

PSPIB acknowledges the purpose for a rule that ensures the affordable tenants are offered products of a similar quality and standard as the market tenants so that the lowest quality dwellings are not offered or allocated only as affordable dwellings.

Our concern is that the strict requirement in paragraph 43-152(3)(e), along with the supporting commentary in the EM, will mean that very few BTR developments will practically be able to satisfy this requirement. This is because, for a variety of different reasons relating to the layout, design and operation of a development, our experience suggests that no two units in a full development may be **exactly** the same. This is a natural function of the design elements of a building which are dominated by the land size, proximity to other structures and the associated architectural and engineering requirements.

In order to potentially comply with this requirement (which for the reasons above may not be possible on BTR developments), there is likely to be an increase in the overall construction costs and/or a reduction in the rents due to a higher proportion of the dwelling being leased as affordable dwellings to satisfy the 'same size' and 'same amenity' requirements. Compliance with this requirement will therefore impact the overall returns from a BTR facility and reduce the value proposition for institutional investors.

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[4] https://dictionary.cambridge.org/dictionary/english/same#google_vignette
[5] *Avondale Motors (Parts) Pty Ltd v. FC of T* (1971) 124 CLR 97 at 105.
[6] https://www.oed.com/dictionary/amenity_n?tab=meaning_and_use.

As a general observation from our experience, BTR building designs will not be designed differently to specifically comply with the same size and same amenity requirement, nor, on the other hand, to create a separate class of lower standard units to be offered as affordable dwellings. To maximise the value of the BTR development the building and each unit needs to be fit for market purposes.

In light of the above, we foresee a number of practical issues with the proposed same size and same amenity approach adopted in the Exposure Draft Legislation. For example, the 'same' size and 'same' amenity requirement will be challenged in the following circumstances, which are common in BTR developments:

- Corner-units in residential towers can often have different floorspace (e.g., due to curved walls in the design).
- Some units may have pillars / columns due to structural requirements of the entire building, which perform a load-bearing or stabilizing function, but consume floorspace of certain units.
- Some units have balconies, and others do not. Additionally, not all balconies are the same size, due to either design aesthetics or engineering / regulatory requirements.
- The 'same' amenity requirement practically would mean that a significant exercise would need to be undertaken to confirm that the exact same oven, dishwasher, washing machine, and dryer (and other similar amenities) are provided to tenants.

We submit that a sufficient degree of flexibility is required for the developer to lease dwellings to affordable tenants within a configuration type (e.g., 1 / 2 / 3-bedroom units) provided the dwelling is of a quality and condition that reasonably reflects the market dwellings.

Submission:

The same size and same amenity requirements should be replaced with a more general and less rigid requirement to ensure that each of the dwellings that are leased to affordable tenants is of a quality and condition that reasonably reflects the market dwellings.

Submission 5: The minimum lease period and associated requirements should be clarified

Paragraph 43-152(3)(a) of the Exposure Draft Legislation incorporates a requirement in respect of the minimum lease period. Our interpretation of the Exposure Draft Legislation is that all dwellings in a BTR development – i.e., affordable dwellings and ordinary dwellings – are required to be either:

- 'Available' to the public to be tenanted by way of a lease for a period of 3 years or more; or
- Are being tenanted by way of a lease as a result of being made available to the public for a period of 3 years or more; or
- temporarily unable to satisfy either of the above requirements due to construction of an extension, alteration or improvement or the making of repairs.

We believe the following points are relevant to highlight in respect of the minimum lease condition.

A) Three-year minimum lease term

Our interpretation of the Exposure Draft Legislation is that all dwellings must be offered to tenants on a three-year term. This appears to be applicable to both affordable dwellings and ordinary dwellings.

As noted above, we acknowledge the policy intent of ensuring that a minimum proportion of dwellings are made available as affordable tenancies, and that it is required to have some mechanisms and safeguards in place to ensure that affordable tenants are provided with stability. However, the policy for offering market dwellings for a minimum three-year term is unclear as this is inconsistent with general market practice. Market based tenants should be offered standard market lease terms (e.g., 12-month rental periods) to ensure that these dwellings can be tenanted and the product offered by the active BTR development is comparable to other BTR products.

B) Annual rent review process

The Exposure Draft Legislation does not make it clear how annual rent review processes (including fixed annual uplifts) can occur for both affordable dwellings and ordinary dwellings. The specific wording of subsection 43-152(3) appears to just require that the rent payable in respect of affordable dwellings is 74.9% or less of the market rate.

The Exposure Draft Legislation or the EM should clarify that annual rent review processes will be allowable for both affordable and ordinary dwellings, subject to the relevant legislative and regulatory requirements in each State/Territory.

C) Determination of 'market rent' for the purposes of the 74.9% requirement

Clarity is also requested as to how the requirement in paragraph 43-152(3)(d) (i.e., that the rent payable for the affordable dwelling be 74.9% or less of the market rate) is to be assessed in respect of lease terms that are not common in the market (e.g., 2 or 3-year lease terms). It is important that the BTR development has a clearly defined and accepted approach to determining market value, particularly with respect to lease terms that depart from market practice, in order to have certainty as to the population of affordable dwellings at any given time.

D) Clarity of legislation as compared to the EM

Paragraph 1.29 of the EM outlines the following in respect of the minimum lease period:

> *"This requirement does not apply where a tenant requests a shorter lease term (a tenanted dwelling in this circumstance remains a dwelling in a BTR development)…"*

The wording of paragraph 43-152(3)(a) does not appear to clearly confirm that the BTR concessions will still be available if a lease arrangement is entered into with a tenant for a period shorter than three years.

It is also not clear practically how it could be established that this requirement has been satisfied – this in theory would require significant documentation to evidence that (i) each individual tenancy was offered for a three-year term; and (ii) negotiations occurred with the prospective tenant with the prospective tenant explicitly requesting a tenancy shorter than three years.

Submission:

The minimum lease period and associated requirements should be clarified, and updated as follows:

1. Market BTR dwellings should be permitted to be offered for a three-year lease term;
2. The Exposure Draft Legislation and/or the EM should be clarified to confirm that annual rent review processes are allowable, subject to State/Territory requirements;

3. The Exposure Draft Legislation should be clarified to confirm the methodology for determining market rent for the purposes of paragraph 43-152(3)(d), particularly in relation to lease terms uncommon in the market (e.g., 2 or 3-year terms); and
4. The wording of the Exposure Draft Legislation should be clarified to align with the policy intent set out in the EM, specifically in relation to the process of prospective tenants requesting a lease term of less than three years.

Submission 6: The reporting requirements should be simplified and streamlined

Section 43-153 of the Exposure Draft Legislation incorporates several reporting requirements in respect of the BTR concessions. The following reporting requirements appear to be contemplated:

1. Reporting to the Commissioner of certain ‘trigger events’ within 28 days of the event occurring. These events include:
    a. The BTR development commences to be an active BTR development (i.e., the BTR development becomes operational);
    b. An expansion of an active BTR development;
    c. A change in the direct ownership in an active BTR development; and
    d. The BTR development ceasing to be an active BTR development.
2. In addition to trigger event reporting, a trustee of a MIT must notify the Commissioner prior to making a fund payment where all or part of that fund payment consists of rental income under a lease of a dwelling that is part of an active BTR development during the BTR compliance period for that dwelling. The EM makes it clear that this reporting obligation supersedes existing reporting requirements under the *Tax Administration Act 1953*.

The notices that are required to be submitted to the Commissioner must be in an approved form. The term ‘approved form’ is defined in section 388-50 of the *Tax Administration Act 1953*, and importantly is relevant from a ‘failure to lodge’ penalty and significant global entity perspective.

A MIT that is majority owned by institutional investors is likely to be classified as a “significant global entity” in accordance with section 960-55 of the *Income Tax Assessment Act 1997*. Where a significant global entity fails to lodge an approved form with the Commissioner on time, the minimum penalty as at the date of this submission is AUD $156,500 (i.e., for a form that is lodged 1 day late).

These reporting requirements impose a significant burden on significant global entity investors such as PSPIB and create a material compliance risk for failure to comply. It is also relevant to highlight that in the context of real estate investments (including BTR developments), the operation of the building is often outsourced to a third-party manager. Accordingly, there may be scenarios where a trigger event has occurred due to the activities of the third-party manager and the investor is not aware (and therefore does not complete and lodge the relevant notices on time – which could result in material failure to lodge penalties).

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Submission:

- The reporting requirements for entities participating in BTR developments should be incorporated into a specific schedule that is lodged alongside the annual tax return for the MIT / AMIT. That is, the reporting regarding trigger events should be captured in one annual schedule, rather than imposing individual reporting requirements for each trigger event.

- To the extent that the information that Treasury is seeking in respect of BTR developments that cannot be captured in an annual tax return or schedule, all necessary information should already be provided to the Australian Taxation Office either through the Foreign Resident Capital Gains Withholding notifications and any additional information should be incorporated into the disclosures under this regime.

- The MIT fund payment reporting in respect of BTR concessions should be included as an additional component of the Annual Income Investment Report lodgement that is required to be completed by MITs / AMITs, rather than a standalone reporting requirement.

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PSPIB values and appreciates the ability to provide our views through the consultation process.

Yours sincerely

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