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Submission to: Australian Government, The Treasury

Build to Rent tax concessions

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Summary

The government proposes to equalise withholding tax treatment of Build to Rent (BTR) housing with that for other asset classes, and to bring the depreciation treatment of BTR developments into line with that for serviced apartments. Both of these changes are reasonable and deserve support in the interests of accelerating the expansion of a housing typology with the potential to fulfil several important housing policy objectives, as listed in Section 1 of this submission.

The proposal that BTR project eligibility for the new tax arrangements will depend on the inclusion of affordable housing units is also a laudable bid to satisfy another policy objective. The precise nature of the proposed affordable housing to be provided is, however, somewhat modest. It will be targeted to relatively high income households, and its affordable status will expire after 15 years. Thus, even within this limited period, the measures will make little or no contribution to easing unmet housing need experienced by low income Australians.

Even so, there are questions on whether a BTR project's associated loss of future revenue (through affordable housing regime compliance) may negate the advantage to a scheme proponent conferred by the tax changes as proposed.

If there are well-grounded fears that the net viability impact of the proposed changes may be negligible – or even negative – there could be a case for legislating the introduction of the currently envisaged affordable housing requirement for activation at a future date – e.g. applicable to schemes starting on site five years after the tax change. One argument for such an approach would be to support the objective of embedding BTR industry growth during the second half of the 2020s, particularly in support of the National Housing Accord 1.2 million homes new supply target.

Assuming, however, that the net viability impact of the proposed reform package is clearly positive, the package deserves support as it stands. Beyond that, the legislation should also stipulate an independent review after five years to consider scope for strengthening the affordable housing requirement at that stage.

More broadly, it seems illogical that a policy seeking to generate (sub-market) affordable housing provision in the course of market housing development is restricted to only a very small niche within overall residential development industry output. It would apply to neither domestically-funded BTR projects, nor – more importantly – to build to sell projects. This seems particularly incongruous when the targeted niche is an industry sector already placed at a competitive disadvantage by other property tax settings that are not proposed for reform (negative gearing, Capital Gains Tax discount, GST).

A more logical approach in attempting to secure a small contribution of sub-market affordable rental housing as a routine spin-off from new market housing development would be to:

- Expand the scope of such a policy to all new BTS as well as BTR housebuilding projects above a given threshold size – other than in areas with low land value
- Implement the policy via the landuse planning system rather than via the Federal tax system, through arrangements where development approval is conditional on pledged affordable housing contributions (sometimes termed 'mandatory inclusionary zoning').

All of this highlights the unsatisfactory nature of progressing housing reform in an unco-ordinated piecemeal manner, an approach certain to further add to regulatory complexity and cost. As already evident at the time of the 2010 Henry Tax Review, and as also exemplified in this submission, Australia's existing residential property taxation regime is riddled with illogicalities and inconsistencies. These call for a root and branch review to inform a comprehensive housing reform strategy.

1. Build to Rent housing – overview

Build to Rent is the term used in Australia to describe residential developments (usually apartment blocks) designed and constructed for long term rental use under a single owner – typically an institutional investor such as a super fund, insurance company or sovereign wealth entity. The prime business objective for BTR proponents is a secure and predictable income stream. This contrasts with the capital gain motivation typically uppermost for the small scale landlords who dominate Australia's private rental market.

The BTR model that has begun to emerge in Australia in recent years is tending to target high end tenants. And while it may be expected that industry output will diversify over time, it will generate housing affordable to low/moderate income earners only if regulated and/or incentivised to do so. As argued in a recent report by the National Housing Supply and Affordability Council[1], the model nevertheless offers scope to fulfil several other housing policy objectives:

1. Possible net addition to housing supply – conventional wisdom says will moderate both house prices and rents over time

2. When rental income (not capital gain) is prime landlord motivation, the product is inherently more secure tenure from tenant perspective

3. Multi-unit buildings commissioned for retention in single ownership should incentivise utility, durability and energy efficiency in design and construction

4. Professional and customer-oriented management promised by BTR is potentially beneficial for BTR tenants and perhaps beyond – as 'positive disrupter' for private rental housing more broadly.

5. As a new component of the rental market, BTR provision potentially broadens rental housing choice – albeit choice restricted to moderate to high income households

6. Given investor intentions for a long term hold, BTR construction demand promises to moderate housebuilding industry volatility in response to short-lived market downturns.

There is also the hope that, as mentioned above, regulatory instruments and/or tax concessions could harness industry growth via incorporation of sub-market rental accommodation in market price BTR developments.

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[1] NHSAC (2023) Barriers to Institutional Investment, Finance and Innovation in Housing https://nhsac.gov.au/sites/nhsac.gov.au/files/2024-02/barriers-to-institutional-investment-report.pdf

2. Build to Rent housing in Australia

In the form of purpose-built student accommodation (PBSA), BTR has been expanding steadily in Australia since the 1990s. By 2023 it was estimated that the industry had generated 84,000 bedspaces[2] (over and above those provided by universities themselves). Only since the late 2010s, however, has a 'mainstream market' version of BTR begun to emerge in some capital cities, notably Melbourne. Some 5,000 units had been completed by 2023, with 9,000 under construction and another 24,000 in the pipeline[3].

Institutionally financed purpose built rental housing is much more strongly represented in other high income countries, most notably in Canada and the United States. Its still very limited presence in Australia is partly attributable to its historically less favourable tax treatment compared with other forms of housing.

Unlike small scale private landlords, BTR investors do not benefit from standard state land tax liability thresholds and rates which are typically preferential for so-called 'mum and dad investors'. Also, by comparison with both build to sell (BTS) and PBSA developers, BTR proponents face higher costs of provision because – unlike the former – they are exposed to GST. While PBSA is arguably a variant of BTR, such developments are treated in the tax system as 'commercial residential' projects – meaning that they are effectively insulated from GST on expenditure. Beyond this, since most apartments built in contemporary Australia are purchased by small landlords, multi-unit BTS developers are also indirect beneficiaries of the negative gearing and Capital Gains Tax concessions that pump up the apartment prices that such purchasers are willing to pay.

As reported by BTR industry players, and validated by independent research[4], these factors contribute to a situation in which typically marginal project feasibility means that BTR developers are usually hard pressed to outbid residential developer market rivals for suitable sites.

Beyond this, as it attempts to gain a foothold in Australia, mainstream market BTR remains an unfamiliar asset class from the perspective of domestic institutional investors. Risk aversion towards BTR investment therefore remains high. For this reason, at least until it gains scale and maturity, Australian industry growth is likely to be substantially reliant on overseas-based funders – that is, institutions already well-accustomed to the BTR product from their interest in it in North America, Europe or elsewhere.

3. Managed Investment Trust tax liabilities

Managed Investment Trusts are the legal structures typically used to facilitate large-scale property investment, whether in the form of commercial, retail or – latterly – residential development. Unlike

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[2] Savills (2023) Australian Student Accommodation 2023 https://pdf.savills.asia/asia-pacific-research/australian-research/australia-student-accommodation/australian-student-accommodation-2023.pdf

[3] JLL (2024) Australian Apartment Market Overview Q4 2023 https://www.jll.com.au/en/trends-and-insights/research/australian-apartment-market-overview-q4-2023

[4] UNSW City Futures Research Centre (2019) Build-to-rent in Australia: product feasibility and potential affordable housing contribution; Sydney: Landcom https://apo.org.au/node/246516

other Australian companies, which pay 30% tax on their profits, MIT investment income is assessed for tax at the level of the Trust's unit-holders.

MITs can invest in residential property, but under current arrangements, income from 'residential housing' (other than affordable rental housing) is subject to a 30% withholding tax for foreign investors. Effectively, this means that overseas-based investors in BTR operations using MITs are taxed at a higher rate than domestic institutions and at a higher rate than overseas investors in other asset classes (e.g. commercial/retail property) where a 15% withholding tax rate applies.

From the industry perspective the more 'highly taxed' status of overseas-based BTR investors is considered both important and problematic because, for reasons explained above, overseas investors would be otherwise likely to act as prime movers in the hoped-for early expansion of an Australian BTR sector[5].

4. Budget 2023 reform proposals

MIT withholding tax changes initially announced in Budget 2023 have now been incorporated in a wider reform package for which Parliamentary endorsement is now sought. The key proposals are:

- Capital works deduction rate increased from 2.5% to 4% - i.e. allowing expenses to be depreciated for tax over a 25-year span, rather than standard 40 years, and
- Withholding tax rate on fund payments from eligible MIT investments reduced from 30% to 15%.

Relative to standard company tax rates (see above), the proposed new withholding tax rate is considered by Treasury as 'concessional'. From the industry perspective, however, the proposal is considered as 'levelling the playing field' since it also equalises tax liability on residential and commercial property income for asset-generated income regardless of whether the investor is a domestic or international entity. Similarly, in increasing the capital works deduction rate, the proposals bring BTR into line with the established framework for serviced apartments in this respect.

Qualification for the above arrangements is proposed as being conditional on the following:

- The development consists of 50 or more residential dwellings for rent
- The scheme is to be held as rental housing for at least 15 years
- Tenancies must be of at least 3 years duration
- 10% of the dwellings are made available as affordable tenancies.

Beyond this, the affordable housing obligation is more precisely defined as follows:

- Designated affordable units must be made available for at least 15 years
- Rent must be restricted to a maximum of 74.9% of 'comparable market rents'

[5] UNSW City Futures Research Centre (2019) Build-to-rent in Australia: product feasibility and potential affordable housing contribution; Sydney: Landcom https://apo.org.au/node/246516

- Affordable units must be rented out to households defined as in receipt of low-moderate incomes.

Proposed income limits are pitched relatively high at 120% of average earnings for a single person, 130% of average earnings for a couple, and 140% for a family with children. For a single person, as at November 2023, the nominal income limit would have been $122,000 – around double the allowable limit for NRAS eligibility.

5. Comments on reform proposals

For the reasons listed in Section 1, there is a valid case for Australian governments to encourage the expansion of BTR housing provision. That should include, at the very least, re-balancing of any taxation or regulatory regimes that unduly disadvantage BTR development with respect to competing forms of residential construction or in relation to other investment asset classes.

Beyond this, considering the sector's current 'infant industry' status, there could be arguments for at least temporarily providing substantive tax or regulatory concessions with the aim of enabling BTR to become established as a mature asset class. Consistent with this are the recent actions of most state governments in enacting 20-year discounts on BTR land tax liabilities[6].

Against this backdrop, the currently proposed BTR tax reforms appear reasonable in themselves. The stipulation that qualification for this tax treatment is conditional on the provision of sub-market rental units as part of a BTR project is more debatable. Granted, the incorporation of sub-market rate tenancies within market rate BTR developments is, in principle, an attractive prospect. Likewise, leveraging BTR industry expansion to generate affordable housing provision at no cost to government is undoubtedly appealing. However, a number of questions are raised by this aspect of the proposals.

Do the proposed tax changes represent genuine 'concessions'?

Stipulating that qualification for the reduced withholding tax rate and depreciation rule change is conditional on provision of affordable housing units would seem reasonable if the proposed changes can be fairly defined as 'concessions', particularly if the financial benefit derived by a BTR proponent is at least similar to the cost (or income forgone) of fulfilling the requirement as defined. If, however, the changes are more accurately characterised as tax equalisation measures, the justification seems more debatable.

What is the risk that the affordable housing requirement could compromise project viability?

The BTR development industry will naturally express concern that, at the project scale, the financial value of the proposed reforms may be no greater than the reduced landlord revenue that would result from affordable housing incorporation as specified. BTR developers might, as a result, choose to forgo the benefit of the reduced tax rate. The financial viability of BTR development would thus remain unchanged from the current status quo, meaning that industry expansion might well continue only at its current very modest pace. Such an outcome would frustrate the government's

[6] NHSAC (2023) Barriers to Institutional Investment, Finance and Innovation in Housing https://nhsac.gov.au/sites/nhsac.gov.au/files/2024-02/barriers-to-institutional-investment-report.pdf

declared intentions to facilitate the industry's more rapid expansion while, at the same time, boosting affordable housing provision.

It must be assumed that the proposals have been drafted in the belief that their net effect will be to enhance scheme viability, notwithstanding the associated affordable housing requirements as specified. It would be helpful for Treasury to publish its financial feasibility modelling demonstrating this. Unless the prospective financial gain from the proposed tax changes is substantial, associated affordable housing delivery responsibilities as specified will likely leave BTR developers at a continuing disadvantage against BTS and PBSA rivals who remain generally free of such obligations (an issue discussed in Section 6).

If there are well-grounded fears that the net viability impact of the proposed changes is negligible – or even negative – there could be a case for legislating the introduction of the currently envisaged affordable housing requirement for activation at a future date – e.g. applicable to schemes starting on site five years after the tax change. One argument for such an approach would be to support the objective of embedding BTR industry growth during the second half of the 2020s, particularly in support of the National Housing Accord 1.2 million homes new supply target. As it gains maturity and becomes familiar to the domestic finance sector, it would be anticipated that the industry should become increasingly capable of delivering meaningful affordable housing obligations.

Assuming, however, that the net viability impact of the proposed reforms is clearly positive, the package deserves support. Beyond that, the legislation should include a pledge for an independent review after five years to consider the scope for strengthening the affordable housing requirement at that stage. This suggestion reflects the judgement that the requirement, as currently proposed, remains modest – see below.

Another possibility that should be considered would be to equalise the tax treatment of BTR projects with that of other asset classes in relation to energy performance. Since other asset classes enjoy the ability to reduce their MIT tax rate from 15% to 10% by making their properties 5-star Greenstar, there seems a valid argument that the same should apply to BTR.

To what extent will the 'affordable rental' obligation meet housing need?

Irrespective of the financial viability question, it is important to consider the precise nature of the affordable housing obligation specified in the draft bills. On the one hand, the stipulation that 10% of units must be provided as such appears fairly ambitious. On the other hand, the time-limited duration of 'affordable' status (lapsing after 15 years) is a weakness. Moreover, both the 'discount to market' rent setting basis and the proposed income eligibility rules mean that the units are unlikely to be occupied by below average income earners.

Exactly how will 'affordable rents' be determined?

A detailed point in relation to rent setting for the affordable units is that it needs to be made clear in the legislation that the '74.9% of market rates' formula relates to market rents for comparable dwellings net of any element of BTR rents attributable to use of onsite community services – e.g. gyms and workspaces. In other words, affordable unit tenants need to be enabled to opt out of using – and paying for – such facilities.

How will the discharge of affordable rental obligations be ensured?

Another question concerns the administrative arrangements for the allocation and management of the affordable units. Some state government schemes that mandate the inclusion of affordable housing units within market rate developments require that the former are managed by registered community housing providers (CHPs). The same is true of the Commonwealth Government's 2017 amendment to income tax rules whereby an individual landlord can benefit from an increased discount on Capital Gains Tax (60% rather than the standard 50%) for a dwelling rented out at a discounted rate. Involving a registered CHP as suggested would provide greater assurance that the obligations will be appropriately discharged.

What about honouring affordable housing contributions via cash payments?

Consideration should also be given to the possibility that, particularly for smaller schemes (e.g. 50-100 units), a BTR developer could discharge its obligation via a cash payment equating to the associated financial cost. This would mirror the way that the City of Sydney's long-established scheme for developer contributions to affordable housing usually operates. Such payments could be accumulated by the relevant state/territory government and ring-fenced for subsequent disbursement as capital grants for social housing development.

6. A wider perspective

If implemented as currently proposed, and assuming BTR projects remain viable on this basis, the new regime will gradually generate a body of shallowly affordable housing as an offshoot of market BTR projects funded by overseas investors. Fifteen years after the introduction of the new regime the net growth of this cohort will probably begin to slow, as initially designated affordable units cease to be managed as such.

More broadly, a framework for incorporating affordable rental housing units as a small proportion of larger market housing developments is a highly attractive prospect, particularly if – as posited in land economics – the cost is borne by land value (which, being typically high in urban Australia, could realistically support this). At the same time, in the form currently proposed, the affordable tenancies that may be generated through these measures will make little or no contribution to easing unmet housing need among low income households.

Beyond this, it seems illogical that – as is now proposed – the application of such a policy is restricted to only a very small niche within overall residential development industry output. It would apply to neither domestically-funded BTR projects, nor – more importantly – to BTS. This is particularly the case when the targeted niche is, as it would seem, otherwise placed at a disadvantage by other property tax settings that are not proposed for reform.

A more logical approach in attempting to secure sub-market affordable rental housing as a spin-off from new market housing development would be to:

- Expand the scope of such a policy to all new BTS as well as BTR housebuilding projects above a given threshold size – other than in areas with low land value

- Implement the policy via the landuse planning system rather than via the Federal tax system, through arrangements where development approval is conditional on pledged affordable housing contributions[7].

While such policies would need to be implemented by state/territory governments, they could be financially incentivised to do so by the Commonwealth Government along the lines of the New Home Bonus scheme.

All of this highlights the unsatisfactory nature of progressing housing reform in an unco-ordinated piecemeal manner, an approach certain to further add to regulatory complexity and cost. As already evident at the time of the 2010 Henry Tax Review, and as also exemplified in this submission, Australia's existing residential property taxation regime is riddled with illogicalities and inconsistencies. An example with direct relevance to the subject of this consultation is the fundamentally different tax treatment of PBSA and mainstream BTR development. Such discrepancies call for a root and branch review to inform a comprehensive housing reform strategy.

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[7] Constellation Project (2023) Mandatory Inclusionary Zoning: National Framework https://www.communityhousing.com.au/wp-content/uploads/2023/10/NHHP-Submission-MIZ-national-framework_2023.pptx.pdf?x57237