BUILD-TO-RENT - AUSTRALIAN INCOME TAX CONCESSIONS: FOUNDATIONS LAID, BUT POTENTIAL CRACKS AND MISSING FEATURES MAY YET PLAGUE A PROMISING DEVELOPMENT

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The Australian government has, nearly 12 months after announcing them, released draft legislation to implement two key income tax incentives for build-to-rent (BTR) projects:

- Extending the 15% withholding tax for foreign investors in a managed investment trust (MIT) to BTR rental income from 1 July 2024 (Reduced WHT); and
- Accelerated capital works deductions (4% per annum versus 2.5%) on construction expenditure incurred since 9 May 2023, allowing earlier "tax deferred" returns of capital (Accelerated Depreciation).

Implementing these measures is a positive foundation for BTR - facilitating the delivery of BTR projects is critical to addressing some of the housing shortages in Australia. They remove *some of* the tax barriers to BTR projects. Importantly the measures begin to *reduce* the tax distortions between BTR projects and other commercial or industrial real estate developments. The Reduced WHT is particularly important to attract foreign capital to the BTR sector - and the important role of foreign capital is evidenced by a majority of the significant BTR projects announced involving foreign capital partners. The draft measures also address some key issues we flagged in our previous BTR series (see Part 2 and Part 3).

However, there are unfortunately still a number of issues arising from the draft legislation that may undermine these positive foundations and other tax barriers and issues that remain unaddressed.

SUMMARY OF THE QUALIFYING REQUIREMENTS

The Reduced WHT is proposed to apply to distributions by an MIT of rental income from Active BTR Developments from **1 July 2024**. Accelerated Depreciation is proposed to apply from Active BTR Developments with capital works *begun* after 9 May 2023.

In summary, a development is an Active BTR Development where:

- It consists of at least 50 residential dwellings (in a single building, or when aggregated with other buildings on the same or "adjacent" land) in Australia (and an Active BTR Development will automatically expand if additional dwellings in the building begin to meet the remaining requirements);

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- Every one of the dwellings in the project is at all times either (a) available to the public for a lease, or leased as a result of being made available to the public for lease, where the offer for lease was for a term of three years or more (although the *tenant* can choose to accept a shorter term); or (b) temporarily unable to satisfy (a) due to extensions, alterations, improvements or repairs;
- The dwellings are not part of "commercial residential premises" (e.g. boarding house, hotels);
- All of the dwellings and their "common areas" (areas, facilities, or amenities intended for the use of any dwellings) are owned by a single entity;
- Of the dwellings, 10% or more are "affordable dwellings" (proposed as >75% market rent and leased to a person or household meeting with income less than the relevant income limit);
- Every one of the non-affordable dwellings must have a corresponding "affordable dwelling" that is the same size and has the same amenities (i.e. there must be an "affordable" version of every dwelling of a particular size and amenity in the development); and
- All of these conditions must be satisfied for a continuous period of 15 years (although where the development expands, the 15-year period for the additional dwellings runs from that expansion without affecting the original 15-year period).

Importantly, if those conditions cease to be met at any time in that 15-year period, the entity owning the development is liable for "*Build to Rent Misuse Tax*". That "claws back" the full amount of any Accelerated Depreciation and Reduced WHT benefit across the life of the development (plus an interest component).

There are also additional reporting requirements imposed, including on becoming, ceasing to become or making a payment of rental income from an Active BTR Development.

SOME OF THE FOUNDATIONS ARE STRONG

The draft legislation does, in some respect, contain important elements:

- The ability for the Active BTR Development to be sold to another entity (i.e. for the single owner to change), as well as the freedom for underlying investors to enter and exit. Given the long-term requirement, this allows different investors' capital allocation and risk appetites to be catered for, unlocking greater supply. For example, it allows investors with higher risk but shorter tenor appetites to get the development to operating status, and then for more patient but lower risk appetite capital to take it over. Unfortunately, as set out below, this flexibility is then somewhat undermined.
- Flexibility for a single Active BTR Development to be spread across multiple buildings and "adjacent land". This allows mixed-used developments that not only allow better management of returns and risks but also are more appealing (by allowing complementary tenancies like supermarkets, cafes etc.).
- Allowing existing buildings (e.g. lower-grade offices, hotels, industrial space) to be converted to BTR with capital works on the conversion qualifying for Accelerated Depreciation (as well as rental income from such conversions qualifying for Reduced WHT).

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WHERE ARE THE POTENTIAL CRACKS IN THE FOUNDATIONS?

Unfortunately, there remain some serious challenges with the draft legislation:

Issue	K&L Gates comments
Distortion between BTR and commercial or industrial real estate	▪ In reality, BTR needs to be treated for tax purposes in *at least* the same way as commercial or industrial real estate (i.e. in relation to Reduced WHT), otherwise it will not compete for global capital. ▪ However, the requirements to access the Reduced WHT are far more onerous for BTR than other investments, including, in particular, the requirement for affordable housing, the imposition of a clawback and the 15-year holding period or limitation. ▪ Whilst a comprehensive set of Active BTR Development requirements *may well* be appropriate for an *additional incentive* like Accelerated Depreciation (or, for example, if the Reduced WHT was reduced to 10% (as for clean buildings) where those conditions are satisfied), having them as a gateway to access the Reduced WHT at all unduly burdens BTR developments (which are often *more* (and not less) marginal from a financial perspective) relative to other investments. These onerous conditions may instead mean it is not financially viable to comply with them, with the consequence that BTR may not attract significant foreign capital as the current 30% rate that applies is also not internationally competitive. ▪ At a minimum, access to the Reduced WHT should not include the affordable dwelling requirements or be subject to a clawback (as discussed below). The 50 dwelling, minimum lease terms and single entity requirements are already sufficient to ensure that BTR developments are at "commercial" scale and comparable to commercial or industrial developments.
Affordable housing should be looked at separately	▪ Whilst there is no doubt a need to deliver affordable housing (and affordable housing of a good standard), the draft legislation continues to mix together the objectives of delivering additional housing (BTR generally) and delivering affordable housing. ▪ The risk is that the affordable housing requirements (which are not flexible) mean that BTR developments do not get delivered at all. Experience overseas suggests that affordable housing needs to be specifically incentivised (and the Accelerated Depreciation can be one measure towards that, although it is unlikely to be a particularly effective incentive given it is likely to be a deferral of tax at best). ▪ In our view, the Reduced WHT benefits should be offered to BTR developments generally, even without affordable housing components. A further reduction in the withholding tax rate could potentially be offered for developments that do include an affordable housing component (and meet the relevant conditions). The Reduced WHT would incentivise supply generally to meet a housing shortage, and any further reduction (alongside the Accelerated Depreciation) would incentivise affordable housing.

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Unclear why clawback is required for Reduced WHT for rent	▪ As drafted, if the clawback applies, it recovers all of the historical benefit from the Reduced WHT. It is unclear why this is appropriate policy. Unlike Accelerated Depreciation (which is an *additional incentive* and where it might be said that the size of the benefit received is disproportionate if the development does not meet the conditions for the full period), Reduced WHT only applies to the rental income derived whilst the conditions were satisfied. It is not as if extra rent can suddenly be collected and be subject to Reduced WHT because the conditions cease to be satisfied. ▪ This clawback is not a feature of the Reduced WHT applicable to other MIT investments (and so it again applies a relative disadvantage to BTR). Accordingly, the Reduced WHT on rent should not be subject to a clawback.
Too many "hair triggers" for the clawback	▪ Irrespective of the scope of the clawback, because of the way an Active BTR Development is defined, the triggers of the clawback can operate far too onerously and significantly constrain flexibility. ▪ Take a development with 60 dwellings - if at any point in time the owner wanted to sell a dwelling (because the economics no longer worked for it as a BTR asset), this would immediately undo *all* of the Reduced WHT and Accelerated Depreciation for the whole development (despite the project continuing to have more than 50 dwellings that meet all the requirements). ▪ Or if for some reason there is a mistake on market rent so that an affordable dwelling is 75.1% of market rent rather than 74.9%, or a tenant fails to meet the income criteria for affordable dwellings (maybe they receive an unexpected bonus or sell an asset), again, as drafted, the whole development stops being a qualifying development and the clawback applies to the whole life of the project. ▪ Equally, this may act as a disincentive to experiment with expanding the BTR component. The expansion rules (which appear to be intended to allow expansion by using the existing dwellings to meet the conditions) mean that those additional dwellings also become part of the original Active BTR Development. However, there is no facility to take those dwellings back out of the BTR regime without the clawback applying to the whole project (original and new, and all the way from the start). ▪ The clawback needs to be more granular - for example, by applying on a per dwelling basis where the BTR development still otherwise meets the criteria; and either not apply to the affordable housing rules (or a temporary failure to meet those rules). It should also be clear that any affordable housing requirements in relation to below-market rent and income are assessed at the start of a tenancy.
Reduced WHT not applicable to	▪ The Reduced WHT provision only applies to the rental income from the Active BTR Development. It does not appear to apply to either the distribution of the capital gain on any sale of the whole development to another single entity, or the disposal by

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sale proceeds	underlying investors (despite this being the case for commercial and industrial developments). ▪ As already outlined, the flexibility to allow investors to change and for different risk and tenure profiles to be accommodated across the life of the project is critical. However, this lack of Reduced WHT undermines the flexibility that was introduced. ▪ Even if this Reduced WHT on disposal were subject to the clawback (which ensures that the project cannot be sold for a gain that reflects that the new owner will immediately undo the BTR), this would be an improvement.
15-year time frame or time limit	▪ It is not clear what has justified a 15-year period, given the original government announcement referred to 10 years. The key issue is whether this deters capital, and it may, given the interaction with the clawback means there is a significant period over which capital is at risk of losing the concessions. Notionally, the ability for the project to be sold or for underlying investors to exit may mitigate this (but only if the tax settings for exits are appropriate). ▪ However, it is even less clear why the Reduced WHT should cease to apply after 15 years. Again, that measure only applies to the rental income, and one would have thought if the conditions continue to be satisfied, the Reduced WHT should apply. If the desire is to try and promote capital recycling into new BTR developments (and sale of housing stock), this should be addressed through specific incentives.
Lack of clarity and flexibility around key requirements	▪ There is a lack of clarity and flexibility around other key requirements. ▪ For example, the rules (positively) allow for multiple buildings on adjacent land (and which could allow mixed-use developments as well as more creative large-scale developments over a precinct rather than a single piece of land), but the rules do not explain the meaning of adjacent land (and cross-refer to rules designed for single dwellings). ▪ The common area requirements do not appear to allow shared use of common areas in mixed-use developments, as any common area used by the dwellings must be owned by the single entity that owns the dwellings, and it is not clear whether those common areas could also be provided to other tenants in a mixed-use development. This may operate very inflexibly unless addressed (for example, it is not clear why the common areas are relevant at all to these rules, provided that all residents had access - even in the Accelerated Depreciation, shared common areas should be able to be dealt with, perhaps on a pro-rata basis). ▪ The affordable dwelling requirements around each nonaffordable dwelling having an affordable dwelling that is the same size and amenities, this is prescriptive and inflexible - minor differences in storage, car bays, floor plates etc. would appear to prevent this being satisfied. Whilst it is an understandable desire to ensure that the

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	affordable dwellings are not substandard, this needs to be applied more flexibly.

WHAT FEATURES HAVE BEEN LEFT OUT OF THE PLANS?

In addition to potential cracks in the foundation, a number of the tax barriers to BTR have not been addressed at all, leaving a development with missing features. Some of these are in the control of the federal government and some require cooperation with the states. All remain barriers that need to be addressed to make BTR successful (particularly because many of the same barriers do not exist for commercial and industrial real estate developments). Some of the key issues are as follows:

- The draft legislation makes clear that a BTR development is not, and cannot, be "commercial residential premises", and otherwise does not address any GST issues. In short, that means BTR developers cannot claim GST input tax credits on their costs of acquiring and constructing the development (whereas such credits are available to "build-to-sell" developers). It adds 10% to the effective cost of the BTR development, and where margins can be tight anyway, can be a real barrier to feasibility. Even allowing the input tax credits to be claimed back upfront and then repaid over the 15-year timeframe (or earlier, if sold) would materially assist cash flows and reduce the upfront GST burden;
- Whilst the federal rules have many things in common with state-based concessions for duty and land tax (including generally the minimum number of dwellings and three-year lease terms being offered), there remain differences across the jurisdictions that can be difficult to navigate;
- No clarity has been provided that a BTR project is an "eligible investment business" for the purposes of the "trading trust" rules (which is a precondition for MIT eligibility). Whilst the minimum holding period of 15 years should *surely* mean the primary purpose is to derive rent, the historical views treating residential property development as a trading-type activity remain as a cloud of unnecessary uncertainty. This is particularly so where the plan may be for a developer to sell the Active BTR Development. It would have been easy to specifically allow an Active BTR Development as an eligible investment business; and
- There has been no specific measure to deal with how an Active BTR Development can provide ancillary services (which are not "eligible investment businesses") which overseas experience suggests can make BTR a more attractive proposition for tenants. Whilst there appears to be no restriction on outsourcing (unlike some state tax concessions), this requires a more complex structure (whereas it would have been better to allow any income from those ancillary services to be included in the rental income).

WHERE DO WE GO FROM HERE?

The draft legislation has been going through the process of consultation, and it is hoped that some or all of the above issues will be addressed. To achieve this, a version of this article has been submitted to treasury as part of the consultation process on the draft legislation. Otherwise, what is a promising start may not actually see BTR projects delivered to address housing shortages. The government needs to decide whether it really wants to BTR to be successful, and if so, adopt a more realistic approach.

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