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Consultation: Increasing the Supply of Affordable Housing

The Property Council of Australia welcomes the opportunity to comment on the draft *Treasury Laws Amendment (Reducing Pressure on Housing Affordability No. 2) Bill* ("the draft legislation").

The Property Council strongly supports the Government's commitment to tackling housing affordability, including its strong stance on retaining the negative gearing and capital gains tax settings for mum and dad investors, using financial incentives to drive new housing supply and introducing targeted measures to address housing affordability.

However we believe the proposal to extend the Government's Affordable Housing MIT budget announcement to preclude all other residential property from MITs undermines these policy priorities.

Government incentives to attract institutional scale investment into the affordable rental housing sector are much more likely to be successful if there is a robust Build-to-Rent sector that delivers long-term rental housing. Precluding Build-to-Rent investments from being held by MITs will adversely impact this sector from establishing in Australia at scale. We are aware of 23 potential Build-to-Rent projects that were expected to deliver over 14,600 new rental dwellings that are now on hold as a result of the draft legislation.

For institutional capital, investing in a Build-to-Rent asset is considered primarily on income yield derived from rents, akin to investing in an office or shopping centre. The investment vehicle and tax settings for legitimate Build-to-Rent assets should be aligned with what is available for other commercial real estate investments – i.e. an MIT vehicle and access to the MIT withholding tax rates. The 15% MIT withholding tax rate is comparable with the tax rate payable by domestic superfunds, as well as international investors in the US, UK and Canadian residential REIT markets.

The proposed limitation on MITs holding residential premises also triggers seemingly unintended consequences in relation to retirement villages, student accommodation, ancillary residential investments made by commercial real estate funds and offshore residential investments.

The potential effects of the draft legislation represents new policy by Government that was not canvassed in the Budget or in any other Government review or statement.

Given the substantial potential benefits of a healthy Build-to-Rent sector, we recommend that the Government separate this issue from the draft legislation and establish a short, sharp review of the establishment of Build-to-Rent in Australia and explore the role it can play in helping the Government achieve its stated public policy goal of increased housing affordability. This would enable a more considered review of Build-to-Rent without the limitations of a two-week consultation period.

Our attached submission sets out how a healthy Build-to-Rent sector can contribute to the supply of affordable housing and outlines its significance, along with the retirement living sector, in alleviating housing affordability pressures. The submission also notes the importance of attracting international capital to underpin the supply of housing for Australians.

Given the critical nature of the concerns raised in our submission, we would welcome the opportunity to meet with you to discuss these issues further. Please do not hesitate to have your office contact Tiffany Duarte on [redacted] or [redacted] to arrange a suitable time.

We look forward to hearing from you.

Yours sincerely

Ken Morrison
Chief Executive

PROPERTY COUNCIL of Australia

PROSPERITY | JOBS | STRONG COMMUNITIES

Submission on exposure draft legislation

Treasury Laws Amendment (Reducing Pressure on Housing Affordability No. 2) Bill

September 2017

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Executive Summary

This submission recommends that the issue of whether to facilitate a Build-to-Rent housing sector in Australia be separated from mechanical legislation designed to enact the Budget's affordable rental housing announcements.

This submission also makes recommendations on other seemingly unintended consequences of the exposure draft legislation, particularly in relation to retirement villages.

Build-to-Rent is a well-established housing form in North America, Japan, the UK and parts of Europe. However, market conditions have meant that this sector has never established in Australia. As a result, to our knowledge, the ATO has not received requests to include genuine Build-to-Rent passive-income based investments within a managed investment trust (MIT) structure until now.

Market conditions in Australia are now close to making Build-to-Rent investments viable in a sustainable way, and there is an increasing focus on this from major Australian property companies. As a result, Australian property companies have begun seeking ATO approval to include genuine Build-to-Rent investments within a MIT. We are aware of at least 23 Build-to-Rent projects under consideration which could deliver a minimum of 14,600 new rental dwellings into the market.

The draft *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No.2) Bill 2017* would have the effect of precluding Build-to-Rent from utilising a MIT structure. This would effectively prevent Build-to-Rent establishing in Australia at scale.

This represents a new policy position of Government that was not canvassed in the Budget or in any other Government review or statement.

Given the substantial potential benefits of a healthy Build-to-Rent sector, we recommend that the Government separate this issue from the Budget legislation and establish a short, sharp review of the establishment of Build-to-Rent in Australia. This would enable a more considered review of Build-to-Rent without the limitations of a two-week consultation period.

Why Build-to-Rent is good for Australia

A healthy Build-to-Rent sector is highly aligned with the Government's housing agenda and provides significant benefits for Australia:

1. ***A better quality experience for people who rent***
    - longer tenure options
    - purpose-built facilities with common areas, concierge services and pooled amenities
    - a curated approach to community
    - professional management

2. ***An additional source of housing supply that is not linked to traditional build-to-sell construction cycles***
    - the Government has rightly prioritised initiatives to encourage more housing supply to address housing affordability in a sustainable way

- normal build-to-sell housing construction will occur when a developer believes they can sell for a profit – supply surges and slows as a result
- Build-to-Rent housing creates an asset designed to generate long term rental income flows
- while build-to-sell will always be the dominant source of housing supply, Build-to-Rent can provide additional supply that is not linked to traditional construction cycles
- this additionality of supply is a key reason for the UK Government's strong support for the Build-to-Rent sector in that country
- in the US, investment in multi-family housing actually increased following the GFC.

3. A willing partner to achieve a pipeline of affordable rental housing

- Commonwealth, state and local governments are increasingly interested in incentivising the provision of affordable rental housing
- a healthy and growing Build-to-Rent sector provides the best platform for governments to deliver this outcome
- governments can incentivise this outcome through tax concessions, density bonuses or mandating outcomes on the disposal of government land
- without a healthy at-market Build-to-Rent sector, there is less likely to be a take-up of such government incentives at a scale that will be required to meet the social needs in our large cities.

Why MITs are an appropriate vehicle for Build-to-Rent

MITs are the preferred vehicle for attracting institutional investment into real estate – as such they provide the best opportunity to create Build-to-Rent at scale.

Importantly:

- MITs provide transparency and liquidity for investors and the market
- Legitimate Build-to-Rent satisfies the ATO's passive income tests
- The MIT tax settings should treat Build-to-Rent in the same way as commercial property investment given the common feature is passive rental income
- MITs provide Australian superfunds and foreign investors with equivalent 15% taxation settings
- The MIT requirement for investments to be widely held ensures that foreign investment is not channelled into inappropriate forms of housing or competing with Australian housing purchasers
- MITs are subject to a robust tax and regulatory framework, for example, a non-resident individual cannot inappropriately access the MIT withholding tax rates by setting up a MIT
- MITs provide a deep and liquid market for Build-to-Rent assets for Australian developers who choose to create such assets outside of an MIT structure
- Build-to-Rent MITs do not displace traditional 'mum and dad' owners of investment properties who benefit from negative gearing and capital gains tax setting.

Restricting investment in residential property by an MIT would put Australia out of step with comparable countries such as the US, UK and Canada who all permit residential investment through their REIT rules, and impose a comparable 15% tax rate on non-resident investors.

A Government review of Build-to-Rent

The benefits or otherwise of the potential establishment of Build-to-Rent in Australia should be given appropriate consideration, which is simply not possible in the context of mechanical budget legislation and within the limitations of a two-week consultation period.

The UK Government's efforts to understand and subsequently support Build-to-Rent provides a useful precedent for Australia. In 2012 the Montague Review delivered a targeted report on the benefits of this sector and the actions needed to support it. In 2017 the UK Government's housing white paper expanded on these principles.

We recommend that the proposed limit on an MIT investing in residential property be removed from the draft legislation and an appropriate eminent Australian be appointed to conduct a short, sharp consultative process into the issues surrounding the potential establishment of Build-to-Rent in Australia.

We suggest that Glenn Stevens would be an ideal person for this role, particularly given his recent short, sharp review on housing affordability for the NSW Government.

We understand the Government's desire to ensure revenue integrity and retain community confidence in the role of foreign investment in the creation of housing for Australians. We believe solutions can be found to address these concerns while not blocking the establishment of Build-to-Rent in Australia.

We would also encourage a key element of any review to explore the role Build to Rent can play in helping the Government achieve its stated public policy goal of increased affordable housing.

Impact on retirement living

We strongly encourage the Government to reconsider its decision to use the legislation to prohibit the use of an MIT ownership model for retirement and seniors' accommodation.

The current law (and practice) allows for the market to determine, subject to satisfaction of MIT rules, whether retirement and seniors living is best held in a MIT, trust or company.

Our submission outlines the case of owners who have long operated retirement villages under a MIT – some back as far as 2004 - and the scale of investments that would be impacted by a retrospective change, given any new retirement village projects will effectively result in the loss of MIT status for the entire group. Forcing a restructure of these businesses would increase their cost of capital and in many case lead to increased costs for residents.

Given these retirement and seniors accommodation providers have long acted in accordance with the law, retirement villages offer an affordable choice for residents, and the substantial benefits to residents and government from retirement villages, we believe the status quo should apply.

Other issues with the draft legislation

If Government proceeds with the proposed limitation on MITs holding residential property, it is critical that the following issues are addressed with the draft legislation:

- **Ancillary residential property ownership** – Australian MITs will sometimes own small amounts of residential property if it is ancillary to future expansion plans for their

commercial property or as part of a future development site. The income from these is a minor part of the overall investment. Such sites can be held for many years.

- **Offshore investment** – the draft legislation would prevent Australian-based MITs from investing in offshore multi-family or Build-to-Rent funds.
- **Student accommodation** – student accommodation is a form of purpose built residential accommodation that will be impacted by the proposed prohibition on MITs investing in residential premises to the extent it does not qualify as "commercial residential premises".
- **Existing development projects** – the 14 September start date for the measure has a retrospective impact for any MITs which may have developments or acquisitions underway that complete after this date, which effectively negates the ten year transition period being proposed.

We have provided suggested amendments to address these issues in our submission.

Property touches the lives of all Australians

Property is the nation's largest industry and creates prosperity, jobs and strong communities.

Property is a major part of both the household balance sheet and the Australian economy.

Property:

- directly contributes 11.5 percent of economic activity – or $182 billion to Australian GDP.
- is the nation's second largest employer, creating 1.1 million jobs – which is more than mining and manufacturing combined.
- helps provide a wage to one in four Australians.
- pays $72.2 billion in wages directly, and another $119 billion in wages indirectly.
- delivers 16 percent of the nation's tax revenue, with $72 billion in taxes paid to federal, state and local governments.
- allows people to save for their retirement and reduce government's pension costs, with 14.1 million having a stake in property through their super funds.

About the Property Council

The Property Council of Australia champions the interests of more than 2200 member companies that represent the full spectrum of the industry.

Our members are the nation's investors, owners, managers and developers of properties of all asset classes. They create the landmark projects, environments and communities where people can live, work, shop and play.

The property industry shapes the future of our cities and has a deep long-term interest in seeing them prosper as productive and sustainable places.

Housing markets and housing affordability

Housing affordability means offering people the option to live and work where they wish, match housing options to their lifestyle and family needs, and the comfort of having a good home.

This includes ensuring that there is a choice of affordable tenure options for all Australian households – whether that be home ownership or forms of rental product.

The Government's policy agenda

The Government outlined its policy solutions to improve housing affordability in its 2017 Budget with a strong focus on improving supply and the importance of long-term rental as an important form of tenure – this included:

- A scalpel approach to negative gearing to maintain public confidence in the integrity of the deduction and to maintain the delicate balance of rental markets.
- A strong focus on improving housing supply through incentives for planning reform, a National Housing Infrastructure Facility, land disposal and the National Housing Finance and Investment Corporation.
- Charges and restrictions on individual, foreign investors targeting the demand for residential property.
- An intent to remove blockages to encourage long term investment in affordable rental housing
- Support to overcome the deposit gap and reducing the barriers to downsizing.

The establishment of a Build-to-Rent sector in Australia is entirely consistent with this policy agenda.

Australia's residential market

Traditionally, Australia has adopted a "build-to-sell" approach to residential property.

That is, developers build residential properties (typically detached dwellings or strata apartments) that are sold to individual buyers – who either live in the home ("owner occupiers") or rent the properties in the private rental market ("individual investors").

Development stock for sale will continue to remain the dominant form of housing provision in the Australian market.

However, the provision of rental stock will become more important given:

- The number of Australians renting now totals 6.5 million – and continues to grow.
- The average age of first home buyers has increased to 38 years.
- Australia has consistently failed to develop sufficient housing stock for sale to meet the demand of buyers – with the current estimated deficit approximately 150,000.
- House price to income ratios have grown due to the market imbalance, rising from 4.3% to 6.9% over the past 15 years.
- The deposit gap is widening – with 85.9% of an average household's annual income needed to pay the deposit in 2001, which has risen to 138.9% in 2016.

The high rate of population growth in our major capital cities – combined with poor housing supply and planning policies, as well as excessive property taxes – will exaggerate these effects.

The housing cycle – and our economic trajectory

The housing construction cycle which has been central to Australia's economic fortunes over the past five years is now on the turn.

Building approvals peaked at 242,423 in August 2016 – and have since fallen 10.6% to 216,794 in July 2017.

Dwelling commencements have also fallen in the past nine months – with each of the four largest capital cities recording a drop-in commencements in the past quarter.

Industry expectations are that over the next two years housing supply will continue to contract significantly, but not go into steep decline. However, the number of households requiring housing will increase by an additional 4.3 million to 12.7 million by 3026.

There are myriad reasons for the peak being passed, including:

- Stricter regulatory controls on capital seeking to exit China, making it harder for individual investors as well as development finance to enter Australia.
- Active measures by APRA and the major banks to manage perceived risk in the financial system.
- Higher interest rates for some categories of investors, as well as a sharp contraction in capital for development projects.
- Weaknesses in some state economies (and some micro markets perceived as having too high a degree of risk attached).
- Inefficient and complex planning systems which mean speed-to-market for new projects is out of cycle with demand, and adding to the cost of new housing.

The slowdown in new home construction make it imperative solutions like Build-to-Rent – which have durability over the cycle – remain on the table for governments seeking to maintain economic investment and jobs.

Role of "Build-to-Rent" in alleviating affordability pressures

The housing affordability challenge and changing demographics has resulted in an increasing proportion of people renting for longer periods. The Treasurer has led the debate about alternative rental supply models and the factors holding institutional investment back from this asset class in Australia.

What is "Build-to-Rent"?

A "Build-to-Rent" residential asset is different to other forms of residential accommodation.

In the UK, it is defined as purpose-built apartment buildings designed for the rental market.

It can include features such as:

- Developments at scale (100+ units)
- Designed with the tenant in mind
- Designed and managed to create a community feel
- Fitted out with specific amenities (e.g. concierge desk, business centre, gym, pool etc)
- Dedicated management staff (generally on-site)

Globally, Build-to-Rent is also referred to as multi-family, the private rental sector and residential for rent.

Benefits of "Build-to-Rent"

There is significant evidence from the UK that supporting large scale developments specifically designed for private rent (or with substantial private rental element) delivers real benefits for:

- tenants and the community
- housing supply
- broader economy

Importantly, a successful build-to-rent sector is the best platform for industry to partner with Government to supply residential rental accommodation to lower income households. This is discussed further below.

Benefits for tenants and the community

Build-to-Rent is designed to provide a better quality rental experience for renters.

Importantly, it offers tenants:

- Security of tenure – e.g. longer-term leases.
- Flexibility within the tenancy – e.g. tenants can have pets, hang pictures on walls.
- Greater onsite amenities – e.g. common room facilities, flexible workspace and childcare.
- Housing in close proximity to employment areas, public transport and amenities.
- Professional building manager (usually on-site) and timely maintenance and repairs.

There is also a strong incentive for Build-to-Rent projects to ensure the neighbourhood and services around the building thrive – as such, these developments often act as placemakers for the broader community, and form part of broader urban renewal precincts.

Given the long-term interest of investors in Build-to-Rent, the design of the buildings are also likely to achieve higher energy efficiency ratings and sustainability credentials.

Benefits for housing supply

Build-to-Rent offers an additional, less cyclical source of capital to support housing development.

By way of example, in the UK following the global financial crisis, tightening lending restrictions, recession and wage stagnation meant young home buyers did not have the deposit needed to purchase new housing stock, which led to the collapse of private homebuilding. At the same time, there was still strong demand for housing from the under 35s who work in key urban areas. Build-to-Rent provided the platform to continue to deliver much-needed rental housing supply into the market during the construction downturn.

Critically, Build-to-Rent investments are based on long term prospects for housing demand and can support the continual delivery of housing supply when traditional housing construction levels are low:

- Less construction risk – developments of scale can be completed for a single client reducing the off-the-plan sales risk.
- End buyer certainty – more certainty of an end buyer de-risks large-scale capital-intensive projects such as those in urban renewal sites.
- Absorption – dwellings are sold to a single entity rather than being sold to individual buyers at a sluggish sales rate.
- Mortgage reliance – the delivery of new housing supply is not tied to the constraints of mortgage affordability to underwrite new developments.
- Efficiencies – faster construction programs can allow for the capital being deployed to be recycled more quickly into further schemes.

Benefits for the broader economy

A stable housing supply pipeline underpins jobs in the housing and construction sector.

The British Property Federation estimates that the £10 billion of identified investment into Build-to-Rent would generate around £28 billion of wider economic benefit and the construction of an additional 10,000 new homes each year will add about £1.2 billion to the economy and create 11,000 jobs.

The scale of new housing supply as a result of Build-to-Rent can be fully appreciated through the Brittish Property Federation's interactive supply map:

http://www.bpf.org.uk/what-we-do/bpf-build-rent-map-uk

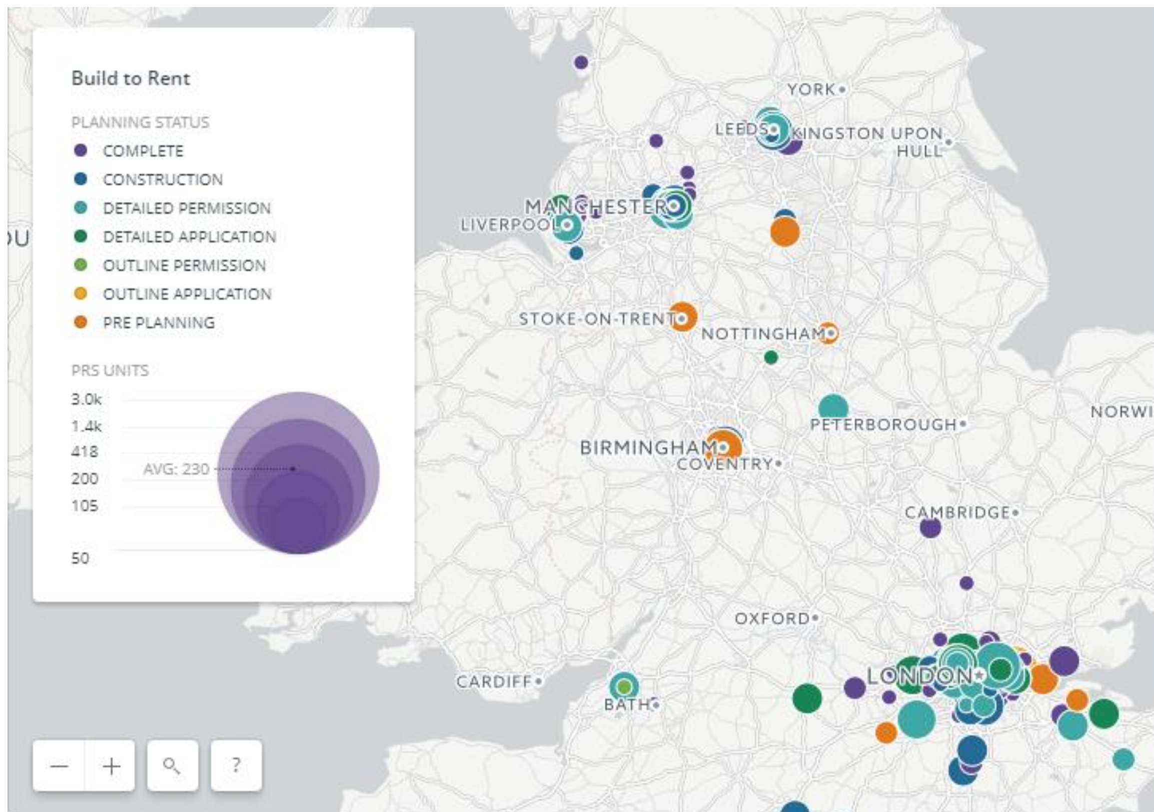

Figure 1 A Snapshot of new planned or completed Build-to-Rent Developments in the UK

A robust rental housing market also supports a more mobile workforce, allowing people to move to where jobs are located. Research has suggested that there is rigidity in the labour market as a consequence of restricted rental choice. This also has broader implications for attracting global talent and businesses. Silicon Valley is the prime example where the development of Build-to-Rent housing has been unable to keep pace with demand resulting in the relocation of key tech businesses relocating to other part of the country.

An alternative real estate sector

Globally, the Build-to-Rent sector is one of the largest commercial real estate asset classes.

Large sophisticated institutional investors – including superfunds, sovereign wealth funds and insurance companies – will generally allocate part of their capital to investments in real estate to diversify their portfolio and generate the best returns for their members.

This can include commercial real estate investments such as office buildings, shopping centres and industrial precincts.

The Build-to-Rent sectors in the US, UK, Canada and other jurisdictions have been able to tap into this institutional capital to transform the supply of rental housing and improve the quality of the rental experience.

The UK experience

Over the past five years, the UK has gone from not having a Build-to-Rent sector to now having 83,650 Build-to-Rent units either completed or planned across the UK, including 15,925 completed, 20,618 under construction, and a further 47,107 with planning permission[1].

The emergence of the Build-to-Rent sector in the UK has come about because it has been a central plank of the UK housing policy. The UK Government's Housing Strategy recognised the increasingly important role of the private rented sector in both meeting people's housing needs and supporting economic growth[2].

The UK Government acknowledged the widening gap between housing supply and household growth resulting in a series of policy changes to stamp duty when purchasing bulk residential and reforms to make REITs work better for residential property to stimulate significant flows of new institutional investment into build to rent.

To accelerate the rate of investment into purpose built-rental properties, in 2012, the British Government commissioned Sir Adrian Montague to consider the potential for attracting large scale institutional investment into new homes for rent.

The Montague Review made a suite of recommendations to overcome the existing barriers to accelerate large-scale investment including:

- The Government clearly signals the importance it attaches to the Build-to-Rent market by reaffirming its commitment to release public land for Build-to-Rent projects and by providing carefully targeted financial support.
- Local governments must specifically recognise the role of the private rented sector when assessing housing demand and planning for housing as part of their strategic housing assessments.
- Local governments should revise community infrastructure levies to reflect the fact that land values based on rental tenure will be lower.
- The Government must provide carefully targeted incentives to incentivise the development of new business models that can be used to seed the sector.
- The Government should establish a Taskforce composed of private sector and public-sector representatives to act as a focal point for the Build-to-Rent sector, identify pilot projects, promote surplus land opportunities and provide support for local governments wanting to encourage long term rental in the areas.

The UK Government subsequently adopted a range of initiatives to support the Build-to-Rent sector. The 2017 UK housing white paper, *Fixing the Broken Housing Market*, again reinforced the importance of this sector to addressing supply, housing choice and economic development.

The Report found that, in many cases it would be appropriate for local authorities to waive mandated affordable housing requirements in support of Build-to-Rent developments. Instead,

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[1] At Q2 2017, British Property Federation

[2] Montague, A. 2012. "Review of the barriers to institutional investment in private rented homes."

the delivery of affordable housing was encouraged through government land sales, planning bonuses and financial incentives. There was no mandate from the UK Government to include affordable housing requirements in any development as it would constrain investment in the sector.

The UK Government acknowledged that purpose-built rental housing was a significant component of addressing housing affordability for their community with the 2017 election focused on how best to support the emerging Build-to-Rent sector.

Why now for Australia?

Build-to-Rent is a well-established housing form in North America, Japan, the UK and parts of Europe. For example, Build-to-Rent is the second largest REIT market in US (after retail) and Japan (after office), and is a growing sector in the UK. Australian superfunds and investment managers are also investing in the US and UK Build-to-Rent markets given their competitive returns and the scale of investment opportunities in those markets.

In Australia, historically the income yields on residential property investments have not been comparable with other commercial real estate investments and have therefore not attracted institutional attention.

Market conditions in Australia are now close to making Build-to-Rent investments viable in a sustainable way, and there is an increasing focus on this from major Australian property companies.

In particular, the tightening of capitalisation rates for traditional real estates sectors has meant that returns on Build-to-Rent assets are becoming more comparable with other real estate investments.

This is coupled with the fact that there is growing demand for long term rental accommodation as an alternative to home ownership, underpinned by Australia's high population growth.

This has led to Australian property companies seeking ATO approval to include genuine Build-to-Rent investments within a MIT.

"Build-to-Rent" as a platform for affordable housing

Long-term residential rental options offered by Build-to-Rent is a significant piece of the broader housing affordability puzzle, providing stable, long term choice of tenure.

A healthy Build-to-Rent sector provides governments with the best opportunity to deliver affordable rental housing. Government incentives to attract institutional scale investment into the affordable rental housing sector are much more likely to be successful if there is a depth of market.

Supplying a mix of market based and affordable rental houses with the appropriate incentives at a sizable scale addresses the biggest hurdle faced by institutional investors: competitive yields.

The rental sectors in the US and UK can be viewed as a case study for Australia – with the right mix of policies and incentives, the government can increase supply of affordable rental housing:

Government- Owned Land Sales

- Both the US and the UK governments have actively worked with the property industry to leverage brownfield, government-owned sites to incentivise delivery of vibrant mixed-used developments composed of 'tenure blind' residences: a mix of owner-occupiers, market renters and discount affordable rentals.
- Tenure blind residences, commonly referred to as 'salt and peppering' in Australia, is the approach preferred by Community Housing Providers and State Governments to maximize the success of the community.

Leveraging the Planning System

- The UK has actively leveraged the planning system to incentivise the supply of affordable housing within broader build-to-rent schemes such as density bonuses and greater flexibility on design and space standards.
- Planning incentives are a cost-effective way to incentivise the delivery of affordable housing in target, local government areas based on the needs of the community.

Tax Incentives

- It is well recognised in the US that affordable housing would not be considered an investment option if the Federal Government had not provided low cost financing and significant tax incentives.
- Tax and financial incentives in the US have been consistent since the Great Depression to support affordable housing.
- This consistency in government policy has established a niche developer/operator sector that focuses specifically on the delivery of affordable housing.

Two case studies of UK London based urban renewal developments with a mix of at-market and affordable housing are provided below:

Case study – Greenford Green

Greystar's Greenford Green will be the UK's largest purpose-designed build-to-rent development so far with approximately 2,000 homes, approximately 75% of which will be available for rent on the previously derelict industrial site.

There will be a range of apartments including studios, one-bedrooms, two-bedrooms and three-bedrooms in a genuinely tenure-blind neighbourhood, which include options available for discount rents.

The development will include a suite of amenities including retail, cafes and open space as well as on-site healthcare and local cinema that will be available to residents and the broader community. Residents will enjoy gardens, gyms, roof top terraces and residents' lounges.

Case study – Creekside Wharf

Essential Living's Creekside Wharf Development gained planning approval in July 2015 for the delivery of 249 new homes.

The development will include a building designed specifically for families, more than two-thirds of the site will be covered by high quality landscaped public realm and children's play space, and over 1,400sqm of shared amenity space will be provided, including exercise areas, communal lounges, kitchens and rooftop terraces.

The family focus means there is an onsite nursery, additional acoustic insulation and enhanced child safety balconies.

Of the 249 new homes, a quarter will be Discounted Market Rents, which will be integrated throughout the development.

What is needed to make Build-to-Rent work?

Critically, the overseas experience has demonstrated that the key to a successful Build-to-Rent sector is scale – this means it is essential to attract investment capital and have a sophisticated vehicle which can deploy this capital to deliver quality rental accommodation.

Given the newness of the Build-to-Rent asset class in Australia, it will be necessary to harness foreign institutional capital initially, as they have more experience with this asset class compared to domestic superfunds. We understand from our discussions with domestic superfunds that they would prefer to hold off investing in the Build-to-Rent sector until it has matured and they can be confident of the depth of the market.

For institutional capital, investing in a Build-to-Rent asset is akin to investing in an office or shopping centre as each investment proposal is considered primarily on income yield derived from rents. As such, the expected investment vehicle and tax settings should be aligned with what is available for other commercial real estate investments – i.e. a MIT and access to the MIT withholding tax rates.

This is important because investment decisions are based on after-tax returns given pension funds and sovereign wealth funds are typically lowly taxed in their home jurisdictions

Australia's MIT regime, which was recently modernised by the Government, provides the platform to attract the required capital to establish Build-to-Rent as an asset class in Australia. Other vehicles such as unit trusts or domestic companies do not provide the opportunity to create this asset class at scale because they have less capacity to attract domestic and offshore capital.

Build-to-Rent and the MIT framework

As noted above, the Build-to-Rent asset class in the US, UK, Canada and other jurisdictions has developed because it has been able to attract global institutional capital.

In Australia, the growing interest in the residential property asset class has emerged as the net income returns become more comparable to alternate commercial investments (where yields are seeing continual compression).

As global capital is mobile, Australia's tax and regulatory settings play a critical factor in either supporting or discouraging investment.

Role of MITs for property investment

An MIT is a type of collective investment vehicle which is widely held and primarily makes passive investments. It allows the pooling of funds from both institutional and 'mum and dad' investors – both domestic and international.

The purpose of collective investment vehicles in the property investment arena is to provide investors with the opportunity to:

- invest in large scale real estate assets they could not own directly
- benefit from the market experience and insights of professional asset managers
- provide liquidity to investment in large real estate assets that would otherwise be highly illiquid
- diversify their investment portfolio to reduce the risk from market downturns.

MITs are subject to a robust tax and regulatory framework that provides investor protections, such as ASIC licensing requirements and continuous disclosure requirements under ASX listing rules (for listed entities).

The MIT tax framework was modernised in 2016 to enhance the competitiveness of Australia's funds management industry. Importantly, in order to access the MIT 15% concessional tax rates, the MIT must have sufficient management in Australia.

The MIT rules are also sufficiently robust to ensure a non-resident individual cannot inappropriately access the MIT withholding tax rates by setting up a MIT. In order to qualify as an MIT, the trust needs to be widely held which by definition requires at least 25 members, with special rules applying for institutional investors who are recognised as being widely held. Importantly, a trust will not qualify as an MIT if its ownership is concentrated among non-institutional investors i.e. 10 or less investors own 75% or more of the MIT, or any individual non-resident owns 10% or more.

Comparison of tax rates

Australia's tax rates for non-resident MIT investors is comparable to US, UK and Canada.

The current MIT withholding tax rates were adjusted in 2012, increasing the concessional rate from 7.5% to 15% (the non-concessional rate remained at 30%).

The impacts of the proposed increase were considered by the House of Representatives Standing Committee on Economics which commented that *"Treasury reiterated that the headline tax rate at 15 per cent is 'broadly in line with other advanced economies…"*.

Treasury's comments of 2012 remain applicable and continue to be reflected by the current withholding tax rates in the US, UK and Canada:

	Australia	**US/UK/Canada**
Concessional rate[3]	15%	15%
Non-concessional rate	30%	20-30%

Ensuring a level playing field

The concessional MIT rate of 15% is in line with the Australian domestic rate applicable to both institutional and self-managed superannuation funds.

Given that the overwhelming majority of investment within Build-to-Rent MITs would come from institutional investors (as it does with other commercial property sectors), it is not reasonable to compare the 15% withholding tax rate with those of Australian individuals and companies:

- Private individuals who invest in residential accommodation get the benefit of negative gearing and capital gains tax concessions. This is not available to MITs or their non-resident investors.
- Companies that were to invest and hold residential rental accommodation would face higher costs of capital than those investing through a MIT. This would also be the case for companies developing and holding commercial property outside of a MIT.

'Eligible investment business' test

To satisfy Division 6C's eligible investment business test, a property trust must demonstrate that it is investing in land for the purpose, or primarily for the purpose, of deriving rent.

It is generally accepted that this test:

- does not require the investment to produce rental income at all times and that provided the primary purpose of the investment is to derive rental income, activities such as acquiring, developing, constructing, altering, repairing and improving the premises on the land will satisfy the test;
- applies equally to all forms of real estate investment; and
- is applied on a case by case basis, according to the facts and circumstances of each investment.

[3] Provided under domestic law or tax treaty

However, the commentary in the draft explanatory memorandum ("EM") on the Affordable Housing MIT contradicts the current accepted practice.

The draft EM contains assumptions regarding the treatment of residential property being held only for capital gains purposes – while this may be the case for many residential property investors, each investment should be assessed on its merits and a residential property investment made with the primary purpose of generating income returns should be able to satisfy the eligible investment business test.

Furthermore, the draft EM gives the example of the construction of a dwelling that is intended to be used to derive rent as failing the eligible investment business test (at para 2.33).

This contradicts the existing law and accepted practice – for example, the Explanatory Memorandum to *Tax Laws Amendment (2008 Measures No. 5) Bill 2008* states –

> *"Para 5.5 Division 6C applies to tax the income of certain 'public unit trusts' and their equity holders like companies and their shareholders if the trust is a 'public trading trust'. A public unit trust is a public trading trust if at any time during an income year it operates, or controls operations of an entity that carries on activity that is not an eligible investment business. An eligible investment business is defined in section 102M of Division 6C as any, or any combination of:*
>
> - *investing in land (**including the acquisition and development of land**) for the purpose or primarily for the purpose of deriving rent; or*
> - *investing or trading in any, or any combination of, the financial instruments as listed in the definition in section 102M, paragraph (b)." [emphasis added]*

Sector neutral approach

As noted above, global capital treats residential property in the same way it views other commercial real estate opportunities – as part of its real estate allocation.

The US, UK and Canadian REIT regimes reflect this 'sector neutral' approach and permit investment in "residential REITs".

Any limitation on MITs holding residential property will adversely impact Australia's ability to source capital for such assets from international markets. It will also adversely impact Australia's investment management sector as they will not be able to develop expertise in managing such funds, placing Australia at a disadvantage in comparison to countries like the US where the management of residential REITs is significant.

Consistent with international REIT regimes, there should be no limitation on MITs holding residential property provided the asset is held for the purpose, or primarily for the purpose, of deriving rent – this test should apply equally for commercial and residential real estate investments.

Impact of draft legislation on potential Build-to-Rent developments

We have set out below indicative case studies of the types of Build-to-Rent opportunities that are currently being explored in the market. With the right policy settings, these opportunities could bring forward much needed housing supply and create community precincts of benefit to our cities.

However, the proposed prohibition on MITs investing in residential premises other than affordable housing could halt the development of the Build-to-Rent sector before it can actually get off the ground.

Based on initial discussions with Australia's leading developers and fund managers, we are aware of at least 23 Build-to-Rent projects under consideration which could deliver a minimum of 14,600 new rental dwellings into the market. The ability to include a component of affordable/social housing in each project will depend on the level of support provided at the state and local government level.

Case study 1: Sydney residential development with at-market and affordable component

A large ASX listed property fund manager is currently exploring an opportunity to develop a large scale "Build-to-Rent" project in Sydney.

The project is seeking to deliver 1,000 new apartments into the market, with a mix of 1, 2 and 3 bedroom apartments.

The target market is a cross section of the community including key workers, with a mix of 40% affordable, 10% social, 10% student and 40% at-market (subject to agreeing parameters and incentives with state and local government authorities).

The preferred investment vehicle is a MIT, given it is a well understood vehicle for institutional investment, with the initial investors expected to be predominantly domestic superfunds.

The ability to supply this mix of dwellings is now under review given the proposed changes to the MIT rules.

Case study 2: Global institutional capital exploring the sector and Melbourne CBD opportunity

A global institutional investor that currently invests in a range of Australian commercial real estate was investigating an investment in a proposed Build-to-Rent project.

The project was located in Melbourne CBD close to public transport and amenities, and would have resulted in the supply of 600 one and two bedroom apartments, at market rentals of between $520 to $720 per week.

The development would have on-site management and purpose build amenities befitting a "Build-to-Rent" residential asset.

The proposed income returns on the project were competitive with other commercial real estate investment opportunities in Australia.

Following the government announcement, the global institutional investor has put their assessment of the project and the Australian Build-to-Rent sector on hold.

Case study 3: Retail and residential precinct

A large retail landlord is exploring a "Build-to-Rent" project that would be developed over the airspace above its existing suburban shopping centre, which is held in an MIT.

The development offers an opportunity to create up to 600 new 1 and 2 bedroom apartments at-market rentals in a high-growth area in Sydney, close to transport and existing amenities.

The at-market returns expected on the project make the anticipated yield on the Build-to-Rent asset comparable to the broader commercial returns of the MIT.

The project will not be able to proceed outside of the MIT structure as the shopping centre owners want to retain control of the site to enable future development opportunities. The importance of retaining control over the shopping centre site is critical to all retail landlords.

Recommendation – Build-to-Rent review

Given the substantial benefits of a healthy Build-to-Rent sector, we recommend that Government:

- remove the limitation on MITs holding residential premises from the mechanical legislation designed to enact the Budget's affordable rental housing announcements; and
- appoint an appropriate eminent Australian to conduct a short, sharp consultative process into the issues surrounding the potential establishment of Build-to-Rent in Australia.

The UK's 2012 Montague Review, which was discussed above, provides a useful precedent as it provided the UK Government with an avenue to better understand the benefits of the sector and the actions needed to support it.

A key element of the review should be to explore the role Build-to-Rent can play in helping the Government achieve its stated public policy goal of increase affordable housing. The review also provides the opportunity ventilate any concerns around revenue integrity and the role foreign investment can play in the creation of housing for Australians and develop targeted solutions while not blocking the establishment of Build-to-Rent in Australia.

We suggest that Glenn Stevens would be an ideal person for this role, particularly given his recent short, sharp review on housing affordability for the NSW Government.

Recommendation – clarify EM language

If the Government proceeds with the draft legislation, the commentary in the EM in relation to the application of Division 6C must be amended to reflect current accepted practice – see suggested changes below:

2.10 There also currently is significant uncertainty about the eligibility rules for trusts being MITs if investments are made in dwellings that are residential premises. This is because there is a view that investment in residential property is not made for a primary purpose of earning rental income. It is instead for delivering capital gains from increased property values, and therefore not eligible for the MIT tax concessions. However, each investment must be considered on its merits to determine if primary purpose of the investment is to derive rental income.

….

2.32 Section 102M of the ITAA 1936 then provides that a trading business means a business that does not consist wholly of eligible investment business. Section 102M provides that eligible investment business means:

- *investing in land for the purpose, or primarily for the purpose, of deriving rent; or*
- *investing or trading in certain equities, financial instruments and financial arrangements.*

2.33 ~~Some of the activities that trusts can undertake concerning dwellings that are residential premises (but not commercial residential premises) and be a MIT would not otherwise be eligible investment business. An example is the construction of a dwelling, even if it is to be used to provide affordable housing for the purpose, or primarily for the purpose, of deriving rent.~~

2.34 While it is generally accepted that activities such as constructing a residential premises with the intention of using the premises to derive rent would be eligible investment business, to avoid any doubt ~~Therefore~~ an amendment is made so that, for the purpose of applying the trading trust test in subsection 275-10(4), investments in dwellings that are residential premises (but not commercial residential premises) are disregarded if at all times they satisfy the eligibility conditions (see paragraphs 2.22). [Schedule 1, item 3, subsection 275-10(4)]

….

2.38 Most trusts that are MITs would satisfy the first and third conditions for being a public unit trust, meaning that the only reason they are not public trading trusts is because they are not trading trusts. ~~As noted in paragraph 2.22 some of the activities that trusts can undertake for dwellings that are residential premises (but not commercial residential premises) and be MITs do not come within the meaning of eligible investment business. Therefore a significant number of trusts that invested in affordable housing activities would ordinarily be public trading trusts, meaning that they could not be MITs.~~

2.39 While it is generally accepted that activities as noted in paragraph 2.22 when done with the intention of using the premises to derive rent would be eligible investment business, to avoid any doubt ~~Therefore~~ the definition of public trading trust is amended to ensure that in considering if a trust is a public trading trust, affordable housing activities as set out in the eligibility conditions for dwellings that are residential premises (but not commercial residential premises) that trusts can undertake and be MITs are disregarded. This includes constructing, altering, repairing and improving the dwelling and some other activities. [Schedule 2, item 1, subsection 102R(5) of the ITAA 1936]

Retirement and seniors living

Prohibiting the use of an MIT ownership model for retirement and seniors' accommodation, including retirement villages, stops the market from determining the most commercially viable business structure for this much-needed form of residential property.

Under the current law, the market can determine the most appropriate ownership model for retirement and seniors living – whether this is held in a company, a trust or an MIT subject to the satisfaction of passive income requirements. The law allows each operator to determine the optimal structure based on its business model, investors and stakeholders.

Role of retirement and seniors living

Retirement villages play an important role in housing Australia's growing seniors' population. There are approximately 2,300 retirement villages nationwide which provide homes to nearly 200,000 older people (ABS, 2017). The number of older people who are living in, or wish to live in, a retirement village is projected to increase to approximately 382,000 in 2025 (Grant Thornton, 2015). The proportion of the population who are aged 65 years and older is projected to more than double by 2054-55 compared with 2015 (Treasury, 2015).

Retirement villages provide many benefits to both residents and government.

Villages are purpose-built for older people with design elements such as bathroom grab rails, emergency call systems and limited stairs which allow them to live independently for longer, and within a community of their peers. Retirement villages often provide a range of health, leisure and support services.

Retirement villages generate $2.16 billion in savings to the health care system (Grant Thornton, 2015). Residents living in retirement villages generally enter residential aged care five years later than seniors living in the wider community, saving government $1.98 billion in aged care costs. A further $177 million is saved through retirement village residents requiring fewer hospital and GP visits, earlier discharge from hospital, and better mental health.

Living in a retirement village is also affordable for residents.

The majority (82%) of village residents receive the Australian age pension, with 44% receiving the full age pension and 38% receiving a part aged pension (McCrindle Baynes, 2013)

Many retirement villages apply a financial model which utilises a "deferred management fee" (DMF) as a way to keep village living affordable. The price paid to enter a village is often intentionally lower than comparable accommodation in the surrounding community. This is made possible by the operator deferring their profit (the DMF) to the end of the resident's stay.

The recurrent fees paid by a resident during their stay for services such as maintenance of communal areas are also calculated on a cost-recovery basis and are not designed to generate a profit for the village operator.

Impact of draft legislation on retirement villages

The proposed prohibition on MITs investing in residential premises will impact existing retirement village operators operating under a MIT ownership model. The ATO view is that retirement villages are not 'commercial residential premises' and would therefore not qualify for this exception from the proposed change.

Further, the change is effectively retrospective for operators with development projects in the pipeline. This is because the completion of any development projects after the 14 September announcement date will result in the loss of MIT status for the entire group.

We have set out below case studies of existing retirement village operators who will be adversely impacted by the proposed prohibition on MITs investing in residential premises.

Case study 1

A large property developer and operator has operated under a MIT structure since 2004, and invested in retirement villages and land for retirement villages since 2014.

Their MIT covers nine retirement villages, with around 375 occupied units.

This developer has six projects being developed across high-growth Queensland and NSW locations that will be completed after 14 September 2017. This pipeline would deliver an additional 350 units in FY18, 200 units in FY19 and more than 3,000 units in FY20+.

The loss of MIT status for the trust would make investing in retirement villages less desirable due to the increased cost of capital.

Case study 2

A large property developer and operator established a MIT structure in 2004, and has 34 villages in the structure including DMF villages and rental villages.

There are three sites with land that would likely be developed by potential buyers.

In the rental villages, most residents (41%) are aged between 75 and 84 years. The next highest age brackets are for those aged 85 to 94 years (25%) and 65 to 74 years (21%). Ten percent of residents are aged 55 to 64 years, and 3% are aged 94 to 104 years. 65% of residents are female and 35% are male. Less than 20% of residents are married or have a de facto partner, as 50% are widowed, 22% are divorced, and 11% never married.

It is estimated a very high percentage of residents would be on the age pension.

The loss of MIT status for the trust would result in a higher cost of funds due to a diminished ability to attract foreign investment. Any increase in the cost of funds would likely increase fees payable by village residents.

Case study 3

An Australian fund manager is seeking to establish a retirement village property fund using an MIT vehicle. The fund manager has around $200-300m of foreign investment capital interested in the retirement sector.

If the proposed change is introduced, this would reduce the sources of capital available for the fund, and therefore impact its viability.

Recommendation – retirement living

The Property Council recommends that the proposed limitation on MITs holding residential premises be removed.

If Government proceeds with the proposed limitation, it is critical that retirement villages are carved out of the measure on the basis that:

- A significant number of retirement village operators have been operating within a MIT structure for many years in accordance with the law and without any adverse public policy impact
- Forced restructuring of those businesses would increase their cost of capital, and in many cases lead to an increased cost for residents.

If the Government does not carve out retirement villages from the proposed limitation, the transition period must be broadened to cover any "arrangements" entered into prior to 14 September 2017 rather than for any dwellings that are held after this date. The term 'arrangement' in the retirement village context is well understood based on GSTR 2011/1 and TR 2002/14 when it comes to transitional rules covering staged developments. This will give industry time to orderly transition into a new operating model, without halting the supply of new villages in the interim.

Unintended consequences for existing real estate market

The proposed prohibition on MITs investing in residential premises goes well beyond its intended policy intent of incentivising investment in affordable housing. Unless amended, the prohibition will also adversely impact:

- commercial real estate MITs which acquire residential premises adjoining existing or future developments (both in Australia and offshore)
- the ability of MITs to develop mixed-use precincts in accordance with state and local government policies
- MITs investing in offshore residential premises
- student accommodation
- existing projects under development

Each of these issues is discussed further below.

Ancillary investments in residential assets

MITs that own commercial or retail property investments will often look to re-develop or expand those investments. In order to do so, the MIT (or its controlled entities) may acquire interests in properties bordering their existing assets (“ancillary investments”). These properties may be commercial, retail or residential properties.

Similarly, MITs may acquire greenfield sites that they intend to develop into commercial or retail property investments to be held to derive rental income. As part of these developments properties around the main site may be acquired by the MIT (or its controlled entities). Again, these properties may be commercial, retail or residential properties.

These ancillary investments are not separate businesses; rather they are part of, and incidental to, the broader commercial or retail investment business. Any income generated is a very minor part of the MITs overall income. Given the time taken to make plans for developments and to get necessary consents these properties may be rented for many years before they are incorporated into the main business.

This position applies equally to retail and commercial activities in Australia and overseas.

While there is an “incidental” exception proposed in s. 275-10(4D)(d) of the exposure draft, where use of residential premises is incidental to the use of the dwelling or a larger asset that includes the dwelling, this exception does not appear to have application where a stand-alone dwelling is residential premises and the ownership of that dwelling is incidental to broader non-residential eligible investment business activities.

Urban renewal and mixed-use precincts

It is becoming increasingly common for state and local government planning policies to promote mixed-use precincts – i.e. developments that contain office, retail and residential components – for very sound planning reasons.

Build-to-Rent presents an opportunity for property MITs with the necessary expertise and capital to build mixed-use precincts, particularly in larger urban renewal sites, where the long-term ownership and control of the commercial and residential properties are aligned in the hands of the investors.

Any requirement to force the sale of the residential component of these precincts can present difficulties for MITs who may wish to retain ownership and control over the residential premises to enable future expansion opportunities in relation to the commercial component of the precinct.

Investing in non-Australian residential assets

The proposed limitation on MITs holding residential premises is not limited to Australian residential premises. We understand that this is an unintended position – MITs should be able to invest in foreign residential premises (provided the investment satisfies the eligible investment business requirements).

We note that investment in foreign real estate (including foreign residential premises) by Australian MITs results in assessable foreign source income that is taxable in the hands of the Australian resident investors in the MIT. As the income is foreign source income there is no Australian withholding tax imposed of the distribution of this income to non-resident investors in the MITs.

Fixing this unintended outcome is critical to ensuring Australian investors continue to have the opportunity to invest in foreign residential markets through Australian investment managers, rather than investing directly in foreign markets or via an offshore investment manager (e.g. in Singapore).

Student accommodation

Australia's tertiary education sector is one of our primary exports. The growth in international students studying at Australian universities has led to significant investment in student accommodation.

Student accommodation is a form of purpose built residential accommodation that will be impacted by the proposed prohibition on MITs investing in residential premises to the extent it does not qualify as "commercial residential premises".

This could discourage investment in the sector, and lead to greater pressure on housing affordability as international students compete with local buyers and renters for accommodation close to university precincts.

Retrospective application of amendment

The proposed limitation is effective for any residential premises acquired after 14 September 2017. This is effectively a retrospective impact for MITs which may have developments or acquisitions under way that complete after this date.

Recommendation – unintended consequences

If Government proceeds with the proposed limitation on MITs holding residential premises, it is critical that the following changes are made to the legislation and explanatory memorandum to alleviate the unintended consequences:

- To address the ancillary investments issue, a further exclusion be included in section 275-10(4D) along the lines of:

  "(e) the holding of the dwelling, whether by the trustee referred to in subsection (4C)(a) or by an entity controlled by that trustee, is incidental to a non-residential premises eligible investment business of the trustee."

- To address the non-Australian assets issue, Section 275-10(4C)(a) be amended to include the words "in Australia" as per the below:

  *"(a) the trustee of the trust holds an *ownership interest in a *dwelling that is in Australia and that is *residential premises but not *commercial residential premises"*

- Carve out student accommodation from the limitation.

- Clarify the transition period to cover developments or acquisitions under way that complete after 14 September.

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