PROPERTY COUNCIL of Australia

Australia's property industry
Creating for Generations

Mr Mark Fitt
Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Via email: economics.sen@aph.gov.au

5 March 2018

Dear Mr Fitt

Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018

The Property Council of Australia welcomes the opportunity to comment on the Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018 ("the proposed legislation").

The Property Council strongly supports the Government's commitment to tackling housing affordability through the use of incentives to drive new supply and encourage private investment through targeted tax measures.

The Property Council supports the use of an additional affordable housing capital gains tax (CGT) discount of up to 10 percent to act as an incentive for individual investors to increase the supply of affordable housing.

However, we believe that this incentive – in isolation – will be ineffective in encouraging institutional scale investment in the supply of affordable housing for members of the community earning low to moderate incomes.

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.

Build-to-Rent is a well-established housing option internationally, providing long term rental accommodation and a better-quality rental experience. Governments overseas have facilitated the emergence of this asset class to encourage housing diversity and increase housing supply. Importantly, the Build-to-Rent sector has subsequently been successfully leveraged to attract significant investment into the supply of affordable rental housing.

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.

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The September 2017 exposure draft version of *Treasury Laws Amendment (Reducing Pressure on Housing Affordability No. 2) Bill* proposed to ban managed investment trusts (MITs) from investing in residential property (other than affordable housing). This would have had the effect of preventing the establishment of a Build-to-Rent sector of any scale in Australia. It sent a clear message that the Australian Government did not support Build-to-Rent to the international capital that was interested in investing in this emerging sector in Australia.

The following recommendations provide a broader package of financial incentives that, when coupled with an approach that allows institutional investors to treat residential real estate investment in the same way it views other commercial real estate opportunities, would be better able to encourage investment in affordable rental housing. Specifically:

1. Continue to allow MITs to hold residential premises if they are held for the primary purpose of deriving rent in accordance with Division 6C's eligible investment business test.
2. Ensure Build-to-Rent property held within a MIT is subject to the same withholding tax rates as other forms of institutional real estate investment (ie. 15% for eligible jurisdictions).
3. Provide a stronger incentive for investment in affordable rental housing by applying a 10% withholding tax rate to affordable housing components of any Build-to-Rent developments held within a MIT– similar to that provided under the current MIT legislation for clean building MITs.
4. Provide an additional 10% capital gains tax discount to the components of any Build-to-Rent development that have been used to provide affordable housing for at least 3 years (1095 days) as per the proposed legislation currently before Parliament.

Our attached submission sets out how a healthy Build-to-Rent sector can contribute to the supply of affordable housing and outlines it significance in alleviating housing affordability pressures. This submission also notes the importance of attracting international capital to underpin the supply of new housing for Australians.

Given the significant opportunity provided by the Build-to-Rent sector to support housing affordability, we welcome the opportunity to appear before the Senate Standing Committee on Economics to discuss these issues further. Please do not hesitate to contact Rebecca Douthwaite on [redacted] should you wish to discuss this submission further.

Yours sincerely

[redacted]

Ken Morrison
Chief Executive

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Submission:

Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018

March 2018

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Contents

1. Executive Summary

This submission recommends that a broader package of financial incentives, coupled with clarity on the use of MITs for residential real estate, is required to encourage substantial institutional investment into the supply of affordable housing.

This submission argues that 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.

Build-to-Rent is a well-established housing option internationally, providing long term rental accommodation and a better-quality rental experience. Governments overseas have facilitated the emergence of this asset class to encourage housing diversity and increase housing supply.

A healthy Build-to-Rent sector is highly aligned with the Government's commitment to improve housing affordability, create jobs, maintain economic growth, and importantly attract significant investment into the supply of affordable rental housing.

The benefits of a Build-to-Rent sector includes:

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 – securing jobs
- 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.

The objective of the proposed legislation is to provide more Australians with access to affordable rental housing by incentivising investment through the provision of an additional CGT incentive.

However, in isolation, the provision of an additional CGT incentive for investors – including resident investor in MITs – will be ineffective in encouraging any significant institutional scale investment in the supply of affordable housing.

To meet the objective of the proposed legislation, a broader package of incentives, that are coupled with clarity on the use of MITs for residential real estate, is required to establish a healthy Build-to-Rent sector. Only then, will the objective of the proposed legislation be achieved and deliver an increased supply of affordable rental housing.

The submission makes the following recommendations to meet the objective of the proposed legislation:

1. Continue to allow managed investment trusts (MITs) to hold residential premises if they are held for the primary purpose of deriving rent in accordance with Division 6C's eligible investment business test.

2. Subject residential property held within a MIT to a 15% withholding tax rate for consistency with other forms of institutional real estate investment.

3. Extend a 10% withholding tax rate to affordable housing components of any Build-to-Rent developments held within a MIT– similar to that provided under the current MIT legislation for clean building MITs.

4. Provide an additional 10% capital gains discount to the components of any Build-to-Rent development that have been used to provide affordable housing for at least 3 years (1095 days) – as per the proposed legislation currently before Parliament.

2. Context

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.

In 2017 the Property Council formed a new National Build-to-Rent Roundtable to unpick the public policy challenges of attracting institutional investment into the supply of residential rental housing and affordable rental housing.

The Roundtable comprises major domestic REITs, offshore and domestic investors, and advisory firms who bring expertise, practical experience and balance sheet strength to the policy discussion.

Significantly, the members of the Roundtable are the private sector investors that will eventually weigh up the incentives of allocating capital to affordable rental housing within a broader real estate portfolio.

Consistent feedback from members has indicated that the additional affordable housing CGT discount of up to 10 percent will be an ineffective incentive to substantially increase the supply of affordable housing.

The feedback also suggests that a broad package of financial incentives coupled with an approach that allows institutional investors to treat residential real estate investment in the same way it views other commercial real estate opportunities will be more effective in attracting investment in affordable housing.

3. 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 and security 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.

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 makes 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.

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4. 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 people who rent.

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.

Case Study: A Net Increase in Supply

Build-to-Rent Developments allow residential dwellings to be integrated into broader mixed-use developments without losing control of the assets.

A large retail landlord in Sydney is exploring "Build-to-Rent" projects that would be developed over the airspace above its existing suburban shopping centers. Build-to-Rent allows landlords to deliver residential product while retaining control of the air space over their shopping centers, for most investors this is of critical importance meaning "Build-to-Sell" often will not be contemplated.

Initial investigations show the potential to create circa 1,000 new apartments across three assets in Sydney, all of which are close to transport and existing amenities. It is anticipated that if investors can see a marketable investment yield from "Build-to-Rent" they will deliver these through cycle having cross portfolio finance facilities and less reliance on bank funding for each development project.

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).

Case Study: Bring Forward Supply

Build-to-Rent Developments allow an additional, less cyclical source of capital to support housing development. Further, institutional investment funds control the largest pool of funds available for investment outside the direct resources of governments or private individuals.

One of Australia's biggest residential developers is reviewing sites in Northern Sydney, Western Sydney and Inner North Melbourne as a potential Build-to-Rent opportunity.

The price ranges, yield, apartment mix still not certain, but overall the is the potential to position to deliver ~300-400 apartments over 3 projects.

Doing these as Build-to-Rent would bring forward supply by ~2-4 years and could be expected to be delivered by ~2022

Case Study: Accelerating Delivery of Supply

Build-to-Rent Developments typically have a single buyer, so developers are not reliant on individual unit sales to determine delivery. In addition, there is no risk of tightening lending requirements placed private investors that may impede off-the-plan sales and slow the rate of supply to the broader housing market.

A large residential developer in Sydney is considering utilising a mixed Built-to-Sell and Build-to-Rent scheme to accelerate the delivery of over 700 apartments in the western suburbs. The sales rates achievable as a 100% Build-to-Sell model would result in a delayed project given the appropriate level of pre-sales would take considerably longer to achieve. As significant rental demand exists approximately 35% of the project will be retained as Build-to-Rent stock allowing the pre-sales target to be reached and construction to commence.

A Residential developer is exploring the opportunity in South West Sydney that will deliver approximately 100 apartments. Through a Build-to-Rent model these apartments could be delivered by 2020/2021, which is 3 years earlier than expected.

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

Supply map of Build-to-Rent projects in the UK

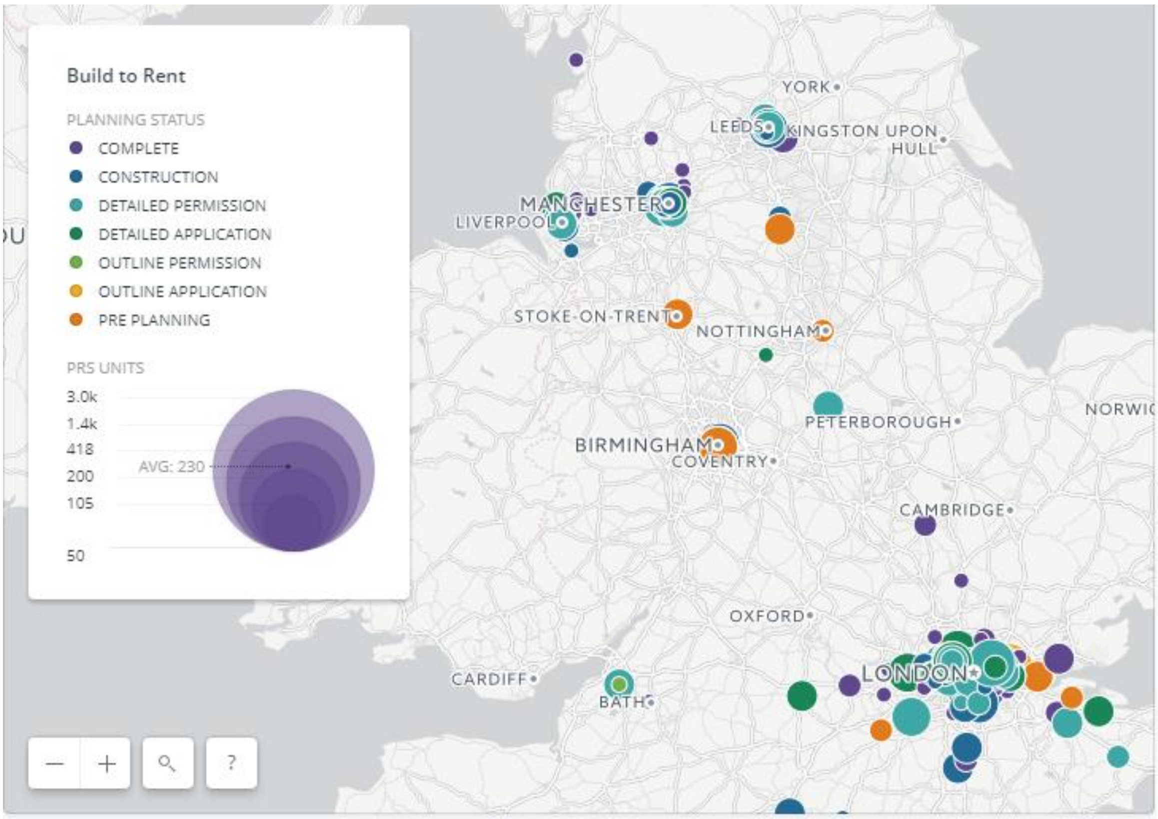

Figure 1 A Snapshot of new planned or completed Build-to-Rent Developments in the UK

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 a 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 institutionally owned 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, as well as residential investments such as Build-to-Rent.

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.

"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.

In 2016, the Property Council commissioned research by *Barwise Consulting* and *SGS Economics & Planning* to better understand the barriers to attracting institutional investment into discount to market rental housing, including the investment equation and the efficiency of financial spend for tax payers.

The research concluded that if the rate of return is commensurate to the risk involved and if there is certainty about the level and durability of government support, institutional investors could be interested in investing in into discount to market rental housing.

Importantly the financial model indicated that government assistance is essential to support the entry of institutional investment into the provision of affordable rental housing.

Supplying a mix of market based and affordable rental housing 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 London based urban renewal developments with a mix of at-market and affordable housing are provided over page.

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 available as affordable housing, which will be integrated throughout the development.

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.

[1] At Q2 2017, British Property Federation
[2] Montague, A. 2012. "Review of the barriers to institutional investment in private rented homes."

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, 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.

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.

5. 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.

However, the draft legislation originally presented in September 2017's version of the *Treasury Laws Amendment (Reducing Pressure on Housing Affordability No. 2) Bill* sought to preclude all other residential property from MITs.

The then accompanying Explanatory Material contained 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.

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 then proposed prohibition on MITs investing in residential premises other than affordable housing would 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.

The September 2017 *Treasury Laws Amendment (Reducing Pressure on Housing Affordability No. 2) Bill* has created significant uncertainty for investors and increased sovereign risk for international capital looking to support the supply of new residential in Australia.

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.

There is a misassumption regarding residential property as 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.

[3] Provided under domestic law or tax treaty

Recommendation One

Continue to allow managed investment trusts (MITs) to hold residential premises if they are held for the primary purpose of deriving rent in accordance with Division 6C's eligible investment business test.

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.

Recommendation Two

Ensure Build-to-Rent property held within a MIT is subject to the same withholding tax rates as other forms of institutional real estate investment (ie. 15% for eligible jurisdictions).

Follow Precedence

A useful precedent exists within the MIT regime which could be used as a solution. MIT legislation provides a 10% withholding tax rate for investments in energy efficient developments (known as clean building MITs) as an incentive for this investment. This 10% MIT withholding tax rate could also be extended to the affordable housing component of any Build-to-Rent developments.

Superannuation funds could also be offered a 10% tax rate to the extent their investments are in affordable housing.

This would provide a real incentive to invest in much needed affordable rental housing.

Recommendation Three

Provide a stronger incentive for investment in affordable rental housing by applying a 10% withholding tax rate to affordable housing components of any Build-to-Rent developments held within a MIT– similar to that provided under the current MIT legislation for clean building MITs.

6. Meeting the Objectives of the Proposed Legislation

The objective of the proposed legislation is to provide more Australians with access to affordable rental housing by incentivising investment through the provision of an additional CGT incentive.

However, in isolation of a package of measures, the provision of an additional CGT incentive for investors – including resident investor in MITs – will be ineffective in encouraging any significant institutional scale investment in the supply of affordable housing.

To meet the objective of the proposed legislation, a broader package of incentives that are coupled with clarity on the use of MITs for residential real estate is required as recommended above. Only then, will the objective of the proposed legislation be achieved and deliver an increased supply of affordable rental housing.

Recommendation Four

Provide an additional 10% CGT discount to the components of any Build-to-Rent development that have been used to provide affordable housing for at least 3 years (1095 days) to resident investors in MITs – as per the proposed legislation currently before Parliament.

Australia's property industry
Creating for Generations

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