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Landcom reports on feasibility of Build-to-Rent projects

A recent report by Landcom '*Build-to-Rent in Australia: Product feasibility and potential affordable housing contribution*' (July 2019) looks at the feasibility of build-to-rent (BtR) developments in light of current market conditions and policy settings. Recent changes to tax treatment of income from Managed Investment Trusts (MIT) is likely to have a significant impact for foreign investors.

Context of the Report

Landcom has recently produced a report entitled *'Build-to-Rent in Australia: Product feasibility and potential affordable housing contribution'* (July 2019) (**Report**). Landcom reviewed the BtR sector as part of its role in providing industry leadership, promoting innovation and working towards strategies to meet its housing diversity objective. Landcom is particularly interested in the potential for BtR in large-scale urban renewal projects and sought to understand the potential contribution BtR may make to affordable housing as a market product.

Current state of the sector

The BtR sector is already well established in the United States (where it is referred to as 'multi-family housing') and is becoming an established product in the United Kingdom (**UK**). Although there has been significant industry discussion over the past few years about the emergence of the BtR sector in Australia, the number of developments is still relatively small. Currently, there are just over 9,000 BtR units underway or announced over nine major projects since 2017 (pp 48-49 Report). However, the number estimated by Property Council of Australia (**PCA**) is much higher: 14,600 units over 23 announced and unannounced projects as at March 2018 (p 48 Report). PCA believes some of these projects will be abandoned due to the changes to the tax treatment of MIT residential housing income.

UK example: role in urban regeneration placemaking and vitality

The Report found that in the UK BtR developments have often featured in brownfield regeneration projects – often in medium to high density schemes and clustered around transport hubs. The quicker build time of BtR schemes compared to build-to-sell (**BtS**) schemes allowed for quicker re-population and promoted 'instant vitality' by bringing early demand for associated services.

Differences in financing requirements likely to drive different investors

The Report notes that the current BtR project proponents are typically developers looking to expand beyond their existing BtS business. Differences in financing requirements for BtS and BtR is likely to be crucial in determining investment sources. Typically, BtS is debt financed by Australian banks or sometimes at a corporate level on money markets. The developer will contribute equity (often in the form of land) and must meet a certain level of pre-sales.

BtR is typically debt and equity financed; financing is likely to be from a much wider range of financial institutions including superannuation funds, foreign pension funds and sovereign wealth funds. This likely source of investment is important in the context of the tax changes to MIT residential housing income.

Feasibility modelling: impacts of different market conditions and policy settings

- The Report established a base case of five categories of BtR studio/apartment categories situated in inner Sydney:

studio basic and premium and apartment basic, standard and premium. It found the following:
  - both basic and premium studios recorded a positive estimated annualised return on development with premium studios recording the highest returns. Lower rents on studios was “hugely outweighed by the ability to accommodate much larger numbers” (p 13); and
  - all three apartment categories recorded a negative estimated annualised return on development. The “estimated capital value based on operating return is below the required capital to develop the project” and higher rents on premium product would “do no more than offset the associated higher cost of such provision” (p 13).
- The Report then modelled factors on the base case that might potentially reduce development costs or enhance rental revenue. None of the factors alone, other than a 50% reduction in land costs, were sufficient to generate a positive return on development of apartments.
- The Report also modelled the impact of policy levers on the base case. Taxation settings and planning policy were discussed in detail. The Report saw some justification in some of the changes long proposed by industry, for example changes to:
  - land tax – seen as unfairly applying to BtR landlords by comparison with small scale landlords who are often effectively exempt (because the value of their landholdings is normally below the land tax threshold. Further, if a BtR developer owns the whole apartment building it is more likely to exceed the premium threshold at which point a higher rate applies. There is also a surcharge of 2% for ‘foreign persons’ (but foreign persons who are ‘Australian-based developers’ are exempt from the surcharge or entitled to a refund in certain circumstances). However, the Report noted there are good policy reasons for having land tax including discouraging un-rented speculative holdings and large land holdings “and the political power that historically comes with land ownership” (p 75 Report);) ; and
  - GST for rental properties to ‘level the playing field’ with BtS developments (sale of a new BtS property is a taxable supply and input tax credits can be claimed, by comparison rental of a property is an ‘input taxed sale’ on which no GST is levied and no credits can be claimed).
- The Report did not support a change in policy settings to put BtR providers on equal footing with community housing providers (**CHPs**) (e.g. in New South Wales, exemptions from income tax, land tax, council rates, provision for GST input claims, density bonuses, reduced parking requirements and access to discounted or free land). It pointed out that CHPs are subject to particular government requirements and regulatory oversight and it “does not seem appropriate to extend such advantages to a purely for-profit provider” (p 16).
- The Report considered the impact of land tax, local government taxes, development GST and stamp duty and found that none of the possible tax changes in this area would be sufficient alone to lift returns sufficiently to make BtR competitive with BtS for the long-term.

Impact of changes to MITs

- The Report considered the impact of legislative changes to concessional treatment of MIT residential housing income (*Treasury Laws Amendment (Making Sure Foreign Investors Pay their Fair Share of Tax in Australia and Other Measures) Act 2019* (Cth). At the time the Report was prepared these changes were still before parliament but legislation has now passed and took effect on 1 July 2019 (with certain transitional arrangements). ‘MIT residential housing income’ other than ‘affordable rental housing’ is now ‘non-concessional income’. Tax on that income for foreign investors will be withheld at a rate of 30% tax. ‘MIT Residential Housing Income’ is income of the MIT to the extent it is attributable to a ‘residential dwelling asset’ (whether or not held by the MIT). A residential dwelling asset is a residential dwelling of taxable Australian real property but does not include commercial residential premises such as a hotel or a caravan park or camping ground (s12-452 *Taxation Administration Act 1953* (Cth)).
- Previously, generally, the rate of MIT withholding tax was 15% tax for residents of ‘exchange of information countries’ or 10% tax for ‘Clean Building MITs’. The clean building MIT rate no longer applies to MIT residential housing income or any other non-concessional MIT income (see paragraph12-385(3)(a)*Taxation Administration Act 1953* (Cth)).
- This tax setting is important as foreign investors are seen as the likely ‘prime movers’ in the emergence of the BtR sector. MITs including ‘cross staple arrangements’ have long been used in the real estate, projects and infrastructure space as an important driver of foreign investment in these sectors. The government has continued to recognised the importance of this for projects and infrastructure by exempting income from an MIT cross-staple arrangement that is, or is attributable to, rent from an “approved economic infrastructure facility”.
- The limited exemption for affordable housing does seek to incentivise investment in this area but the exemption is narrow: the asset must be tenanted or available to be tenanted under the management of an eligible CHP, which must have issued the owner with a certificate covering the asset for the relevant period. The tenants or occupants must also not hold an interest of 10% or more in the MIT.
- Given the narrow focus of this exemption, it is unlikely to drive broader scale investment in the BtR sector, especially when project proponents are looking to diversify risk by diversifying product offering to include premium

as well as affordable product.

BtR as pathway to more affordable housing

- The Report considers BtR as a pathway to more affordable housing. The thinking behind this is that mixed tenure of affordable and market rental may be easier to achieve in a BtR project compared with a BtS project. It concluded that evidence from overseas jurisdictions demonstrated that a BtR market could be “made to work” with “appropriate housing conditions and a favourable policy approach”. The Report found that these conditions are not presently in Australia and that the production of apartments would require substantial policy re-sets. Changes to taxing of MIT income will be unlikely to help this re-set.

According to the Report, only studios are viable under the current ‘base case’ settings. Significant changes in design, procurement and housing market scenarios and policy settings would be required to drive positive returns on apartments. Recent legislative changes in the treatment of MIT residential housing income is likely to make investment in the sector less attractive to foreign investors. It is yet to be seen whether the tax concession available for affordable housing rental income will generate foreign investment in that subsector. Despite the findings of the Report, the current Australian projects indicate that some domestic developers see some benefits in BtR projects; benefits such as counter-cyclical business development, minimisation of developed value leakage and risk diversification.