Build-to-rent still elusive: Australia's tax landscape makes it so

Build-to-rent residential construction projects face big tax obstacles but there are ways this can be fixed. **James Alcock**

by **Matthew Cridland**

A clear pathway for institutional investment in Australian residential premises remains elusive despite the success Australian businesses, such as Lendlease, have enjoyed in the same sector in the US and Britian.

The key impediment is Australia's tax landscape.

Most inbound institutional investment in Australian real estate occurs via a managed investment trust. MIT distributions to eligible foreign investors, of rent and capital gains, are generally concessionally taxed at 15 per cent on a final withholding basis.

However, the Australian Taxation Office does not accept that a MIT may own residential premises, other than "commercial residential premises" (hotels, motels and serviced apartments).

The government has announced changes to clarify that MITs may also own affordable housing, while shadow treasurer [Chris Bowen has said a future Labor government may go further and allow MITs]to own residential premises.

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Even if such a change were to occur, "indirect tax leakage" from GST, stamp duty and land tax is enough to kill off most projects.

For example, assume a foreign pension fund wants to establish a MIT to construct and own 250 new apartments in Sydney. The intention is to retain and lease them to residents on five-year terms. The unimproved land cost is $22 million and construction cost is $88 million.

Stamp duty on $22 million, applying the premium rate and foreign purchaser surcharge, is $3.24 million.FIRB application fees for commercial land are $25,700.

No credits would be available for the $10 million of GST included in the land and construction costs. In contrast, if the apartments were built for sale, the $10 million would be fully recoverable.

Land tax, based on a $22 million unimproved land value and including the foreigner owner surcharge, is $854,652.

Prohibitive costs

Overall, the indirect tax leakage is about $13.5 million upfront and $850,000 annually. When rental yields are compressed, these costs are prohibitive and a clear disincentive to develop and hold. It is a key reason why most new residential premises, except retirement villages and student accommodation, are developed for sale.

In contrast to the commercial sector, "endorsed charities" are eligible for indirect tax concessions. In NSW, land that is owned by a charity, for use in its charitable activities, may be exempt from duty and land tax. Council rate concessions may also apply.

Further, if an endorsed charity uses residential premises to provide affordable housing at less than 75 per cent of market rental, full GST credits are available on any associated costs. In the above example, if the 250 apartments were owned and used by a charity for affordable housing, $10 million of credits would be available. The credits would be paid out as monthly cash refunds during the construction phase.

To allow commercial build-to-rent projects to succeed, a co-ordinated tax approach is required from the Commonwealth and state governments.

At a Commonwealth level, the MIT rules should be clarified to allow investment in residential premises. The GST rules should also be amended to allow an initial credit for GST included in land and development costs for build-to-rent projects. Those credits could be repaid progressively over time, say 10 years, or when the building is sold (if earlier). This would mean there is still the same overall GST leakage ($10 million in the above example), but it is spread over time to reduce prohibitive upfront costs.

At a state level, build-to-rent projects should be exempt from foreign purchaser duty and land tax surcharges.

There is also disparity in how individual and institutional residential investors are treated for land tax purposes. If it is assumed the unimproved land value of the 250 apartments in the above example is about $88,000 each, an individual investor who owns one apartment will be below the land tax threshold ($629,000 in NSW) and pay no land tax. In contrast, an institutional investor that owns all 250 apartments will be well over the threshold and liable to land tax at the highest applicable rates.

While this is intended under current land tax laws, it seems a perverse outcome that the same apartment building may be subject to land tax if there is one institutional investor, but not if there are 250 individual investors.

To compensate for this disparity, an option is to exempt build-to-rent projects from stamp duty. This would see a large upfront cost replaced with a smaller annual cost. The ACT government is currently trialling the gradual reduction of stamp duty in favour of land tax. Build-to-rent projects may provide other states an opportunity to do the same.

While such reforms appear a long way off, there are exciting opportunities for the commercial sector to partner with endorsed charities now on affordable housing projects without the same tax impediments.

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