BTR SERIES PART 2: GETTING THE TAX RIGHT—AUSTRALIAN INCOME AND CAPITAL GAINS TAX

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As trailed in Part 1 of our build-to-rent (BTR) series, the Australian Government has announced plans to remove some of the key income tax barriers to BTR projects. In this Part 2, we take a closer look at those plans (and how the qualification criteria may need to be managed to ensure success) as well as the broader Australian income and capital gains tax considerations for BTR projects.

UNLOCKING FOREIGN CAPITAL: REDUCED WITHHOLDING TAX RATES FOR FOREIGN INVESTORS IN BTR

The centerpiece change to the Australian tax landscape has been the announced reduction in managed investment trust (MIT) withholding tax to 15% (Reduced WHT) for foreign investors in BTR **from 1 July 2024**. This potential game changing announcement allows foreign capital to partner with existing pools of capital in Australia by removing the comparative disadvantage to other investments - *but* it will only succeed if the tax qualification settings are right. We have seen this announcement unlock potential investment already with a number of proposed BTR partnerships involving foreign capital (but these likely remain subject to the details of the qualification criteria).

So far the details of the qualification criteria for Reduced WHT have been scant. We understand consultation will be undertaken, but indications are that to qualify for Reduced WHT the BTR project will require *at least*:

- A minimum proportion of affordable dwellings; and
- Minimum lengths of "single ownership" of the BTR property.

Whilst potentially feasible, we know from experience that the practical and technical implementation—if not done appropriately—risks undoing the positive response generated so far. We have set out below what we see are going to be some likely qualification criteria for Reduced WHT, and recommendations as to the approach needed based on our experience and discussions with industry.

Key Requirement	K&L Gates Comments
Minimum proportion of affordable dwellings	▪ Likely qualification criteria that reflects social licence requirements. ▪ The rules need to be implemented flexibly to ensure project economics stack up (otherwise no housing, affordable or otherwise, gets delivered).

	For example, allowing percentage ranges or graduated percentages based on total dwellings (as larger projects may be able to support greater proportions of affordable dwellings). ▪ Flexibility is also required in how the affordable housing is delivered or managed, including permitting delivery by the project operator or by partnering with community housing providers (and with the permitted lease and structure arrangements being able to reflect these alternatives). Part of the product differentiator with BTR projects is the amenity they can offer to tenants via the management platform (as discussed below). Ideally, the qualification criteria, as it relates to affordable housing, will enable operators to seamlessly offer that amenity to affordable housing tenants.
Level at which minimum ownership imposed	▪ This is another likely qualification criteria that reflects dual policy intent of longer-term rental tenancies and permanently increasing the rental housing stock. ▪ We expect a 10 year period is likely—the key issue will be whether this requirement is imposed at the asset-owning or project level only (which is needed to address policy intent) or also to underlying investors (which may not be suitable to the available capital sources). ▪ Requiring lock-up of underlying investors would substantially reduce the pool of foreign investors and reduce the number of viable projects (as that would not allow different investors with different risk profiles or economic return requirements to invest at different stages of the project). ▪ We recommend that any minimum ownership requirement only be at asset-holding level, and critically should allow foreign investors to benefit from Reduced WHT on exit prior to the 10 year period (unlike current requirements to access Reduced WHT for affordable housing).
Other potential MIT requirements: number/category of dwellings	▪ The accelerated depreciation provisions (discussed below) will only apply to projects with *50 or more dwellings*. ▪ This is an unduly narrow requirement that should either be relaxed or not incorporated into the Reduced WHT

	qualification requirements for the reasons discussed below.
Other potential MIT requirements: minimum lease terms	▪ Likewise, the accelerated depreciation provisions discussed below require minimum lease terms to be offered. ▪ If they are also to form part of the criteria for Reduced WHT, these need to be flexibly implemented (as discussed below).
Allowing ancillary services to be provided	▪ Based on our international experience, a key element of successful BTR assets is the provision of optional or add-on services that turn BTR projects into thriving communities. ▪ The qualification rules should first allow for these types of facilities within the scope of the BTR project (whether that be resident facilities such as pools, gyms, theatres, parking, etc. or ancillary commercial facilities such as local stores, restaurants, dry-cleaners, etc.). ▪ The income from such ancillary facilities should either be accepted as being part of the acceptable BTR project income for Reduced WHT or be allowed to be provided through other associated entities, without adversely impacting the treatment of income from the BTR assets as passive income.
Clarification that BTR projects are not "trading"	▪ There have been unhelpful comments in the past that BTR projects may be treated as "trading" rather than "investment" activities (so that they would not qualify to be held within MITs / not qualify for Reduced WHT), and needing to consider "trading" rules has added uncertainty. ▪ Given the introduction of qualification criteria, BTR projects that meet those criteria (including around ancillary services) should not separately have to worry about "trading" activity rules.
Clawback mechanism	▪ Any clawback mechanisms where BTR projects cease to qualify at a future stage need to be carefully designed. ▪ Sophisticated commercial parties should be able to manage or allocate the risks easily whilst allowing for

	clawback.

ACCELERATED DEPRECIATION: RETURNING CAPITAL SOONER

The Australian Government also announced accelerated capital works deductions allowed for eligible BTR projects, by allowing capital works to be depreciated at 4% (up from 2.5%) per year (or over 25 years instead of 40 years). The qualification criteria announced were that the project must consist of 50 or more apartments or dwellings made available for rent to the general public, with dwellings retained under single ownership for 10 years and with landlords offering lease terms of at least three years for each dwelling.

The accelerated depreciation will shelter more taxable income of the BTR project during the critical early phase of operations, and allow capital to be returned to investors sooner from available cash flows and increasing debt serviceability, both of which can be critical to the economic success of BTR projects.

However, as with the Reduced WHT, implementation will be key. Key issues include:

- Ensuring any clawback mechanism for depreciation does not leave a latent charge within the project as a result of the exit of investors (or other events outside the control of investors);
- Ensuring that construction expenditure on capital works can apply to repurposing existing buildings given the potential for repurposing of existing lower grade offices into BTR, which is an increasing opportunity as commercial tenants continue the "flight to quality";
- Allowing underlying investors to exit without prejudicing the 10 year minimum holding period (provided the actual asset remains used for BTR);
- The requirement of three year lease terms should be based on an offer requirement as indicated in the details to date, rather than be based on any average of the actual lease terms or similar. This takes into account differences in tenant preferences and not exposing to unnecessary risk of clawbacks, where the relevant BTR developers or operators are otherwise seeking to meet the requirements; and
- The minimum number of dwellings should be reduced from 50 to 10 or 15 (consistent with other existing 4% depreciation rate projects in the capital works provisions), and the types of residences that qualify should be any type of residential dwelling (and not just, for example, apartments). This will prevent BTR being the sole domain of high rise projects that struggle with planning approval and local objections, and allow medium density developments (such as town houses or even duplex style properties within a larger development) that can actually be delivered. This will also recognize that consumer demand for product in the housing or rental market is not limited to high rise apartment living.

DEBT FUNDING: APPARENTLY NO LONGER SO WELCOME IN AUSTRALIA

The Australian Government has recently introduced to parliament its new thin capitalisation legislation (which commenced on 1 July 2023 despite not yet being legislated), and it aims to significantly curtail the availability of debt deductions. This may have a significant impact on the economics of BTR projects.

The rules by default limit interest deductions to an amount equal to 30% of "tax EBITDA" (broadly taxable income before interest, taxes, depreciation and amortization) (the "fixed ratio" method). There is also a "third party-debt rule" that can, in currently very limited circumstances, allow all interest deductions on external third-party debt (but no other debt deductions).

However, there will be some challenges for BTR projects, including that (based on the current rules):

- To qualify for Reduced WHT, it will be necessary to have a trust that qualifies as a MIT - but the thin capitalization rules don't allow for trust grouping and deal with trust structures in helpful way;
- For example, if relying on the fixed ratio method, the borrower may need to be the asset-owning or rent receiving entity (and not a holding entity)—otherwise depreciation or capital works deductions can result in a permanent reduction in "tax EBITDA" (and therefore in borrowing capacity); and
- On the other hand, if relying on the "third-party debt rule," it may be necessary to either borrow in a direct holding entity (given the requirement that the lender only have recourse to the assets of the borrower) or to rely on the conduit financier rules (which do permit a broader security package).

STRUCTURING CONSIDERATIONS REMAIN FUNDAMENTAL

Having in place the right structure for investors will remain fundamental, and there remain a number of potential "traps" in the BTR space. Key issues will include:

- Managing the complex application of the thin capitalisation regime;
- Ensuring the ability to qualify for MIT status—which requires the right mix or character of investors, plus a trustee with an AFSL;
- Ensuring the structure does not offend "trading trust" rules;
- Managing cross-staple arrangement rules—even where a BTR project might otherwise qualify under the MIT rules, it is likely that cross-staple income rules will apply, and these can reverse the Reduced WHT;
- Managing the tax on exit for foreign investors—even if the MIT BTR settings allow gains on exit of foreign investors to qualify for Reduced WHT, it is important that the investment structure allows exit at the right level to facilitate this; and
- Determining whether foreign pension fund or sovereign wealth fund investors may be able to access the limited withholding tax exemptions on BTR—this requires careful consideration of both the level of investment (generally <10%) but also the governance rights that may be granted.

Part 3 in our BTR series will focus on the Australian state tax aspects of the BTR landscape and some of the key initiatives—and challenges—for BTR projects.

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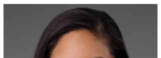

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