Increasing the supply of Affordable Housing – additional CGT discount and providing affordable housing through MITs

21 September 2017

In brief

On 15 September 2017, Treasury released draft legislation aimed at increasing the supply of 'affordable housing' in Australia. These measures were previously announced in the 2017-18 Federal Budget, and include an increased CGT discount for Australian resident individuals investing in affordable housing and the introduction an Affordable Housing Managed Investment Trust (**MIT**). In a surprise move, the Government has also announced a so-called 'integrity measure' to prevent MITs from holding residential premises other than affordable housing and commercial residential premises. The draft legislation is open for comment until 28 September 2017.

Although the integration of affordable housing into the MIT regime is a positive step forward in encouraging greater investment in this asset class to help solve the housing crisis, the exclusion of other residential premises is disappointing as it creates an additional barrier or disincentive for foreign institutional investors from investing in large scale 'build to rent' residential real estate projects.

Additionally, in our view further tax measures are required to effectively direct institutional capital to the affordable housing asset class, including for example the introduction of stamp duty and land tax concessions for affordable housing by State Governments and amendments to the GST rules to allow investors to claim GST credits incurred on the cost of constructing affordable housing real estate.

In detail

Targeting Australian individual investors: Additional capital gains discount for affordable housing

The draft legislation proposes to provide an additional affordable housing capital gains tax (**CGT**) discount to Australian individual investors. Once enacted, this measure will increase the CGT discount to up to 60% from 1 January 2018 for Australian resident individual investors in 'affordable housing' where the individual holds the investment (both directly and indirectly via trusts) for greater than 3 years (which is less than the MIT 10 year holding period – see below for further details). The 3 year required holding period (which may be aggregated across different periods) means that the increased CGT discount will be first available for disposals after 1 January 2021. There is no proposal to increase the CGT discount for superannuation funds investing in affordable housing.

Targeting foreign investors: Affordable housing regime for MITs

The draft legislation also includes a tax concession for foreign investors to encourage a longer term investment of capital in Australian MITs that develop and hold ‘affordable housing’ from 1 July 2017.

To align the incentive with the Governments policy objective of developing a stable supply of affordable housing in the Australian market, the MIT must hold and lease the property for a minimum 10 year period to be eligible to access the 15% withholding tax rate on any capital gain. Where the affordable housing is held for less than 10 years, capital gains on the sale of the investment will be subject to 30% withholding tax.

Additionally, to qualify for the MIT tax concessions (including the concessional rate of withholding on distributions to certain foreign residents), the trust must use the dwelling for the purpose, or primarily for the purpose, of deriving rent from providing affordable housing, or be constructing, altering, improving, repairing or otherwise preparing the dwelling for later use in providing affordable housing.

On this aspect, it should be noted that the Explanatory Memorandum to the draft legislation outlines factors that need to be considered in determining whether an investment in a dwelling is held for the purpose, or primarily for the purpose of deriving rent. These factors include:

- the trust’s investment strategy;
- the length of time the dwelling is intended to be held for, and any plan for disposal;
- any arrangements entered into or activities undertaken by the trustee (including in relation to the development of the property, its management, and other incidental activities);
- features of the dwelling affecting its suitability for rent by affordable housing tenants; and
- projected rental yields and capital growth to determine the purpose for holding the dwelling.

The Explanatory Memorandum also makes comments that there is a ‘*need to hold dwellings used to provide affordable housing for significantly longer than a period of three or more years*’. *Furthermore, it makes reference to a case in which ‘the Commissioner, in recent advice had regard to the nature of the investment, such that it ensured that the property would be held for the long-term and that the net rental yield would likely exceed the capital growth of the property over the 10 year rental period.*’

We highlight that these comments provide a signal as to the Government’s view on the operation of the ‘primarily for the purpose’ test in a broader MIT and Division 6C context. It is unclear however whether consideration has been given to the fact that the net rental yield on the property is likely to be discounted (on the basis that the asset is being provided as ‘affordable housing’) which could adversely impact the likelihood of the net rental yield exceeding the capital growth of the property over the investment period.

Definition of ‘affordable housing’

There are a number of conditions that must be met in order for a dwelling to be considered as being used to provide affordable housing:

- the dwelling is residential premises that is not commercial residential premises;

- the tenancy of the dwelling or its occupancy is exclusively managed by an eligible community housing provider;
- the eligible community housing provider has given each entity that holds an ownership interest in the dwelling certification that the dwelling was used to provide affordable housing;
- no entity that has an ownership interest in the dwelling is entitled to receive an National Rental Affordability Scheme (**NRAS**) incentive for the NRAS year; and
- if an ownership interest in the dwelling is held by a MIT, the tenant does not have 10% or more interest in the MIT.

Typically, housing that is provided through an eligible community housing provider would be rented at below market value (e.g. 20 – 25% below market value).

Excluding residential premises from the MIT regime

Whilst the draft legislation allows for the investment in ‘affordable housing’ by MITs, it also specifically excludes MITs from investing in other residential premises (but not commercial residential premises) unless the use is incidental to the earning of other income from the asset of which the dwelling is a part.

However, a transitional period (broadly until 1 October 2027) is provided in the draft legislation for any residential premises held by MITs on 14 September 2017. There is some uncertainty as to whether new works can be undertaken on these premises before they cease to be covered by the transitional rule.

It is noted that the term ‘commercial residential premises’ takes its meaning from the GST Act which generally includes premises such as hotels, motels, hostels, off-campus student accommodation and home parks (manufactured housing estates). Investments in these asset classes should therefore not be impacted by the proposed changes for residential premises. On this aspect, the comments in the Explanatory Memorandum suggest that the decision to base the carve out from these changes to the MIT rules to the GST definition of ‘commercial residential premises’ was influenced by the volume of judicial and administrative guidance that has developed over time: see for example *GSTR 2012/6*, rather than a deliberate policy decision as to the specific assets classes which should be in or out of the MIT regime.

Application to proposed collective investment vehicles (**CIVs**)

The Explanatory Memorandum to the draft legislation also signals that the Government intends that the proposed corporate and limited partnership CIVs will be able to invest in affordable housing in the same manner as MITs. It is also intended that legislation to introduce the framework for the new types of CIVs will ensure members of CIVs have access to the additional affordable housing capital gains discount in the same manner as members of MITs.

PwC insights

The integration of affordable housing into the MIT regime is a positive step forward in encouraging greater investment in this asset class to help solve the housing crisis. However, there are also many other opportunities for State and Federal Governments to address housing affordability issues in the economy, both through the tax system and other legislative (or policy) measures.

The exclusion of other residential premises from the MIT regime is particularly disappointing. This exclusion, if implemented, may have a number of flow-on consequences such as:

- the hampering of the development and expansion of the 'build to rent' market in Australia with an associated negative impact to the overall housing supply;
- a potential barrier to the development of mixed use premises with recent development applications often requiring a portion of the building to be ascribed to residential use;
- the creation of a 'contagion effect' to income from the eligible investments held by a MIT where the MIT invests in mixed use assets that include residential dwellings and the income from the residential premises is more than just incidental to the income from the eligible investments.

The potential impact to the 'build to rent' market in Australia is of particular interest due to the impact the new laws will have on foreign institutional investors seeking to make long term investments into this sector of the Australian residential real estate market. This change to the tax system will also create a bias which favours domestic institutional investors in the Australian 'build to rent' market (such as superannuation funds) over foreign institutional investors due to the difference in tax rates.

We are therefore of the view that the MIT regime should be broadened (or at least not prohibited) to non-commercial residential asset classes (such as multi-family housing) where the assets are held for the long term (say over 10 years) to derive rent and/or support an increase in the supply of long term rental stock in the Australian housing market (e.g. purpose built rental accommodation). While we appreciate the Government is attempting to divert institutional capital into the affordable housing class, we believe that they could achieve an improved outcome by offering extra tax concessions for investment in affordable housing, including for example lower MIT withholding tax rates of 10% (similar to that afforded to 'clean building MITs) and/or removal of the GST cost for this type of premises.

In relation to 'affordable housing' more specifically, we agree that legislative amendment is required given the very low rental yield of this asset class. In addition, institutional investment into affordable housing could only realistically come from 'build to rent' rather than 'buy for rent' strategies given the inflated housing market prices.

We believe that further measures are also required to direct institutional capital to the affordable housing (and more generally residential real estate) asset class, including:

- the State Governments assisting with planning processes and considering stamp duty and land tax concessions for affordable housing;
- possible State and Federal Government investment in affordable housing, similar to the NSW Social and Affordable Housing Fund;
- possible contribution of Government-owned land either at nil cost or a discount to market, or via a long-term lease scheme;
- GST rules will need to be amended to allow for GST credits incurred on construction costs for the development of residential real estate that will be leased. Note that concessions already exists that allow certain charities to claim GST credits for the provision of low cost housing and an extension of this concession to the private sector will, in our view, be required.

We also highlight that there may be unintended outcomes and inconsistencies as a result of the draft legislation terminology being leveraged from existing terminology in the GST Act. For example, it appears that 'residential premises' located outside of the 'direct tax zone' (i.e. Australia) may be caught by the new law. This seems to be the intention as residential property outside Australia will not be managed by an eligible Community Housing Provider. Whilst prima facie the exclusion of residential premises from the MIT regime would not seem to be of particular concern (due to non-Australian sourced income being an 'excluded amount' under the definition of an MIT 'fund payment'), where a MIT hold both Australian sourced income and income from foreign residential property it may no longer qualify for the MIT withholding tax rate under the proposed new law.

Other potential 'unintended' outcomes could arise where for example:

a. a MIT acquires a residential property adjoining an existing property (but a different CGT) with the intention to expand say, a shopping centre or an industrial property. The ownership of this residential property would be prohibited and would not fall within the exception.

b. a public unit trust controls another entity that holds affordable housing assets. The amendment to the public trading trust definition in Section 109R would not seem to operate as intended as and the head trust would become a public trading trust.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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