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# ***Student accommodation as an eligible investment business***

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## ***In brief***

In recent years, there has been a significant increase in the amount of investment into ‘on’ and ‘off’ campus student accommodation projects in Australia. The growth has largely been driven by a range of recent economic and regulatory trends. In light of education-related travel being Australia’s fourth most valuable export,<sup>1</sup> a depreciated Australian dollar (compared with recent levels) and macro-economic trends (such as population growth for people aged between 18 and 25 years and a rising housing affordability issue), it comes as no surprise that this asset class in particular has attracted significant foreign investment.<sup>2</sup>

From a taxation perspective, investors into passive asset classes, such as Australian real estate trusts, are eligible to receive preferential taxation treatment through the use of ‘flow-through’ trust structures. Indeed, Australia has sought to harness the benefits of flow-through taxation to encourage investment in Australia through the managed investment trust (MIT) regime. However, in respect of both regimes, there are certain legislative conditions which first must be met before these concessional tax rates can be accessed.

This article will focus on ‘off-campus’ student accommodation (as on-campus facilities typically give rise to different taxation issues) and whether projects of this nature will qualify as an ‘eligible investment business’ for the purposes of s 102M of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).<sup>3</sup>

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<sup>1</sup> Department of Foreign Affairs and Trade, “Australia’s top 10 goods & services exports and imports”. Available at <http://dfat.gov.au/trade/resources/tradeat-a-glance/Pages/top-goods-services.aspx>.

<sup>2</sup> Department of Foreign Affairs and Trade, “Australia’s top 10 goods & services exports and imports”. Available at <http://dfat.gov.au/trade/resources/tradeat-a-glance/Pages/top-goods-services.aspx>.

<sup>3</sup> S 275-10(3)(b) of the *Income Tax Assessment Act 1997* (Cth).

## ***In detail***

### ***Typical student accommodation structure***

To assist us in our discussion, we have outlined a typical investment structure which may be employed by fund managers investing in an off-campus student accommodation facility. It is also worthwhile noting that returns to investors in off-campus student accommodation are typically in the form of:

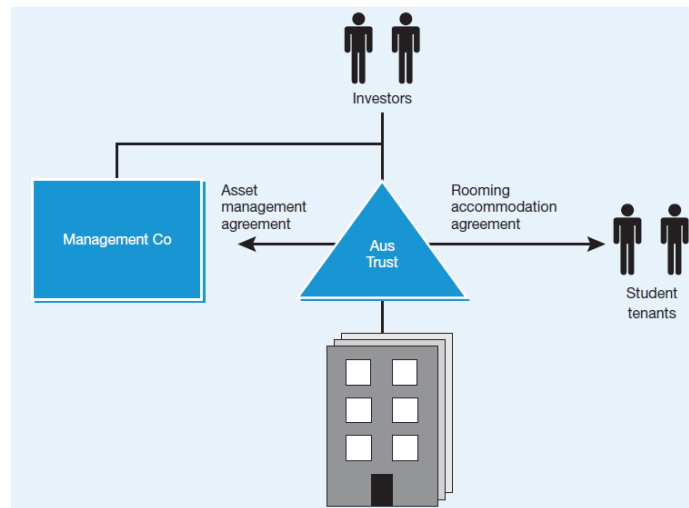
- ongoing returns in the form of rent, and
- capital appreciation from rising values of student accommodation land and buildings.

A typical trust structure broadly involves:

- investors acquiring a unit in an Australian trust (Aus Trust),
- Aus Trust holding the land and buildings used to provide the student accommodation (usually multiple sites are held in different sub-trusts),
- Aus Trust entering rooming accommodation agreements with student tenants, and
- Aus Trust entering into a management agreement with a related or unrelated entity.

Diagram 1 illustrates this structure.

***Diagram 1***



### ***Identifying the issue***

Australia has sought to limit a taxpayer's ability to erode the so-called classical system of company taxation with the benefits available from the flow-through nature of trust taxation. This was first achieved by the introduction of Div 6B ITAA36, which sought to tax public unit trusts which were substituted for a company. This was then extended, following comments in the parliament's draft tax white paper (1985), to include all public unit trusts which operate or control the affairs or operations of a trading businesses through Div 6C ITAA36. All along, the focus has been on restricting the tax benefits afforded to Aus Trust in situations where it operates or controls a trading business (which is any business activity that is not an 'eligible investment business').

The technical uncertainty which exists in the context of student accommodation is whether Aus Trust operates an 'eligible investment business' and is therefore excluded from the scope of the Div 6C integrity rules, or not. The purpose of this article is to understand this technical issue in the context of student accommodation projects.

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### ***What is an ‘eligible investment business’?***

The approach of the Australian taxation system to ensuring that the benefits of trust taxation (including the added incentives within the MIT regime) are not available to widely held trusts that carry on a trading business is to prescribe a list of qualifying eligible activities. Qualifying eligible activities include a number of activities. However, for our purposes, we will focus on the first of these requirements in s 102M, namely, “investing in land for the purpose, or primarily for the purpose, of deriving rent”.

In the context of our student accommodation example set out above, this broad requirement can be broken down into the following three cumulative hurdles:

1. Aus Trust invests in land,
2. the return derived by Aus Trust from that land is rent, and
3. the purpose, or a principal purpose, of Aus Trust’s investment into the land was deriving rent.

As noted below, Div 6C relaxes this strict requirement somewhat by including a broader class of property within the meaning of land and providing a legislative safe harbour for insignificant amounts of non-rent income.<sup>4</sup>

### ***Is student accommodation a qualifying business?***

We turn now to consider whether businesses of this nature clear all three of these hurdles.

#### *Investment in land*

In our experience, there is usually little difficulty in concluding that the purchase of land and buildings for the purposes of providing student accommodation satisfies the definition of investing in land at common law.<sup>5</sup> Even where the assets acquired to carry out the student accommodation business go beyond land and buildings (to include moveable property, i.e. chattels), the assets may still meet this requirement. This is because the meaning of land is expanded to encompass chattels where they are incidental and relevant to the renting of land and ancillary to its ownership or use.<sup>6</sup> Helpfully, the explanatory memorandum (EM) provides the example of a shopping centre where certain fittings and moveable furnishings are provided in the common areas, concluding that these chattels were land on the basis that they fell within the statutory safe harbour.<sup>7</sup> We consider this example to be analogous to the types of fittings and moveable property often provided as part of student accommodation.

Consequently, student accommodation businesses should be able to provide furnishings and fittings in the common areas without endangering a trigger of Div 6C.

#### *Rent*

‘Rent’ is not defined in the ITAA36 and therefore takes its ordinary meaning within the context it is found. However, courts have not been able to agree on a unified articulation of this ordinary meaning. The traditional common law meaning of ‘rent’ has developed through a long line of authorities, and was summarised by Mahoney JA in *Commissioner of Stamp Duties (NSW) v JV (Crows Nest) Pty Ltd*:<sup>8</sup>

“The term ‘rent’ in its ordinary or at least essential meaning in the law refers to a payment made for the possession of realty under a lease.”

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<sup>4</sup> S 102MB ITAA36.

<sup>5</sup> See Encyclopaedic Australian legal dictionary. See also Co Litt 4a; Halsbury’s laws of England, 4th ed, vol 39(2) reissue, para 76.

<sup>6</sup> S 102MB(1).

<sup>7</sup> Example 5.1 from the EM to Tax Laws Amendment (2008 Measures No. 5) Act 2008 (Cth).

<sup>8</sup> (1986) 7 NSWLR 529 at 531E, referring to the judgment of Owen J in *Junghem v Wood* (1958) 58 SR (NSW) 327 at 331.

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Recently, however, courts have questioned whether the strict common law definition of rent is appropriate in the context of both a lease and statute. This was observed by Brooking J in *Commissioner of State Revenue (Vic) v Price Brent Services Pty Ltd*:<sup>9</sup>

“In recent years there has been a reluctance to attribute to the expression ‘rent’, when used in a lease or a statute, the strict meaning of that term at common law, a meaning reflecting the medieval notion of rent as a thing issuing from the land.”

Later, his Honour observed that a number of recent decisions had led to the development of the meaning of rent, saying:<sup>10</sup>

“As a result of recent decisions the expression ‘contractual rent’, used by way of contrast to ‘true’ rent (that is, rent according to the traditional common law view), has gained currency.”

As discussed above, Div 6C is concerned with excluding activities which amount to a ‘trading business’. It achieves this by limiting the returns which can be generated from investments in land to rent. While this context does not mandate one interpretation of rent over another, it does suggest that ‘rent’ was included in Div 6C to capture forms of passive income.

What is clear from the case law concerning the meaning of ‘rent’ is that, where a payment is for possession of real property under a lease, it must be rent within its traditional common law meaning. In other words, the existence of a traditional lease strongly suggests that payments in respect of that document will be rent (where they are for the possession of real property).

In light of the above, the essential question to be answered in relation to the meaning of ‘rent’ is whether the rooming accommodation agreement (mandated by state laws — generally, Residential Tenancies Acts) are a lease at law.<sup>11</sup>

*Is the student accommodation agreement a lease?*

The typical characteristics of a lease include:

- a landlord and tenant,
- the tenant having exclusive possession over a particular area of land,<sup>12</sup>
- a fixed term which is defined and less than the period which the landlord holds the land, and
- rent payable in return for the grant of an interest in property under the lease.

Of these factors, the tenant having ‘exclusive possession’ is often the essential characteristic that distinguishes a lease from other forms of contractual rights (such as a licence). Very briefly, ‘exclusive possession’ is the tenant’s right to exclude all others from the land, including the landlord, subject only to the terms of the lease.

It was the existence of these essential features that recently lead Croft J in the Victorian Supreme Court to find that an Airbnb agreement was a lease.<sup>13</sup> Croft J found that the Airbnb agreement was a lease as based on a holistic assessment of the intention to grant exclusive possession. While refraining from engaging in a detailed examination of the terms of the Airbnb agreement, Croft J referred to extensive authority when

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<sup>9</sup> *Commissioner of State Revenue (Vic) v Price Brent Services Pty Ltd* [1995] 2 VR 582 at 585.

<sup>10</sup> *Ibid* at 585.

<sup>11</sup> While the observations of Brooking J in *Price Brent* and may provide the starting point for a line of reasoning which supports the looking to ‘contractual rent’ for the purposes of assessing whether a business is a qualifying eligible activity, in the case of student accommodation, we do not think this is a necessary step.

<sup>12</sup> Although occasionally a lease can exist without the tenant having a proprietary interest: *Bruton v London & Quadrant Housing Trust* [2000] 1 AC 406.

<sup>13</sup> *Swan v Uecker* [2016] VSC 313.

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seeking to characterise the Airbnb agreement as a lease. The majority of Croft J's reasons focused on distinguishing the Airbnb agreement from an agreement with a lodger,<sup>14</sup> with an acknowledgment that surrounding circumstances are only to be referred to where the terms of an agreement are ambiguous.<sup>15</sup> Croft J's approach in regards to the Airbnb agreement is instructive of how courts may construct the character of such short-term 'lease' arrangements.

Having considered the terms of the relevant rooming accommodation agreements that are typically entered into between Aus Trust and the student tenants, it would appear to us that they generally display the characteristics of a lease. This is on the basis that they contain the following terms which are consistent with a grant of 'exclusive possession':

- student tenants are granted quiet enjoyment of their premises,
- any right of access granted in favour of the landlord is limited to specific circumstances and is often subject to certain mandatory minimum notice periods (either imposed by statute or by the agreement itself),
- the term of the agreement is fixed,<sup>16</sup> and
- the language used in the agreement supports the conclusion that the parties intended to grant exclusive possession under a lease (i.e. by using the term 'rent').

Complications may arise where the agreements provide for a payment which encompasses something other than exclusive possession of land, for example, ancillary outgoings or services. Helpfully, in these circumstances, the courts have been inclined to construe single, undivided amounts as rent,<sup>17</sup> so long as exclusive possession is granted under the agreement and the services are incidental and customarily provided in the renting of the land.

#### *Purpose*

The purpose, or the principal purpose, of the investment in land must be deriving rent. Our experience is that this requirement has been relatively uncontentious; where the asset is land and the return generated from that land is rent, it has often been thought that the relevant purpose followed as a matter of course. Even where contention may have arisen, it is our experience that the proportion of income which could potentially characterised as income other than rent would fall well within the safe harbour provided in s 102MB(2) ITAA36.

#### ***Recent developments***

The ATO recently issued TA 2017/1 which deals with trust taxation and the use of stapled structures. The taxpayer alert clarifies that Australian real estate investment trusts (REITs) should not be caught by the alert. The rationale for the exclusion of REITs appears to be that these investment types were not intended to be caught within this policy decision, and they usually are technically compliant investments.

While it is early days and further guidance or details are expected to be provided by the ATO in the future, it is reasonable to expect that a similar rationale should extend to exclude Australian student accommodation investment trusts from risks identified in TA 2017/1. This is because at a broad level, both Australian REITs and student accommodation investments:

- hold land within a trust (Aus Trust) which engages tenants in leases, and

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<sup>14</sup> Ibid at [33]-[37].

<sup>15</sup> Citing National Outdoor Advertising Pty Ltd v Wavon Pty Ltd (1988) 4 BPR 97,322 at 9,733-9,734.

<sup>16</sup> Even a relatively brief term is sufficient to characterise student accommodation agreements as leases: *Swan v Uecker* [2016] VSC 313.

<sup>17</sup> See *Commissioner of State Revenue (Vic) v Price Brent Services Pty Ltd* [1995] 2 VR 582 at 588-589.

- 
- engage a manager (Management Co) to provide services to the land trust.

However, it remains to be seen whether the ATO will accept that TA 2017/1 does not apply to such property trusts.

### ***The takeaway***

In summary, there are specific issues which present themselves when seeking to apply s 102M to student accommodation, namely:

- the characterisation of the payment received from student tenants as rent, and
- the purpose for which the investment in land has been made, particularly where the land is held in a separate entity (Aus Trust) to the entity which carries out the operating activities (Management Co).

With the magnitude of the industry at stake, we would encourage public guidance from the ATO clarifying the bounds of 'rent' for the purposes of Div 6C generally. Further, the most recent industry guidance provided by the ATO (i.e. the draft infrastructure framework) leave the topics of 'investment in land' and the appropriate meaning of 'rent' untouched. Again, we would encourage that, to the extent this guidance is still in draft, comments be added to create greater certainty about these points.

### ***Let's talk***

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

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