2017-18 Budget and other developments affecting the institutional real estate sector

18 May 2017

In brief

In this update we explore some of the key measures in the 2017-18 Federal Budget impacting the real estate industry and also provide an update on other real estate related consultation matters.

The key real estate measures that were introduced as part of the Budget are aimed at combating the housing affordability crisis. These measures include the introduction an Affordable Housing Managed Investment Trust (MIT), strengthening the foreign resident capital gain tax (CGT) withholding regime, increased CGT discount for Australian resident individuals holding affordable housing, and proposing new rules affecting foreign ownership of residential real estate.

Whilst we generally support the Government's housing proposals, in our view additional measures are required to direct institutional capital to the affordable housing (and more generally residential real estate) asset class, including State Governments assisting with planning processes, stamp duty and land tax concessions for affordable housing, possible Government investment in affordable housing (similar to the NSW Social and Affordable Housing Fund) and amendments to the goods and services tax (GST) rules to allow GST credits on construction costs for the development of residential real estate that will be leased.

We would expect the discussion regarding Affordable Housing MITs (and the residential real estate asset class more broadly) will be brought together as part of the ongoing consultation on stapled structures and the Australian Taxation Office's (ATO's) Division 6C working group.

In detail

Key real estate related Budget measures

Affordable housing regime for Managed Investment Trusts (MITs)

The Federal Government is seeking to encourage investment in "affordable" (community based) housing through expanding the definition of an eligible investment business (contained in Division 6C of the Income Tax Assessment Act 1936) to include the acquisition, construction, or redevelopment of affordable housing. This will enable foreign investors to access to the concessional MIT withholding tax rate on investment returns and allow resident investors access to flow-through tax treatment.

In order to qualify for the new regime, which is proposed to apply from income years starting on or after 1 July 2017, the Affordable Housing MIT must hold and make available for rent the "affordable housing" asset for at least 10 years.

Typically, 'affordable housing' refers to residential housing where the rent charged is below market value (e.g. 20 to 25 per cent below market value). The Government will consult further on the implementation of this policy, including on the precise definition of affordable housing and tenant eligibility, and what qualifies as rent charged below the market rate.

To the extent the affordable housing is held for less than 10 years, capital gains derived on the sale of the investment will be subject to 30 per cent withholding tax (instead of the 15 per cent MIT concessional rate).

Further, as an additional integrity measure, up to 20 per cent of the income the MIT derives can be from other eligible investment activities permitted under the existing law. However, if this 20 per cent threshold is breached (i.e. less than 80 per cent of the MIT's income is from affordable housing in an income year), the non-resident withholding tax rate will be 30 per cent on investment returns for that income year rather than 15 per cent.

Foreign resident CGT withholding regime

From 1 July 2017, the foreign resident CGT withholding rate for foreign tax residents has increased from 10 per cent to 12.5 per cent, and the CGT withholding threshold for real property has been reduced from $2 million to $750,000.

Collection of GST on sale of residential real estate

From 1 July 2018, the Government will strengthen compliance with the GST law by requiring purchasers of newly constructed residential properties or new subdivisions to remit the GST directly to the ATO as part of settlement. By changing the compliance obligations, this measure will significantly alter the way in which the ATO collects the required GST.

Foreign Investment Review Board (FIRB) changes

The Government will introduce a range of amendments with effect from 1 July 2017, to clarify and simplify Australia's foreign investment framework. There is not much detail but it is stated that this will make foreign investor obligations clearer, and allow for more efficient allocation of FIRB screening resources to higher risk cases.

Other housing measures

There were a number of other measures aimed at solving the housing crisis, including:

- from 1 January 2018, increasing the CGT discount to 60 per cent for Australian resident individuals who invest directly in affordable housing or via an Affordable Housing MIT where the investment is held for three years or more and managed by a community housing provider. However, no further discount was afforded to superannuation funds.

- denying foreign residents and temporary residents access to the CGT main residence exemption from 7.30pm (AEST) 9 May 2017, subject to transitional rules.

- introducing an annual charge on foreign owners of residential real estate that is unoccupied (or not available for rent). However, clarity is required as to how current State Government levies on absentee foreign owners might interact with this additional annual charge.

- allowing a person aged 65 years or over to make a non-concessional superannuation contribution of up to $300,000 from the proceeds of selling their home from 1 July 2018. These contributions will be in addition to those currently permitted under existing rules and caps for superannuation contributions.

- developers of new residential real estate are capped at selling no more than 50 per cent of the property to foreign investors. We note that in the context of the affordable housing regime, it is unclear whether this measure will extend to indirect ownership such that it might affect foreign owned MITs that are acquiring affordable housing properties from a developer.

Update on other real estate related consultation matters

Treasury consultation on stapled structures

On 24 March 2017, the Government released a Consultation Paper which seeks stakeholder views on potential policy options in relation to stapled structures, the taxation of real property investments and the re-characterisation of trading income. This comes following the release of *Taxpayer Alert TA 2017/1* (the Alert) and the draft Privatisation and Infrastructure – Australian Federal Tax Framework (the Framework) by the Commissioner of Taxation in January 2017. Submissions on the Consultation Paper were due 20 April 2017.

There has been much uncertainty in the market since the release of the Alert (which expressed the Commissioner's concern over arrangements that fragment integrated trading businesses in order to re-characterise trading income into passive income) and the Framework in January 2017, specifically around the relevant industries to which the Alert could apply and little description as to the type of assets that would be acceptable to be held in stapled structures, e.g. hotels, retirement villages, student accommodation and agriculture.

PwC submitted a response to the Consultation Paper highlighting that any significant policy change from the current settings will inevitably have immediate consequences by reducing investor confidence and market capitalisation of Australian institutions. The potential for a significant shift in tax policy will impact a large number of stakeholders, including State and Territory Governments, a range of foreign institutional investors, Australian superannuation funds and Australian Securities Exchange listed entities including Real Estate Investment Trusts.

On 2 May 2017, the Government released a statement confirming their commitment to this issue but also stated that in

> *"[r]ecognising the economic significance of stapled structures in the Australian economy and that this is a complex and sensitive issue, the Government will not be responding to the issue in the Budget."*

The consultation period now has been extended until July 2017.

Division 6C working group

The Division 6C working group which includes the ATO, advisers, and industry representatives is working towards the ATO releasing practical guidance on the terms 'investing in land for the purpose, or primarily for the purpose, of deriving rent', and 'what is incidental and relevant' to the leasing of land. This is particularly relevant to determine whether a trust is a trading trust and, thus, cannot be a MIT. It is expected the ATO will release this practical guidance on 'what is incidental and relevant' before 30 June 2017.

Attribution MIT technical amendments

We anticipate amendments to address a number of technical issues in the current attribution MIT legislation to be introduced into Parliament by 30 June 2017.

PwC view

Affordable housing regime for MITs

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 question remains as to whether residential assets more broadly, and more specifically multi-family housing, should also be able to be held via passive trust structures and MITs under the current regime. Whilst the fact sheet accompanying this Budget measure clearly states that the ATO has generally taken the view that residential real estate cannot be held by a MIT on the basis the primary purpose of investing in residential real estate is to derive capital gains rather than a rental return, in our view multi-family housing should also be an eligible asset for MIT purposes where it is held for the long term (say over 10 years) to derive rent. We would recommend taxpayers obtain a ruling from the ATO to confirm this position.

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 our view, institutional investment into affordable housing could only realistically come from 'build to rent' rather than 'buy for rent' strategies given the inflated housing price market. Interestingly, the threshold for an Affordable Housing MIT to derive 80 per cent of its income from affordable housing is contrasted with clean building MITs which are required to derive 100 per cent of their income from clean buildings.

Whilst we generally support the Government's proposal, we believe that additional measures are 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;
- GST rules will need to be amended to allow GST credits on construction costs for the development of residential real estate that will be leased. Note that concessions already exist 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 should, in our view, be provided.

We expect the discussion regarding Affordable Housing MITs (and the residential real estate asset class more broadly) will be brought together as part of the ongoing consultation on stapled structures and the Division 6C working group.

Treasury consultation on stapled structures

Given the Treasurer did not commit in the Media Release or in the Budget to certain policy objectives or protected asset classes, there will remain, at least for the time being, a degree of uncertainty as to the future policy direction and tax treatment of stapled structures. This uncertainty is something all stakeholders will have to work through in the short to medium term. However, given the high priority of this issue, we expect timely and targeted consultation to occur in the months to come – with the consultation period now extended until July 2017.

Foreign resident CGT withholding regime

Whilst the Government's aim is to reduce the risk that foreign residents avoid paying a CGT liability they owe in Australia, as a result of these proposed amendments, a much larger number of transactions will be potentially caught by this regime.

Resident vendors (including MITs and other trusts, even if held by non-residents) are not unaffected by this regime - under the current law, a resident vendor is required to get a clearance certificate from the ATO confirming they are an Australian resident when they dispose of real property that would otherwise be subject to withholding. The original $2 million threshold for real property was intended to carve out the majority of residential house sales. Assuming the current clearance certificate process remains in place, the proposed decrease to $750,000 will have a huge impact on residential housing sales going forward.

The takeaway

In the context of Institutional Residential Real Estate investors, the Budget has not produced any significant or controversial measures. However, the implementation of an Affordable Housing MIT could, along with other additional measures to reduce barriers to entry, provide a new avenue for investing into residential real estate classes. We think however this should be broadened to ordinary residential asset classes (such as multi-family housing) where the assets are held for the long term (say over 10 years) to derive rent. We expect that the Affordable Housing MIT work stream will be combined with the ongoing consultation process on stapled structures and Division 6C and therefore taxpayers should monitor the progress of these issues closely.

Let's talk

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

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