

## **BTR Series Part 10: BTR and Investment Structuring—What Do Investors Need to Know Now?**

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In this final Part 10 of our build-to-rent (BTR) series, we identify some key investment structuring challenges for investors in new BTR assets in Australia, and consider how investors may be able to overcome some of them through a review of the current Australian and overseas legal landscapes. We conclude by noting that significant opportunities for current and potential investors in new Australian BTR assets exist, even if investment challenges remain in the short to medium-term.

## **BTR INVESTMENT STRUCTURING CHALLENGES - SOLUTIONS AND BENEFITS**

As mentioned earlier in our series, Australia is currently experiencing a national housing affordability crisis that continues to

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worsen. At this time, it appears that the only current real solution to the urgent need for more social and affordable housing is the BTR project model.

In **Part 1** of this BTR series, we discussed the fact that there is a sizeable gap in the Australian property market. The size of the BTR sector as a percentage of the residential market as a whole in Australia is just 0.2%, whereas it is 5% in the United Kingdom and 12% in the United States. Institutional investment in the residential market is currently also just a fraction of that compared to some other countries—in Australia, institutional investment represents just 3% of funding in the domestic residential market whereas in the United States and Germany, it is closer to 5%.

Given the maturity of BTR developments and investments in overseas markets, it makes sense that the Australian BTR market would attract foreign investment from established foreign developers and funds and institutional, superannuation and sovereign wealth funds as the BTR market in Australia grows to meet rising demand in the current housing crisis.

## **CURRENT BTR TAX STRUCTURING CHALLENGES**

Any corporate and funds deal or project is driven first and foremost by tax and corporate structuring. The situation with BTR asset structuring is no different. However, each BTR asset investment will bring about its own unique set of considerations and conditions, and if tax structuring is not done upfront it may result in

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unnecessary tax costs. When structuring a BTR asset investment, investors should note the following tax structuring challenges posed by the current Australian legal framework.

- *Dealing with the complicated Australian thin capitalisation regime-* The Australian Government recently introduced new thin capitalisation legislation to parliament (although not yet legislated, this will apparently have retrospective effect and commence on 1 July 2023). This legislation aims to significantly restrict the availability of debt deductions and may affect the economic viability of BTR projects.
- *Ensuring investment vehicles qualify for managed investment trust (MIT) status-* This requires a certain mix of investors together with a trustee (usually of a unit trust) who holds an Australian financial services licence.
- *Managing cross-staple arrangement rules for investment vehicles-* 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 reduced withholding tax.
- *Ensuring the investment structure does not offend 'trading trust' rules.*
- *Managing tax on exit for foreign investors-* Even if the MIT BTR tax settings allow gains on the exit of foreign investors to qualify for reduced withholding tax, it is important that the investment structure allows exit at the right level to facilitate this.
- *Determining whether foreign pension fund or sovereign wealth fund investors may be able to access the limited withholding tax exemptions for BTR projects-* This requires careful consideration of not only the level of investment (generally

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<10%) but also the governance rights that may be granted.

- *Goods and services tax (GST, Australia's 'value added tax')*- A standard 'for profit' Australian entity that acquires land and incurs development costs solely for the purpose of developing and *selling* new residential premises will be entitled to full GST input tax credits, but under current Australian law, an entity that acquires land and incurs development costs solely for the purpose of developing and leasing new residential premises will not be entitled to full input tax credits. The inability to recover such GST costs may negatively impact the internal rate of return for a BTR project, potentially making it unviable.
- *Transfer duty*- All eight Australian states and territories impose transfer (or 'stamp') duty on transfers of residential land, although different tax rates apply across each of the states and territories. In addition, the six Australian states (but not the Northern Territory or the Australian Capital Territory) impose surcharge transfer duty on transfers of residential land for foreign entities (including Australian entities that are foreign-controlled or owned) at either 7% or 8%. However, in some cases exemptions to such foreign investor surcharge duty may be able to be obtained.
- *Land tax*- All Australian states and territories except for the Northern Territory impose land tax. This is an annual tax applied to taxable land that is usually paid by the owner of the land. As with transfer duty, tax rates vary across the various states and territories. In addition, some Australian states and territories including New South Wales, Victoria and Queensland impose surcharge land tax on foreign owners of land.

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# BTR TAX STRUCTURING SOLUTIONS AND BENEFITS

Despite the above tax challenges for BTR projects in Australia, the following recent key changes to the Australian tax landscape could resolve some significant investor tax issues and provide tax benefits to many investors in BTR projects.

- *The announced reduction in MIT withholding tax to 15% for foreign investors in BTR projects from 1 July 2024.* This 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.
- The Australian Government announced accelerated capital works deductions for eligible BTR projects, allowing capital works to be depreciated at 4% (up from 2.5%) per year (or over 25 years instead of 40 years). The tax qualification criteria include that the project must consist of 50 or more apartments or dwellings made available for rent to the general public, with dwellings 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

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debt serviceability, both of which can be critical to the economic success of BTR projects—but *but* as with reduced withholding tax, implementation will be key.

- *Supplies of accommodation made by an endorsed charity will be GST-free* if the supply is made for consideration that is less than 75% of either the market value or the cost of the supply. The benefit of the accommodation supplies being GST-free is that GST does not apply to the rents or accommodation fee income, but full input tax credits are available on all land acquisition and development costs.
- *Charities may be exempt from transfer duty.* In addition, qualifying BTR projects in some Australian states and territories such as New South Wales are *exempt from foreign investor surcharge purchaser duty.*
- Qualifying BTR projects in some Australian states and territories, such as New South Wales, are *exempt from foreign investor surcharge land tax.*

See **Parts 2** and **3** of this BTR series for further information on the approaches likely needed for investors to qualify for the above tax benefits for BTR projects.

## WHERE DO INVESTORS FIND DEBT FUNDING FOR AUSTRALIAN BTR PROJECTS?

In **Part 5** of this BTR series, we discussed how the National Housing Finance and Investment Corporation (NHFIC)—a corporate Commonwealth (Australian Government) entity with the stated

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purpose of improving housing outcomes for Australia and which manages the AU\$1 billion National Housing Infrastructure Facility—is playing a central role in providing funding to developers to support BTR projects through the giving of concessional loans, investments and grants to registered community housing providers.

NHFIC's support in this regard has been important whilst the traditional bank lenders in Australia become more acquainted with financing of BTR assets. In our experience, the Big Four Australian banks (National Australia Bank, Commonwealth Bank, Westpac and ANZ) are becoming more familiar with financing risks for BTR projects and are financing more and more BTR projects.

Non-bank lenders do provide an alternative for debt financing and may provide more flexible terms, but the cost of debt from such lenders may 'turn off' potential borrowers.

Key obstacles remaining for BTR funding models in Australia include the following:

- As noted above, BTR assets are relatively new in Australia and traditional bank lenders like to see experienced borrowers with successful track records, meaning they may scrutinise the financing applications for BTR assets more closely now than they might in future years;
- BTR projects use short lease terms rather than longer term lease commitments and as financiers like *certainty*, this can pose issues in the lending credit approval processes;
- There is little historical data regarding valuations for BTR

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assets, usually meaning that lenders are often adopting conservative loan-to-value ratios and requiring greater equity than they would for build-to-sell projects; and

- Additional security and guarantees, such as rental guarantees and leasing incentives may be requested by financiers and tripartite agreements - which allow for cure and lender step-in rights - between the lenders, developers, managers and operators may be required as part of the lender's security package.

In **Parts 4** and **5** of this BTR series, we noted that some overseas jurisdictions with more developed BTR sectors may assist in providing some answers to the above debt funding challenges faced by BTR investors in Australia. For example, we are aware that in the United States, grants or low-interest loans are provided to developers to encourage the development of low-income housing and now nearly half of all BTR (also called multifamily) mortgage debts are backed by US federal government agencies such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Government National Mortgage Association (Ginnie Mae).

Arguably, Australia already has a similar set-up with NHFIC, but the US provides a far more advanced concessional financing model and more concessional funding variety for various stakeholders (investors, tenants, developers and financiers).

Finally, investors should also consider whether all of the funding they provide will be by way of equity injection or provided by way of debt. We have seen BTR funding models in the market where



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investor funding is utilised as debt financing for the entity that holds the BTR asset, with such loans being provided on market and on arm's length terms.

## CAN AUSTRALIAN CHARITY LAW APPLY?

In **Part 4** of this BTR series, we discussed how the application of Australian charity law to housing providers may be critical to the success of a BTR project, as a variety of tax incentives, including for GST, duty, land tax and income tax, depends on whether a registered Australian charity provides social and affordable housing.

In this regard, the commissioner of the Australian Charities and Not-for-profits Commission has noted that the fact that the Australian Government has created a housing scheme does not necessarily mean that an entity providing housing under that scheme is 'charitable' under the *Charities Act 2013* (Cth).

Although this can be an issue for registered community housing providers that are proposing to establish special purpose vehicles as charities to undertake certain affordable housing projects, an upfront legal review of the relevant entity's constitution—and a review of the constitution's charitable objects in particular in conjunction with discussions with legal advisers as to the entity's charitable aims—can assist in resolving whether or not that entity may be considered 'charitable' under Australian law.

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# **FINDING THE RIGHT PARTNERS (BUILDERS, DEVELOPERS AND MANAGERS)**

Finding the right partners for a BTR project is critical to its success, just like it is with any investment in real estate assets. Investors in BTR projects are usually passive participants and for such investment models, as part of the initial documentation signed, the investors will generally appoint a third party developer, a third party builder for the construction phase, and an asset manager for the operational stage of the project. Depending on the investment model, an investment manager may also be appointed. Where the investors will not be passive, the developer will generally partner with the investors who will ultimately own the land on which the BTR asset is built. After completion of the build, the investors will be the landlord (or have an interest in the landlord entity) under residential tenancy agreements with the building tenants, with funding provided by way of equity or debt and regulated under a joint venture agreement, a partnership agreement or under co-ownership arrangements, depending on the investment and funding model adopted.

## **FIRB FOR FOREIGN INVESTORS AND INCENTIVES FOR REGISTERED COMMUNITY HOUSING PROVIDERS?**

Some other important considerations for investors may be the

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Foreign Investment Review Board (FIRB) for foreign investors (see **Part 9** of this BTR series), opportunities to adopt sustainability and energy efficiency initiatives (see **Part 8** of this BTR series) and affordable housing incentives being provided to BTR projects where there is a 'registered community housing provider' (see **Part 4** of this BTR series).

## LOWER INVESTMENT YIELDS?

In our experience, investments in BTR residential projects may generate lower yields in the short and medium term compared to other real estate asset classes such as commercial real estate.

However, investors may not be interested in BTR projects for (or at least solely for) the yields, noting that the tax and funding concessions referred to above may be attractive to investors and complement their other asset portfolios.

In addition, it is our observation that besides the above tax and funding incentives, investment in BTR projects is currently being driven by increasing and urgent demand for housing and longer-term investor returns compared to other categories of real estate asset classes such as commercial real estate.

## WHERE TO FROM HERE?

In September 2023, Australia's federal housing minister, Julie Collins, said that there was a '*realistic prospect*' of establishing BTR real estate as a '*significant new investment asset class*' with the

Australian Government now considering reforms to encourage financing and consulting with the state and territory governments to tap into Australia's large pool of superannuation savings in particular for investment in to the emerging BTR sector.<sup>1</sup> It is also notable that the AU\$10 billion Housing Australia Future Fund recently passed parliament, which will allow 30,000 new social and affordable homes to be built.

In this article, and throughout this BTR series, we have proposed a range of tax and legal reforms needed to meet challenges and to support the growth of the BTR sector. It is clear that the Australian Government is taking these issues seriously (though some critics observe that such reform is slower in coming than they would like). Delivering supply of BTR assets also continues to be an issue, though clearly demand is present and investor desire to tap into the obvious gap presented by the lack of maturity of the Australian BTR sector presents some real opportunities. In particular for superannuation, institutional and sovereign wealth investors and perhaps also—later on down the track as the asset class grows in Australia even potentially for mum and dad investors who may be able to one day directly invest in BTR schemes.

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