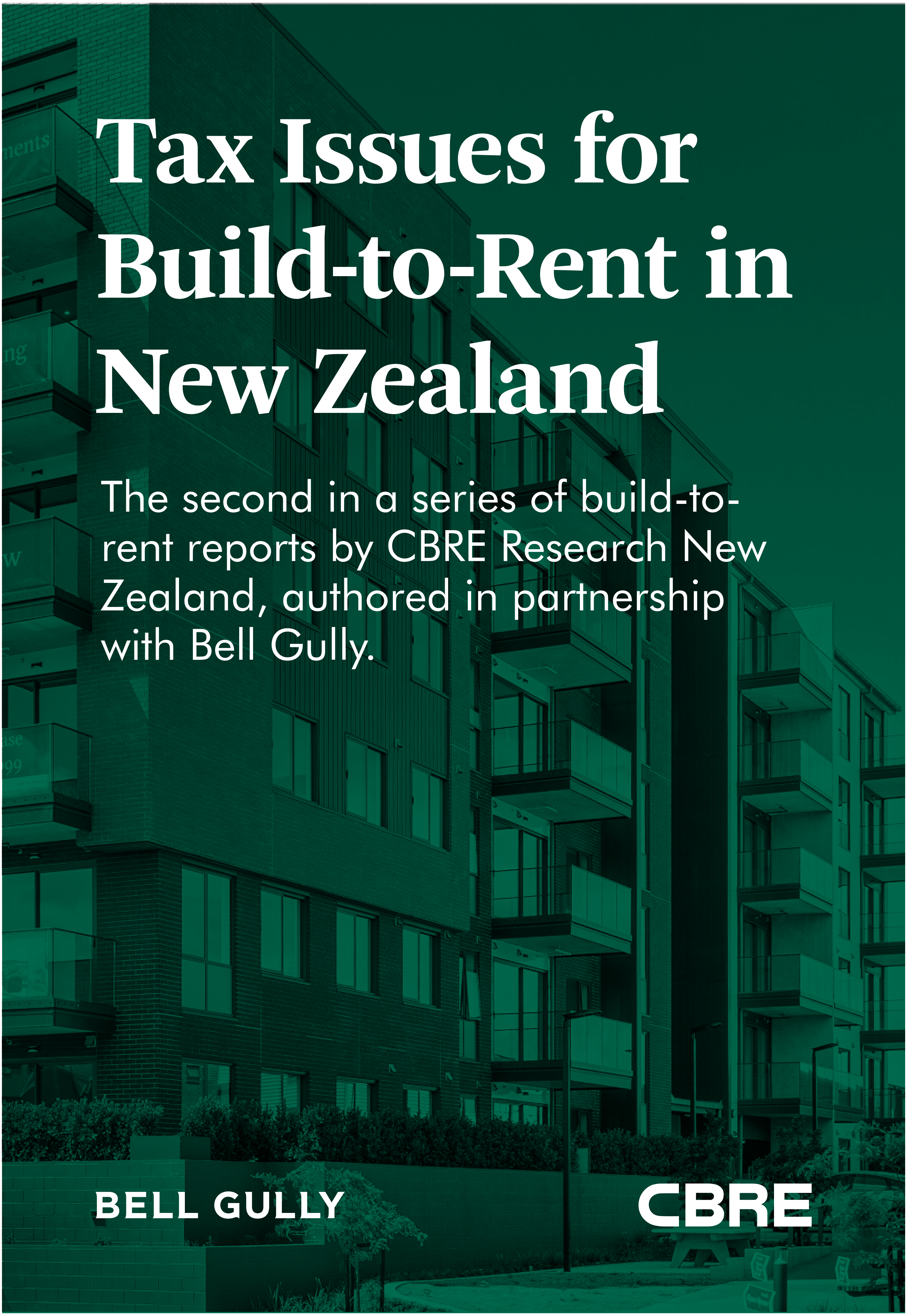

Tax Issues for Build-to-Rent in New Zealand

The second in a series of build-to-rent reports by CBRE Research New Zealand, authored in partnership with Bell Gully.

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Build-to-rent is an emerging asset class in New Zealand with a handful of developments planned, underway, or recently completed. There is growing awareness of the benefits for both investors and occupiers, however it is equally clear that there are multiple headwinds limiting growth potential in the short-term. This research paper delves deeper into the topic of tax, looking at the specific issues affecting the New Zealand market, how they compare to Australia, and the different tax obligations of various build-to-rent ownership structures.

When considering the emergence and growth of build-to-rent in New Zealand, it is important to recognise the institutional structures that have enabled and supported (or sometimes hindered) the asset class in other markets globally. While natural support structures such as demographic change and investment rationale are present locally, institutional support structures that have been essential in the growth of mature build to rent markets offshore are not currently present.

One of these support structures is a comparable tax treatment to other types of commercial property investment. In both New Zealand and Australia, a disproportionate treatment of GST means that build-to-rent developers are tax disadvantaged relative to build-to-sell developers. The situation is more complex in Australia as it is also impacted by stamp duty, land tax and withholding tax. These tax issues are limiting the growth potential of build-to-rent, which conflicts with political desire to increase housing supply by enabling long term stable rental accommodation in desired locations close to transport and jobs. In line with this mandate the Australian Labor party have recently proposed that the withholding tax rate for managed investment trusts be halved from 30% to 15% from 1 January 2020. This will allow investors who use managed investment trusts to be taxed at the same rate for build-to-rent as they would for other commercial asset classes such as shopping centres and office buildings. It also serves to remove one of the major tax impediments for offshore investors who use managed investment trusts as a vehicle for investment in Australian property, significantly deepening the available pool of capital.

GST RECOVERY ON DEVELOPMENT

The single biggest tax issue in a New Zealand context is the recoverability of GST charged to the owner of build-to-rent investments. GST is tax charged on the supply of certain goods or services by a GST registered person. The GST paid by a registered person on input costs is creditable/refundable, but only to the extent to which the acquired goods or services are used in making taxable supplies. The supply of residential accommodation is exempt from GST and is accordingly not a taxable supply. Therefore, GST charged on inputs in making that supply are typically not refundable.

This presents an issue for build-to-rent investments. GST will be charged by the suppliers of building materials and labour in the development of these properties, with that GST being unable to be recovered by the owner. GST charges on the continuing rental costs of owning a dwelling are also unable to be recovered. This recoverability issue is in contrast to a developer for sale who would receive a credit for GST charged on its inputs.

TAX WORKING GROUP RECOMMENDATIONS

The Tax Working Group released its final report in February 2019, recommending the introduction of a broad-based capital gains tax. While the government is yet to indicate if, when, or how this recommendation could be adopted, the introduction of such a tax will inevitably alter the profile of an investment in build-to-rent. Because the investment relies on rental income rather than the derivation of capital gains, it could potentially be less susceptible to the introduction of a capital gains tax compared to other investments.

One of the revenue neutral packages floated in the Tax Working Group report involved the re-introduction of depreciation at a 1% rate on certain buildings and on seismic strengthening costs. It is our view that the elimination of depreciation on buildings in 2011 was unprincipled due to the reality that buildings do depreciate. To this point, the Tax Working Group report referenced international evidence that large buildings typically depreciate at a rate of 2-4% per annum. The reintroduction of depreciation on certain buildings (potentially industrial, commercial and/or multi-unit residential buildings) would mean a reduction of net income, enhancing the tax profile of build to rent investments for those building types. The Tax Working Group did not recommend reintroducing depreciation deductions for standalone residential buildings.

ALTERNATIVE OWNERSHIP STRUCTURES

This section provides a high-level overview of various potential ownership vehicles in connection with build-to-rent investments in New Zealand, outlining their various structures and tax requirements.

Name	Features	Advantages	Disadvantages
Limited Liability Company	A NZ company is taxed on net income at 28%. Unimputed dividends payable to a non-resident shareholder (e.g., distributions of capital gains) will be subject to non-resident withholding tax at a rate of 30% (potentially subject to reduction under an applicable double tax agreement).	Imputation credits are generated for corporate tax paid on net income. These credits can be attached to dividends paid to shareholders and applied to reduce their tax payable on the dividend. Fully imputed dividends paid to non-residents are generally not subject to NZ withholding tax if the investor has an ownership interest of 10% or more in the company or has the benefit of a double tax agreement between NZ and their country of residence.	Untaxed earnings (e.g., capital gains) can become trapped in a corporate structure. This means that outside of certain defined circumstances they are unable to be distributed without tax as they are deemed to be a taxable dividend. A company would also need to monitor shareholder continuity requirements in order to ensure any imputation credit balances are maintained (requiring at least 66% continuity of ownership). The loss of imputation credits would impact the ability to fully impute dividends.
Unit Trust	A unit trust is deemed to be a company for tax purposes. Unit holder treated as a shareholder, units as shares, and distributions as dividends.	As per Limited Liability Company structure above. A unit trust generates imputation credits for tax paid.	As per Limited Liability Company structure above.
Portfolio Investment Entity (or PIE) elections	A portfolio investment entity (PIE) is a company or unit trust which has elected to become a portfolio investment entity for tax purposes. The most common type of PIE is a multi-rate PIE. Income in a PIE will be attributed to shareholders and taxed at shareholders' prescribed investor rates (PIRs). The maximum PIR is 28%. All distributions from a PIE (income or other amounts) are then excluded income for an investor. A PIE may become a listed entity. The tax treatment of a listed PIE is different to a normal PIE, but the broad treatment remains the same from an investor's perspective.	PIEs are subject to concessional tax rates for investors (with the PIRs being capped at 28%).	To become a PIE, an entity is required to meet certain requirements. These include that the company have at least 20 investors, none of whom hold more than 20%. Relief from these requirements can be available where the investor is itself is a PIE or other widely held entity meeting certain criteria. There is also some additional and on-going complexity in monitoring compliance with requirements of the PIE regime.
Limited Partnership	A New Zealand limited partnership (LP) is a flow-through entity for income tax purposes with gains and losses being attributed to the limited partners directly. The LP's income must be attributed to the limited partners on a proportional basis to their ownership percentage of the LP.	Because the income of an LP is attributed directly to its partners for tax purposes, any untaxed earnings of the LP (e.g., capital gains) can be remitted without tax consequences. In contrast to a company structure, there is no need to liquidate a NZ LP or engage in any special return of capital to distribute non-taxable gains in a tax efficient way. The ability for Investors in an LP to derive income directly may provide advantages depending upon the tax profile of the Investor (e.g., whether it has available tax losses, or whether it is subject to a concessional tax rate).	Investors in an LP are treated as acquiring or disposing of assets as their interest in the LP increases or decreases (with some safe harbour rules for deemed transactions below certain value thresholds). These deemed dispositions can give rise to taxation issues.

An investor's decision as to the preferred ownership structure for a New Zealand build-to-rent investment will be highly dependent upon their individual circumstances; their tax profile as a low-rate or tax-exempt entity, their jurisdiction of residence, and other factors.

While we would expect a Limited Liability Company structure to be the most prevalent in the market, alternative structures could be considered, depending upon the profile of the investor.

In particular, non-resident investors might consider the use of an LP structure in order to access any untaxed capital gains directly, and free of New Zealand withholding taxes upon distribution. Taxpayers with available tax losses may also consider the use of an LP structure in order to be able to offset those losses against taxable income from the investment. For investors who benefit from a broad investor base with multiple underlying portfolio investors, the concessional tax rates provided under a PIE structure may be appealing.

Developers of build-to-rent in New Zealand are tax disadvantaged relative to build-to-sell developers, however while this is the reality it is not stopping build-to-rent from occurring. Ninety-six units have been completed to date, with a further 267 in the pipeline. The pipeline in Australia is 10 times the size of New Zealand's, despite their additional tax issues. These active pipelines show that investors are finding ways to proceed with development in the current environment.

However, there is a case to be made for change based on social outcomes. Build-to-rent is long term rental accommodation, widely accepted as a mechanism of growing housing stock, giving security of tenure to a growing renter population, and providing a return to investors. There is a compelling case to remove the disproportionate tax disadvantage by the introduction of a special purpose exemption for build-to-rent investors. We don't view this solution as providing unfair advantage to the build-to-rent sector, but more a levelling of the playing field and encouraging other important social goals.

Build-to-rent is by no means a silver bullet to solve housing woes, but it is part of the solution. Continued urbanisation, the high cost of housing and demographic changes are all contributing to a growing renter population who desire affordable, quality housing with stability of tenure. By addressing the GST tax disadvantage and establishing other support structures, this will enable the build-to-rent sector to flourish in New Zealand, and ultimately benefit society.

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