June 2020

Victoria's Vacant Residential Land Tax

A Case for Reform

Introduction

The vacant residential land tax (VRLT) took effect on 1 January 2018. It is a Victorian state tax levied on residential properties in Melbourne's inner and middle suburbs which are unoccupied for more than six months either continuously or in aggregate in a calendar year.

As a result of the consequences of COVID-19 on the residential property sector, UDIA Victoria makes the case for the following recommendations:

1. *Immediately* stop the application of the VRLT for all new residential dwellings built within the last 2 years, under construction, and to be constructed between 2020 and the end of 2022.
2. *Permanently exempt* developers with unsold dwelling stock from the application of the VRLT by removing it from residential dwellings recently constructed and not yet sold or transferred as a result of market dynamics rather than by design.

Original Policy Intent

When the VRLT was conceived in 2017, the Victorian Government was concerned about the number of properties being left vacant by owners for extended periods of time. At this time, the property market was at a peak and dwelling price had risen rapidly and significantly. Melbourne faced a housing affordability crisis and also a shortage in rental stock as a result of record population growth.

The VRLT was originally intended to address and discourage owners of new housing stock from leaving it vacant, in the face of escalating rental demand and rental costs.

The tax was intended to increase the availability of affordable housing by encouraging landowners to make residential properties available for purchase or rent so that Melbourne's current housing stock is used more efficiently.

Despite this policy intent, and the obvious policy differences between home buyers and developers, the tax was enacted to apply to all landowners including developers left with unsold housing products.

Whilst some concessions were included in the legislation to try to reduce the impact of the tax on developers, they are narrow, complex and reflect limited understanding within Government about the realities of the residential development market and industry.

Under the legislation the State Revenue Office (SRO) does have the discretion to apply concessions and waivers to eligible applicants. However, this remit is narrow, and it is unclear if the SRO will proactively exercise its discretion in response to the significant impacts on the development industry from the COVID-19 pandemic.

Application

The tax applies from 1 January 2018 and it is based on occupation in the preceding year. The tax applies annually at a rate of 1 per cent of the property's capital improved value (CIV) and is payable on a calendar-year basis. For example, tax liabilities for the 2020 year are based on occupation in 2019.

For example, if an apartment valued at $600,000 makes title in calendar year 2020 and is vacant for more than six months during calendar year 2021 and is still owned by the developer as at 31 December 2021, the amount of VRLT payable will be $6,000.

For developments which had an existing dwelling prior to construction, such as a home or renovation and small-scale suburban apartment developments, a grace period applies for 2 years following issue of the building permit, and there is a provision for the Commissioner of State Revenue to extend this period.

This exemption does not extend to developments where the land prior to development did not have a residential dwelling, such as a large-scale apartment development on vacant land. Further this exemption is intended to address delays in construction, not delays in selling/settling apartments due to a market downturn. We appreciate there is currently no legislative power provided to the Commissioner to exercise discretion in relation to delays in selling/settling apartments.

Other exemptions apply for properties that change ownership, land that becomes residential land during the assessment year, holiday homes and property used by the owner for work purposes.

The impact of a market downturn such as COVID-19 (further discussed below) means developers who have completed a development, and due to delays in selling/settling apartments have held those completed apartments for one full calendar year, will pay VRLT. This will apply to apartments sold but not settled, and apartments not sold, and in both of these scenarios it makes no difference if the apartment is being actively marketed for sale and/or rent.

Impact of COVID-19

The impact of COVID-19 on residential vacancy rates is significant and is most pronounced across the following two issues:

1. **Rental vacancy rates** have increased dramatically, especially in Melbourne's CBD and inner suburbs, as a result of the following:
    a. International and interstate border closures
    b. Inability of international student to come to Melbourne
    c. Rising unemployment and underemployment
2. The **elevated level of settlement risk and fall over**, for apartment developments as a result of weak purchasing power, limited foreign investment and an overall weakened property market, will likely lead to higher vacancy rates post-construction in the coming months.

Residential Rental Vacancy Rates

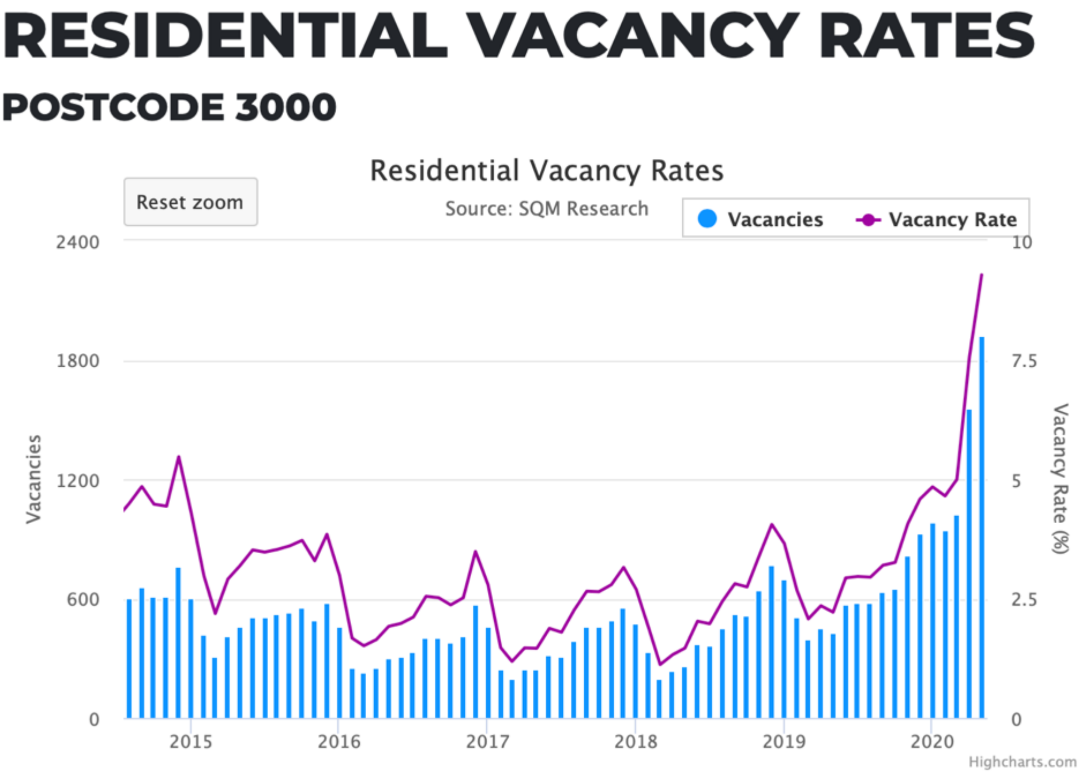
Melbourne's vacancy rate has risen to 3.1% in May, up from 1.9% in March 2020 according to SQM Research.[1]

[1] SQM Research, Residential Vacancy Rates – Melbourne, https://sqmresearch.com.au/graph_vacancy.php?region=vic%3A%3AMelbourne&type=c&t=1, accessed 22 June 2020

City	May 2019 Vacancies	May 2019 Vacancy Rate	April 2020 Vacancies	April 2020 Vacancy Rate	May 2020 Vacancies	May 2020 Vacancy Rate
Sydney	23,796	3.3%	28,734	3.9%	29,416	4.0%
Melbourne	10,349	1.8%	16,575	2.8%	18,499	3.1%
Brisbane	8,133	2.4%	9,555	2.8%	8,780	2.5%
Perth	6,457	3.1%	4,807	2.3%	4,167	2.0%
Adelaide	2,126	1.1%	2,398	1.2%	2,293	1.2%
Canberra	785	1.2%	824	1.2%	880	1.3%
Darwin	1,038	3.3%	837	2.6%	727	2.3%
Hobart	143	0.5%	442	1.4%	386	1.2%
National	**75,083**	**2.2%**	**88,668**	**2.6%**	**86,398**	**2.5%**

Melbourne's vacancy rate has been particularly impacted by the exodus of international students. According to the Mitchell Institute (Victoria University), over 65% of international students live in rental accommodation.[2] The Mitchell Institute estimates that Melbourne has seen a decline of international students by May 2020 of an enormous 13,650. The Mitchell institute estimates that Melbourne has almost 5,000 less people living in the CBD due to the international travel bans impacting international students.

Most worrying is Melbourne's CBD vacancy rate which, according to SQM Research, topped 9.3% in May 2020.



[2] 'International Students Critical to Coronavirus Recovery', Victoria University, Mitchell Institute, https://www.vu.edu.au/mitchell-institute/tertiary-education/international-students-critical-to-coronavirus-recovery, accessed 23 June 2020

Dwelling Investment

The Reserve Bank of Australia has stated that:

> Deterioration in established housing market conditions is expected to prolong the decline in dwelling investment. Dwelling investment is expected to be significantly lower over most of the forecast period than forecast in the previous *Statement*. The trough in construction activity is now projected to occur in early 2021, half a year later than previously expected. The near-term downgrade to activity incorporates information from liaison citing significantly weaker demand for new dwellings.[3]

Dwelling prices are expected to decline by up to 9 percent between March and December 2020 according to the Victorian Government's Treasury forecast released in May 2020.[4]

Further, dwelling investment is likely to remain weak while rents decrease. The weekly median rent for houses in metropolitan Melbourne fell by $10 to $455 in May 2020, while the weekly median rent for houses remained at $350 in regional Victoria according to the REIV.[5]

These factors will all have a material impact on residential vacancy rates, as a direct result of COVID-19, and are not a result of the policy drivers the Victorian Government was seeking to address when the tax was introduced.

A Poorly Targeted Tax

In so far as the VRLT applies to residential property developers left with unsold housing stock, it is an inefficient and inequitable tax which fails to encourage the release of greater affordable housing product into the rental market:

- VRLT is effectively a tax on the trading stock of residential property developers. That we are aware, no other industry in Victoria (or for that matter federally) currently pays tax in respect of its unsold trading stock;

- VRLT is also a tax imposed because trading stock has not been sold within a time frame deemed appropriate by government. The current time frames set by government are arbitrary and lack policy merit. That we are aware, no other industry in Victoria (or for that matter federally) currently pays tax in respect of trading stock not sold within a time frame mandated by government;

- VRLT is not a tax on homes 'left' unoccupied by a developer. The housing stock remains unoccupied because it was always intended to be sold as new product. If occupied, the housing product would transform into a different asset class. Taxing developers on unsold housing stock is akin to taxing motor vehicle traders on vehicles left standing in the yard. Asking motor vehicle traders to lease their vehicles for the period they remain unsold would be considered unreasonable by government because the nature of the product would

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[3] Reserve Bank of Australia, Economic Outlook, May 2020, https://www.rba.gov.au/publications/smp/2020/may/economic-outlook.html, accessed 22 June 2020.
[4] Department of Treasury and Finance, Coronavirus Economic Outlook, https://www.dtf.vic.gov.au/sites/default/files/document/Coronavirus%20Economic%20Outlook%20-%20Fact%20Sheet.pdf, accessed 22 June 2020.
[5] REIV Market Snapshot May 2020, https://reiv.com.au/property-data/residential-rental, accessed 22 June 2020.

irreparably transform from new to used. Yet that is exactly what government is encouraging residential developers to do by imposing VRLT.

- VRLT does not encourage residential developers to make their properties available for purchase or rent. The housing product is already available for purchase from its creation, and is in fact available for purchase prior to its creation under pre-sale models widely used in Victoria. To suggest that VRLT makes that housing product 'more available' for sale is flawed policy logic. To suggest that the product should be leased as an interim step is also flawed logic, as upon so doing a developer will irreversibly change the nature and asset class of its product.

- Two basic financial models exist within Victoria which drive the creation and delivery of affordable residential housing stock. The first is build-to-sell, the second is build-to-rent. There is no such thing as 'build-to-sell-and-maybe-rent' stock that isn't sold within an approved timeframe. VRLT operates to distort market outcomes, and it does it in a manner which is inconsistent with its basic policy intent.

- The financial position of a residential developer is not equivalent to the financial position of a retail purchaser of housing stock in Victoria. They are taxed differently, borrow money differently, hold and transact assets differently. Yet the VRLT lumps them both in together and taxes both more or less equivalently beyond an arbitrary timeline set down by government.

- For a range of commercial and tax reasons residential developers cannot simply reduce the price of unsold housing stock to 'move it out the door'. Similarly, they cannot simply lease unsold residential product to avoid the incidence of VRLT. Residential developers have nothing like the flexibility that retail end purchasers have in deciding how to respond (and manage) the incidence of VRLT to encourage the release of that housing to the rental market. One simple example is GST. If a residential developer leases its unsold housing stock it will forfeit all input tax credits previously claimed in respect of the construction cost of its housing product. This has a materially adverse effect on the build-to-sell financial model used by residential developers to create affordable housing.

- VRLT discourages the creation of affordable housing by residential developers and instead encourages the creation of 'saleable' housing by developers. In a market where government spends considerable time and effort to encourage developers to create diverse, green and adaptable housing product, the prospect of having to pay tax on any unsold product will encourage developers to create more low-risk, sure-sale product. VRLT is therefore working directly against the market outcomes government is itself trying to currently promote in the residential development sector.

Recommendations

1. *Immediately* stop the application of the VRLT for all new residential dwellings built within the last 2 years, under construction, and to be constructed between 2020 and the end of 2022.
2. *Permanently exempt* developers with unsold dwelling stock from the application of the VRLT by removing it from residential dwellings recently constructed and not yet sold or transferred as a result of market dynamics rather than by design.

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Appendix – Case Studies

Lendlease Case Study

Lendlease developed the 883 and 889 Collins Street apartments for sale to owner occupiers and investors with all apartments on the market for sale at all times. Both buildings were completed in 2017 after a staged building permit process, delivering a significant new supply of 1,064 new apartments.

Given the scale of these buildings, the construction period for each building was approximately 2 years and therefore the 2 year grace period afforded to new home construction (2 years from issue of building permit) is of no benefit to buildings of this scale.

As at 1 January 2018, 951 apartments were settled, 92 contracted for sale, and 21 unsold and available for sale. Lendlease continued a diligent sale campaign and settlement process throughout 2018, 2019 and early 2020 to divest the remaining stock in challenging market conditions and forecasts full sell out and settlement by May 2020.

Lendlease is concerned that the potential application of the tax toward developers' residual stock is an unintended and unreasonable consequence of the original intent of the tax as outlined above by the Victorian Government. The 883 and 889 Collins Street developments were built to sell and have made a significant contribution to increasing Melbourne's overall housing stock.

If the tax is applied in its current form, the potential impact to these projects could be in the range of $115,450 to $207,300 for 883 Collins Street and $39,700 to $199,135 for 889 Collins Street depending on which building permit is taken for the commencement of the standard 2 year grace period.

Estimate of Impact (subject to confirmation of how the charges will be applied)

Scenario 1 – From <u>first</u> building permit date with 2, 3 and 4 year grace period

	2 year grace (no extension)	**3 year grace (1 year extension)**	**4 year grace (2 year extension)**
883 Collins	$207,300	$19,800	-
889 Collins	$199,135	$19,350	-

883 Collins Street

- First building permit issued 14 Sep 2015 with practical completion achieved in Aug 2017;
- Settlements commenced from Aug 2017 with the last settlement forecast for May 2020;
- At the end of 2 year grace period – 14 Sep 2017, 106 out of 528 apartments settled;
- At the end of 3 year grace period – 14 Sep 2018, 509 out of 528 apartments settled;
- At the end of 4 year grace period – 14 Sep 2019, 527 out of 528 apartments settled;

889 Collins Street

- First building permit issued 17 Jun 2015 with practical completion achieved in May 2017;

- Settlements commenced from May 2017 with the last settlement achieved in Mar 2019;
- At the end of 2 year grace period – 17 Jun 2017, 514 out of 536 apartments settled;
- At the end of 3 year grace period – 17 Jun 2018, 527 out of 536 apartments settled;
- At the end of 4 year grace period – 17 Jun 2019, all apartments settled;

Scenario 2 – From last building permit date with 2, 3 and 4 year grace period

	2 year grace (no extension)	3 year grace (1 year extension)	4 year grace (2 year extension)
883 Collins	$115,450	$12,500	-
889 Collins	$39,700	-	-

883 Collins Street

- Last building permit issued 24 May 2016 with practical completion achieved in Aug 2017;
- Settlements commenced from Aug 2017 with the last settlement forecast for May 2020;
- At the end of 2 year grace period – 24 May 2018, 483 out of 528 apartments settled;
- At the end of 3 year grace period – 24 May 2019, 525 out of 528 apartments settled;

  At the end of 4 year grace period – 24 May 2020, all apartments settled;

889 Collins Street

- Last building permit issued 4 May 2016 with practical completion achieved in May 2017;
- Settlements commenced from May 2017 with the last settlement achieved in Mar 2019;
- At the end of 2 year grace period – 4 May 2018, 524 out of 536 apartments settled;
- At the end of 3 year grace period – 4 May 2019, all apartments settled;

Salta Properties Case Study

The Park House

Salta Properties is developing a project in Abbotsford called “the Park House”. This project demonstrates the lack of fairness of the VRLT and can be used as an example of what the broader market is facing, particularly in the face of COVID-19 which will limit the pool of buyers in the market.

The Park House project comprises 531 apartments in two buildings. Building A comprises 223 apartments and building B comprises 303 apartments. As at the end of April 2020 154 apartments in building A and 81 apartments in building B have been sold. This leaves 74 apartments in Building A and 222 apartments in Building B still to be sold. This number could increase given the substantial uncertainty over buyers settling as a result of the COVID-19 crisis.

The developer entered this project with 'eyes wide open' knowing there would be a substantial number of apartments to be sold post completion and demonstrating confidence in the ability sell quality stock on completion to buyers who no longer had a reason to purchase off the plan to achieve a stamp duty saving that no longer existed. It is also relevant to note that the VRLT was announced and implemented after the Park House project commenced. It is likely the appetite to commence such a project with low presales would have been reconsidered had the VRLT been in operation prior to the project commencement.

Construction of Building A is due for completion in July 2020 and Building B in November 2020, with titles to be issued just prior to construction completion. Therefore, the calendar year following issue of title is 2021. If any apartment is therefore vacant for more than six month during 2021 and is either unsold or unsettled as at December 2021, then the developer will be liable to pay VRLT.

Based on an average price of remaining stock of $650,000, the total capital improved value of stock remaining is $192,400,000. The table below represents the amount of VRLT payable by the developer in the event the noted proportion of apartments remain vacant as at 31 December 2021.

If stock still exists in December 2022, VRLT will also be payable once again.

% Stock Remaining	CIV @ Average Price	VRLT Payable
100%	$192,400,000	$1,924,000
50%	$96,200,000	$962,000
25%	$48,100,000	$481,000