16 February 2021

Mr Nick Staikos MP
Parliamentary Secretary to the Treasurer

By email: nick.staikos@parliament.vic.gov.au

Dear Mr Staikos

UDIA Victoria feedback – Windfall Gains Tax – Deductions framework

I write to you with further feedback arising from the *Windfall gains tax discussion paper – potential deductions framework* received by UDIA Victoria on 27 January 2022 and the subsequent stakeholder discussion held on 2 February 2022.

UDIA Victoria has consistently argued that a comprehensive deductions framework must be incorporated into the windfall gains tax regime. Whilst we would have much preferred that a deductions framework be incorporated into legislation to provide transparency and accountability through the Parliamentary process, we nonetheless appreciate the opportunity to provide feedback on the issues that will frame the drafting of regulations. We set out our response to each question in the discussion paper, below.

1. Should any deductions be allowed? What is the rationale for allowing deductions?

Yes.

Any attempt to calculate the taxable value uplift without any allowance for the substantial costs and risks incurred in achieving that value uplift is based on misguided starting assumptions. It is the wrong starting point entirely to suggest that the uplift in land value is solely a function of a change in zoning. Value uplift is a function of many factors, primarily the costs, and efforts expended by a developer, as well as the rezoning decision which is the final (and easiest) step in the process.

Rezoning is a complicated and expensive process. The complexity and expense has only increased over time, together with the increased politicisation of decisions relating to land zones.

The additional burden of government regulation and compliance has substantially increased time and risk related to these processes. The breadth and detail of technical reporting required by local and state government to consider a proponent-led Planning Scheme Amendment (PSA) process has reached new extremes, with the level of detail growing exponentially.

UDIA Victoria also notes recent changes to EPA guidelines in relation to potentially contaminated sites which now impact every industrially zoned land parcel (which are the most common source of much-needed infill development sites). Previously, a site could be considered for rezoning with early environmental investigations and then rezoning with an Environmental Audit Overlay (EAO) at PSA stage, with the completion of the audit a precondition to a planning permit. Now EPA and DELWP practice has become that, in most cases, the environmental audit work must be completed prior to the PSA being approved. Completing an audit prior to PSA approval can, depending on the scale of the site, cost anywhere from the hundreds of thousands of dollars to many millions. Developers who undertake such processes are not only investing their efforts to increase the supply of housing in these important areas, they are also undertaking a valuable environmental service by remediating contaminated sites. Without this risky and costly investment, no rezoning would be possible for sites of this type.

Throughout 2021, and as referenced in a previous discussion paper, the Government's rationale appeared to be that the tax is "capturing the economic value created by a Government decision to enable a higher and better use". This is incorrect. It is far more accurate to say that a Government decision to enable a higher and better use *releases* the value that is most often created by the significant time and expense incurred by a developer to bring a site to the point of rezoning.

The position set out in the discussion paper assumes that all value improvement attributable to development costs expended before the V1 valuation are reflected, in a simple linear manner, in the V1 valuation. That is not the case and reflects an overly simplistic way of conceptualising and understanding the relationship between cost and value uplift. None of the value created from pre-rezone costs may be reflected in the V1 valuation in some circumstances. Furthermore, the value increase may be delayed until after rezone, or the value increase may not be proportionate with the costs expended.

Pre-rezoning development costs put the Government in a position to decide in an informed manner whether to rezone land based on the merits created in expending those costs. The rezoning decision that triggers the value uplift between V1 and V2 is a realisation event for value already accumulated and embedded (unrealised) in the land because of the developer's prior work and costs. Although the rezoning decision creates some value, it is erroneous and misleading to say that it creates all the value. Recognising actual costs expended and precluding them from the tax base is the only way of truly reflecting the influence they have on value.

<u>2. What rationale, if any, exists for allowing deductions for costs that are not necessarily incurred as part of the process of seeking a rezoning of land?</u>

As described above, any costs that are involved in getting the site to the point of being <u>developable for a new purpose</u> should be deductible. This includes any planning and applications costs and any remediation costs incurred prior to rezone.

The rationale for this is simple – under any existing use or zoning, none of these costs would be incurred. It is the developer's investment in the rezoning, with all the cost and without certainty of a result, that creates the opportunity in the first place.

Without recognising the investment necessary to seek a rezoning of land, the State embeds the erroneous position that it is the rezoning decision alone that creates all the value. As we have outlined, that is patently false.

It is generally not the practice of developers to incur early-stage pre-zone costs unless they are necessary to achieve a rezone. That is because such expenditure has a funding cost, and early-stage funding for costs of that nature is not funded by external debt – it is generally funded by equity. We do not envisage a situation in practice of developer's incurring costs earlier than they would otherwise be incurred merely because they are deductible for WGT purposes. That is just not the reality of property development in Victoria.

The Commonwealth recognises that costs expended create value, hence the recognition of those costs for tax cost base purposes and the net approach. The State's gross approach only makes sense if one accepts its starting proposition that the rezoning decision creates all value uplift between V1 and V2.

All development costs will be factored into revenue or capital cost bases for Commonwealth purposes, but the realisation of the effective deduction for those costs at a Commonwealth level will generally be aligned with the realisation of the underlying land and will therefore be very delayed.

The WGT is a very separate tax from Commonwealth income tax. Consistent with our position above, the development costs help create the value being taxed by both levels of government. There is no reason why those costs should not be comparably deductible at a State level as at a Commonwealth level. By denying a deduction at a State level and justifying this by reasoning that there will eventually be a Commonwealth deduction, gives the State a free-carry at the expense of the Commonwealth. It also leads to the inconsistent taxation of a similar value pool.

If WGT is truly seeking to tax actual value created from a State Government decision, where is the logic in not allowing a deduction for actual costs incurred to place Government in a position to make that decision? Relying on a theoretical value assessment in the form of V1 to recover those costs is poor tax design.

3. If a cost is reflected in the valuation of a property, what rationale is there, if any, for also allowing a deduction for that cost?

It is false to assume that valuations properly reflect all the costs and encumbrances that might apply to a property. Valuations are typically based on broad-brushed comparable sites which do not reflect the specifics of a particular site.

There is no guarantee that a valuation process can properly allow for the costs of remediation and/or site-specific encumbrances such as flora and fauna, buffers etc. In the case of the former, full remediation costs are often incapable of being known until they have been expended.

UDIA Victoria has many examples where land is valued on a simple "per-hectare" rate, without any understanding of site-specific issues, particularly overlays and environmental matters.

There may be some costs that are reflected in the valuation of a property; however, this would be far from the norm and would not capture most costs. We reiterate that the relationship between costs incurred by a developer do not necessarily bear a linear relationship to a valuation (either CIV1 or CIV2). A tax designed to rely on such a linear relationship for the quantification of the assessable gain is a poorly designed tax, especially in circumstances where it is known from the outset before implementation.

Despite a valuer's best efforts, valuations are not always correct. To give an example, developers often spend great time and cost engaging in due diligence prior to the acquisition of land to determine the extent of any contamination. The result of that due diligence will lead a developer to determine whether to acquire the land, and at what price. Often the cost of this due diligence can be more than $500,000, yet it remains a not uncommon experience for developers to get this wrong and to foot a remediation bill greater than first anticipated.

4. Which costs associated with property development, if any, should be deductible?

We note the Government's language when this tax was announced, in which the Treasurer stated that property developers "can make massive windfall profits overnight". As we outlined in our submission dated 5 July 2021, this is an incredible oversimplification of the process involved in undertaking complex development projects – it is simply not the case for most rezonings involving developers, with the bulk of rezoning processes taking 3-5 years from conception.

Land speculators make profits on rezonings with relatively little investment of time or resources, and without any economic value add in the process. These are typically long-term owners in greenfield expansion areas, not professional developers, and they are usually relatively passive participants in the rezoning process. By contrast, developers purchase land for the express purpose of development – creating jobs, housing, employment precincts and communities. Developing a project takes several years, cost millions of dollars in holding, remediation and planning costs. Developers carry significant project risk, invest enormous sums, pay significant local, state and federal taxes (more than any other industry), and, by doing so, deliver enormous economic and social benefits to Victoria.

Denial of a developer's ability to deduct the costs of capturing the value of the land and bring it to a point of rezoning in effect promotes the interests of speculators over developers. It removes the incentive for a developer to expend that time and cost when it will not be recognised when determining its tax liability. This is a poor tax and planning policy outcome and we doubt it is a consequence that the Government really intends. The effort and risk will simply no longer warrant the potential reward, leaving more sites unremediated and underutilised in areas where supply is needed the most. Moreover, it will encourage speculation rather than development of pre-rezone sites.

All costs reasonably and actually incurred in relation to obtaining a rezoning should be deductible. In relation to the acquisition costs, holding costs, planning costs and development costs set out in the discussion paper, the achievement of a rezoning event, triggering a value uplift and subsequent tax liability would not occur without these costs being incurred. They should all be included as allowable deductions.

As we discussed in the Stakeholder Workshop, we understand that there is an inherent tension between the Government's objective of ensuring certainty and the objective of ensuring that the regulations are fit-for-purpose, continue to reflect market realities and are not overly prescriptive to the point where they arbitrarily exclude reasonable deductions because of narrow drafting.

We encourage the Government to instruct Parliamentary Counsel to ensure that the regulations strike a balance between certainty and flexibility. The Latin maxim *inclusio unius est exclusio alterius* essentially operates to exclude items from contract or statute if they are not expressly included. In relation to the Planning costs listed in the discussion paper, for instance, this causes issues. While those costs that are listed appear to include many of the planning costs associated with a rezoning, it is not an exhaustive list. An obvious omission from the list is legal fees, which are critical and unavoidable in achieving a rezoning outcome – including, but not limited to, a Panel hearing. There is no justification for including the costs of a traffic impact consultant as a deduction, while excluding legal fees.

For this reason, we encourage the Government to adopt flexible language that makes clear its intention but leaves room for reasonable interpretation. In the case of the Planning costs set out in the discussion paper, this may take the form of *"all costs reasonably incurred in the achievement of a Rezoning Event, including professional services fees, consultancy fees and costs of professional and technical reports."*

In relation to remediation costs, the discussion paper states that "specific costs and the highest and best use of land are reflected in valuations via market adjustments. For example, purchasers consider anticipated remediation costs associated with an old petrol station, or cost of development in the price they are willing to pay for that land which is in turn reflected in the valuations." As explained in our response to Question Three, this is not always the case and it cannot be assumed that the existence of contamination, nor the extent of remediation required, is always known at the time of purchase nor factored into the purchase price.

As previously stated, it is common for remediation to be required by a Responsible Authority prior to approval, or for approval to be granted conditional upon that remediation taking place.

Where remediation is required prior to approval being granted, there is no question that it is an unavoidable cost necessarily incurred in the process of achieving the rezoning event. Those costs must be permitted as a deduction.

Where approval is granted on the condition that remediation take place, we acknowledge an argument that those remediation costs will be factored into CIV2. However, as we have outlined, the extent of contamination and the cost of remediation is capable of being known, even to an experienced and well-resourced developer (let alone a valuer). For this reason, we favour these costs being included in the deductions regime to ensure certainty and so as not to leave a landowner incurring significant costs after the CIV2 valuation is determined (and potentially after the objection period has expired).

5. Which costs are sometimes or always incurred in seeking a rezoning?

It is incredibly rare that the costs outlined on page 3 of the discussion paper are not incurred in seeking a rezoning. A non-exhaustive list includes the following:

- application fees
- town planning fees
- civil engineering investigations
- urban design reports
- landscaping reports
- geotechnical engineering investigations
- flora & fauna investigations
- arborist reports
- traffic investigations
- community infrastructure assessments
- housing need assessments
- community consultation costs
- environmental assessment and audit
- environmental remediation
- legal fees
- panel hearing fees

6. How often are remediation works necessary to seek a rezoning of the land, how foreseeable are the circumstances that require such works, and what are the costs of such works relative to the value of the land being remediated?

As discussed at the Stakeholder Workshop, remediation works are often necessary either for a rezoning to be approved or, less often, as a condition included in the approval. As we have explained above, the circumstances requiring remediation works (and the extent of those works) are not always foreseeable, despite extensive due diligence. Like remediation itself, it is not possible to state with accuracy the cost of remediation works relative to the value of the land being remediated. The extent of, and nature, of any contamination and site-specific characteristics which impact the difficulty any remediation works are a case-by-case proposition.

It is misguided to assume that a Valuer's determination of value in infallible, especially where they are required to consider remediation.

7. Some costs required as part of a rezoning can be incurred over a number of years before a rezoning, while the WGT will apply only to the immediate uplift resulting from the rezoning. What is an appropriate time limit on how long before a rezoning a cost can be incurred in order to be deductible?

It makes sense for development costs incurred over a period to be deductible from a value uplift measured at a point in time when it is accepted that the value uplift, at that point in time, was not created exclusively by the rezoning decision. As we have explained, the value uplift is a function of both the rezoning decision and the preceding development costs incurred up until that point in time. CGT and the trading stock rules allow for development costs incurred over the entire landholding period to be deductible because they tax the value improvement over the entire landholding period. Value recognition and cost recognition are therefore aligned at the relevant taxing point (i.e., disposal) for income tax and CGT purposes.

As discussed at the Stakeholder Workshop, it is also important that the Government recognises that the business model of a developer does not allow for long-term landholdings prior to a rezoning event. During the workshop, the Department asked about a situation where a developer may hold land for a 20-year period before rezoning. While a speculator may hold land for this length of time, a developer will usually not, unless stymied by extended planning processes. The financing and holding costs throughout such a long period prohibit a developer from operating along these long timeframes. Instead, a developer will usually purchase land at a point much closer to a rezoning and undertake the actions necessary to achieve that rezoning as expeditiously as possible.

Similarly, there is an inherent need for information used to support a rezoning to be current and timely. In the case of a technical report used to support the case for rezoning, a report that is out of date will do nothing to improve the chances of a rezoning decision. This inherent requirement for up-to-date information renders a time limit of little utility.

For these reasons, we do not consider that an arbitrary time limit is necessary or justified in respect of how long before a rezoning a cost can be incurred to be deductible.

Other considerations

Reasoning that no deduction for development costs is warranted for the purposes of the Windfall Gains Tax because none is given for GAIC or Metropolitan Planning Levy (MPL) purposes is also highly disputable. GAIC is a contribution-based model unrelated with value uplift, one that can be properly calculated and allowed for in a feasibility model, and one that is paid only when a revenue is also about to be received. It is a fundamentally different tax to the Windfall Gains Tax.

Clearly, the Windfall Gains Tax is closer to CGT or GST, and both regimes recognise costs expended to create value when taxing that value. It is the misalignment of the proposed Windfall Gains Tax with CGT and GST that is the issue when dealing with development costs, not their alignment with GAIC and MPL.

The suggestion that income tax and CGT is better suited than the Windfall Gains Tax to recognise the significant costs that a landowner may incur in enhancing the value of land over the duration of the landholding is also dubious. The Windfall Gains Tax will tax the theoretical value improvement achieved at a particular point in time. There is no reason why costs that have contributed to the creation of that value at that time should not be recognised by the State when calculating the tax payable – at best any "windfall" can only be the difference between the two valuations less the direct investment made by the proponent.

The allowance of costs incurred in generating the value uplift in calculating the taxable value uplift is also a way the Government can help address the inequities that could easily result from the State taxing theoretical value gains so early in the land production cycle. As was explained to you during the stakeholder discussion, because of costs incurred before and after the rezoning decision, the theoretical value gain taxed by the State at a discrete moment in time may never get realised. Nevertheless, it will be taxed on the false assumption that it will in every case be realised.

Conclusion

UDIA Victoria looks forward to further engagement on these issues and to being kept informed of the Government's decision-making process throughout. I can be contacted on 0416 443 555 or at matthew@udiavic.com.au if you have any further questions.

Yours faithfully

Matthew Kandelaars
Chief Executive Officer
Urban Development Institute of Australia, Victoria