HM TREASURY

Department for Communities and Local Government

The Government's response to consultation on reforms to the real estate investment trust (REIT) regime:

A) to explore the potential role social housing REITs could play to support the social housing sector;

and

B) to consider the tax treatment of REITs investing in REITs

December 2012

HM TREASURY

The Government's response to consultation on reforms to the real estate investment trust (REIT) regime:

A) to explore the potential role social housing REITs could play to support the social housing sector;

and

B) to consider the tax treatment of REITs investing in REITs

December 2012

Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

Any queries regarding this publication should be sent to us at: public.enquiries@hm-treasury.gov.uk.

ISBN 978-1-909096-39-4
PU1425

Contents

1 The consultation

Background to the consultation

1.1 On 21 March 2012 the Chancellor of the Exchequer announced that the Government would undertake a consultation on Real Estate Investment Trusts (REITs) and in particular: (1) explore the potential role social housing REITs could play to support the social housing sector; and (2) consider the tax treatment of REITs investing in REITs.

1.2 The consultation was launched on 4 April 2012 and closed on 27 June 2012. In addition to publication of the consultation document, the Government also held four workshops and several bilateral meetings with individual stakeholders.

Purpose of the consultation

1.3 The purpose of this consultation was to explore the potential for changes to the REIT regime to help meet wider Government objectives such as increasing affordable housing supply and meeting the fiscal mandate, whilst also retaining the integrity of the REIT regime.

1.4 The purpose of the social housing REIT consultation was to explore ways in which the REIT model might be used to secure additional private finance for the affordable housing sector, while:

- Protecting the taxpayer from additional spending pressures, such as increase in the Welfare bill;
- Protecting the rights of existing social tenants; and
- Protecting the investment in the existing social housing stock.

1.5 For the REITs investing in REITs aspect of the consultation, the purpose was to explore what the benefits of introducing investment diversification are both for companies and for wider Government priorities.

Structure of consultation response

1.6 The remainder of this consultation response document is divided into two sections.

- Chapters 2 and 3 focus on social housing REITs and summarises the key stakeholder messages as well as the Government's response.
- Chapters 4 and 5 focus on the tax treatment of REITs investing in REITs and again summarise the key points raised by stakeholders and the Government's response.

1.7 Finally, chapter 6 sets out the next steps.

2 Consultation responses on the role for social housing REITs

Consultation process

2.1 In addition to the publication of the consultation document, the Government held three social housing consultation workshops which saw 52 attendees representing Private Registered Providers, local authorities, the Scottish and the Welsh governments, investors, umbrella bodies, existing REITs and advisors.

2.2 The Government received a total of 42 written submissions which addressed social housing REITs. All stakeholders welcomed the consultation and the opportunity to engage with Government. It was also highlighted that the social housing REITs consultation was significant in bringing together a wide range of parties to discuss shared interests.

Consultation questions and summary of stakeholder responses

2.3 This section summarises stakeholder responses to the social housing consultation.

Does a financial constraint exist for social housing providers? If so, please elaborate. (Question 1)

2.4 There was consensus amongst respondents that the cost of financing had increased for the social housing sector. However, opinion on the degree of constraint this represented was varied. In particular, most providers have secured funding for their development pipelines in the short to medium term and it was argued by some stakeholders that the success of accessing bond finance demonstrates that investor confidence in the sector is robust.

2.5 Stakeholders commented that as a result of the new Affordable Rent model for social housing, their borrowing requirement is larger than previously. The Affordable Rent model is intended to maximise the supply of social housing against the background of constrained public finances by levering in more private finance. It will increase the number of social homes that can be provided but grants available on an Affordable Rent property total around 20 per cent of the cost of developing the home, lower than at any time since large scale development by housing associations started more than 30 years ago. Providers therefore need to secure a greater proportion of private finance in order to fulfil their commitments under the Affordable Homes Programme. The table below provides a summary of possible future constraints.

Table 2.A: Possible financial constraints

Finance source	Constraint
Bank debt	There are seven main bank lenders to the sector. As a group they have provided the sector with total debt facilities of more than £50 billion. As a result of the credit crunch, banks' own costs of funds have risen above the cost at which they have contracted to lend to Providers and they are therefore keen to reprice or shorten the maturity of existing loans. Where possible new bank debt is at higher margins and shorter term than previously.
Bonds	Historically, easy access to credit in the banking market has meant the sector did not need to make significant use of the capital markets, which were seen as relatively inflexible in comparison. However, the move in the banking market to higher margins and shorter terms, as a result of the credit crunch, has changed this attitude and more Providers have issued bonds. Those Providers with credit ratings have generally been very well regarded by ratings agencies, allowing them to secure funding at low margins. At one workshop, contributors speculated that coupons for housing association bonds may now be regarded by some investors as too small to be of interest. However, recent issuances have been sold by housing associations with no difficulty, so there is no evidence of this feeling in the market at present.
Borrowing capacity	The higher amount of borrowing Providers must undertake as part of the Affordable Homes Programme means some Providers may find themselves exhausting the borrowing capacity of their balance sheets and unable to borrow further until they have paid down existing debt. Without access to more equity, this could prevent them from developing further properties.
Own income	Housing associations often have a number of ways of supplementing their rental income, such as by selling shared ownership or market housing. Exposed to the market in this way, some Providers faced difficulties during the credit crunch. With the housing market still slow Providers may find themselves unable to generate significant funds from this area of business.

2.6 While self-financing has freed local authority providers from the constraints of the Housing Revenue Account subsidy system and increased the resources available to them, the reforms did introduce a cap on the amount of borrowing they can undertake for the purpose of providing housing. This is designed to protect the public balance sheets.

What sources of finance are housing providers currently using to support affordable housing development? (Question 2)

2.7 A number of sources of finance were highlighted in the consultation responses. These are summarised in the table below.

Table 2.B: Sources of finance

Finance type	Explanation
Own resources	Generated from rental income from existing and newly developed homes. Homes developed for social rent make up the majority of any housing association existing stock and the income it provides is key to servicing their debt. In addition, they use receipts from the first tranche shared ownership sales, and outright sale on the open market, to cross subsidise social and Affordable Rented homes.
Section 106 Planning Gain	Section 106 of the Town and Country Planning Act 1990 allows a local planning authority to enter into a legally-binding agreement or planning obligation with a land developer. For instance, a condition for planning permission for building housing on a site might be that a proportion of the housing is affordable. This agreement will often involve a Registered Provider, who will gain the homes at a below market price.
Government Grant	As part of organised programmes, Government has invested £43 billion in housing association affordable housing since the early 1980s. Through mechanisms such as the Recycled Capital Grant Fund, this money still circulates through the sector, developing more homes.
Bonds	A well established source of finance for building affordable housing. To date housing associations have issued almost £10 billion of bonds since 1987. Between January and October 2012 English Registered Providers have raised over £3 billion from bonds and private placements. These typically pay investors a return of between 4.5 per cent and 6 per cent. The Housing Finance Corporation (THFC) acts as a conduit for smaller and medium-sized housing associations to access the capital markets by issuing an aggregate bond that fulfils their individual funding requirements. There is also an active private placement market, which enables smaller issues of debt to be placed with individual investors.
Bank debt	Stakeholders reported that the banks are now offering debt on shorter terms than previously, often at higher margins. Bank lenders who continue to make long-term loans to housing associations may include regular break clauses, giving them the opportunity to re-price at intervals of five years.

What new sources of finance are housing providers exploring to support future development? (Question 3)

2.8 The responses outlined two potential sources of new financing. According to not-for-profit stakeholders there are an increasing number of joint ventures (JV) between Registered Providers (RPs) and developers in the private sector. Usually, both affordable and private sale units are built as part of this arrangement. As part of the agreement the JV then sells the affordable units directly to the RP partner at a price which will, typically, be materially less than that which an RP could acquire the units under a more traditional form of procurement. The profits from the sale of the private units would be distributed to the JV members and could be used by the RP to fund additional affordable housing.

2.9 Responses from for-profit Registered Providers entering the market suggested they expect to fund affordable housing delivery through debt raised against a long term business plan, based around the development and subsequent holding and operating of social housing.

Does the size of the housing association impact the financing opportunities available to it? If yes, please explain. (Question 4)

2.10 The majority of respondents believed that size did impact financing opportunities, particularly as regards bond financing.[1] In their view bond financing tends to favour larger housing associations with larger development programmes and greater and more urgent need for larger sums. Larger housing associations also tend to have a wider specialist skill set as they are able to employ a specialist treasury team and they are often better placed to raise finance.

2.11 Small housing associations (HAs) had tended to be less actively pursuing new sources of funding. It was suggested that this might be due to a self-awareness of the lack of skills or experience needed to achieve good value from complex financial instruments. However, evidence was provided that those wishing to seek bond financing could do so through organisations like the Housing Finance Corporation (THFC) or GB Social Housing. These organisations provide smaller housing associations with opportunities to access the capital markets at interest rates similar to those achieved by own-name bond issues. However some respondents suggested the amount of security required by these aggregators can be challenging.

2.12 Respondents also suggested another consequence of size was carry costs. Proceeds from bond issues are normally paid out immediately; consequently if housing associations are looking to use funds over a period of months, then it will incur negative carry costs (the cost of a bond will be higher than the return from money placed in deposit accounts). A housing association, therefore, needs to have sufficient financial capacity to cover this carry cost and facility to minimise the amount of time they must hold the money before spending it.

How attractive is affordable housing as an investment for institutional investors? What, if any, are the barriers? (Question 5)

2.13 There was a general consensus among contributors that the attractiveness of the affordable housing sector is enhanced by the fact that its revenue stream is index-linked (until March 2015) and largely underpinned by welfare payments (approximately 60 per cent of social housing tenants are in receipt of housing benefit). However, the level of return required to attract investors was dependent upon perceived risk levels and ranged from 4 per cent to 15 per cent (with a median of 6 per cent).

2.14 Some stakeholders suggested that the strength and security of the housing association sector, combined with the index-linked returns it offers, may mean investors would accept a yield of somewhere between 5 per cent and 6 per cent which is in line with returns on bonds.

What role is there for REITs to play in social housing for either low cost rental or affordable home ownership accommodation? (Question 6)

2.15 There was a mixed reaction to the role that REITs could play in the social housing sector due to the regional, financial and demographic challenges that exist. For instance, in areas of low demand the margin between market rent and social rent is significantly narrower than in areas of high demand such as the South East and London. Some stakeholders operating in low demand regions suggested that REITs could not work in this market because providers would not be able to meet the requirements for setting up and attracting REIT investors.

[1] It was also suggested that a housing association's business model, structure and/or geographical spread of its portfolio or the terms of its existing debt offerings may be more important factors impacting upon financing opportunities than its size alone.

2.16 For RPs operating predominantly in high demand regions, there was a much more positive response to the role REITs might play in the social housing sector. In particular, it was suggested that REITs could play a role in converting long term income streams into immediate capital value to allow for re-investment. Additionally, the REIT brand could help RPs attract different sources of funding particularly from overseas and parts of the investment market that is looking for green or social investment.

In what circumstances might REITs be an attractive means of accessing finance compared to existing finance options? (Question 7)

2.17 In terms of when REITs would be considered an attractive option, stakeholders suggested that highly geared associations looking for off-balance sheet financing[2] would find REITs attractive because it would not add to the housing association's indebtedness. The fact that REITs are UK managed and governed by a statutory regime means they would be more attractive to housing associations and councils compared to off-shore structured financing options.

2.18 Whilst the focus of the question was on attractiveness, a number of stakeholders used the opportunity to discuss potential risks in using REITs as a source of financing. The following risks were raised:

- A new REIT needs to be 'seeded' with properties to get started, which can impact on the loan covenants and security arrangements of the existing Provider.
- Investors may retract their funding at short notice. This creates uncertainty for RPs relying on this income to fund their housing development projects.
- The resource cost of managing REITs and their investors is high, particularly as few existing RPs are likely to have expertise or experience in managing equity finance. They would need to rely on employing external expertise which will increase the cost of this type of financing.
- As a for-profit entity, a REIT potentially has a different attitude towards its tenants than a not-for-profit housing association. Some not for profit providers were concerned about the implications of disposing their stock to a for profit organisations and this may reduce the effectiveness of REITs

What would the social housing REIT business model look like to generate attractive returns? (Question 8)

2.19 Whilst a number of reforms have already been introduced to the REIT regime, to encourage the establishment of a residential REIT, the Government understands that differences exist between the private residential property rental market, and the social housing sectors. Consequently, it is plausible that the REIT business model would also differ.

Stakeholder response

2.20 Several organisations provided 'sketch models' of how an affordable housing REIT might look as part of the consultation, several of which would require policy decisions outside the scope of this consultation. They are categorised into three groups as set out in the table below.

[2] Off-balance sheet financing is a form of financing in which large capital expenditures are kept off of a company's balance sheet through various classification methods. Companies use off-balance-sheet financing to keep their debt to equity (D/E) and leverage ratios low

Table 2.C: Social housing REIT models

Type	Explanation
Convert and manage	Under this model, the REIT would purchase void social housing units from an existing social housing provider and convert them into Affordable Rent properties. The REIT would then manage these Affordable Rent units. Affordable Rent only exists in England, and this form of REIT would need to register with the social housing regulator (the Homes and Communities Agency, HCA) in order to own units with embedded social housing grant, and enter into an agreement with the HCA to convert and lease units at Affordable Rents.
Sale and lease back	Under this model the social housing provider will sell its units to the REIT and then lease them back to manage. The REIT may work with one social housing provider who can supply the critical mass of units required; or alternatively it may pool units from a number of social housing providers. Some proposals suggested that the length of the lease would be time limited and that upon expiration the properties would revert back to the social housing provider. Again, it was suggested that this form of REIT would probably be required to register with the social housing regulator.
Build and lease out	This model differs from the others in that the REIT will build the social housing units using its own financing. It will then contract out the management of the properties to social housing providers who will earn an agreed margin. Whether or not the REIT would need to register with the social housing regulator will depend on lease terms and lengths. Providers need to be on the regulators register if they are the landlord entering into the tenancy with the provider. So in a lease and leaseback structure then they would not need to be on the register but it is possible that under a sale and leaseback model they might need to be.

What level of return would be considered attractive to your investors? (Question 9)

2.21 On average a UK REIT generates a return of approximately 8 per cent, primarily based on returns from commercial property (the absence of solely residential REITs being in the main as a result of the low returns expected in this sector).

2.22 The social housing sector is distinct from the private rented sector in that it is in a better position to achieve economies of scale as it often manages large groups of properties in close proximity to one another. In addition the long term void risk is generally perceived as lower, given that the average length of tenure in the social sector is longer and the level of demand illustrated by waiting lists for social housing is high.

2.23 However this sector also charges sub-market rents, which means the gross income generated is potentially lower than can be achieved in the private rental sector. Additionally, the existence of shared ownership units and some units where the tenant has a statutory Right to Buy is regarded negatively by potential investors as it makes the portfolio unpredictable.

2.24 Whilst the economies of scale and lower voids achieved by the social housing sector make a stronger case for establishing a social housing REIT, the lower rental income may be less attractive to investors.

Stakeholder response

2.25 As mentioned above in question 5, the level of return required by investors will depend on risk levels and willingness to accept such risks. Sufficient returns to attract investors were estimated at anywhere from 4 per cent to 15 per cent with a median of 6 per cent.

What reforms would be needed to enable REITs to support a social housing model? (Question 10)

2.26 Stakeholders raised a number of reforms (listed below) which aimed to reduce the operating cost of a social housing REIT, thereby making the vehicle plausibly more financially viable, and relax treatment of investors to give greater flexibility.

- Removal of the listing requirement;
- Expand the definition of "institutional investor" beyond the changes made in Finance Act 2012 ;
- Relaxation of the "holder of excessive rights";
- Reduction of the profit income distribution (PID);
- Disposal rule; and
- Amend the finance cost ratio.

2.27 Respondents raised other concerns, outside the scope of this consultation, which included introducing an SDLT exemption for social housing properties seeded into a REIT; introducing a 10 per cent wear and tear allowance for unfurnished properties that would purportedly increase the viability of a residential REIT; and removing the borrowing cap on councils so that those with ALMOs can borrow on the same terms as other types of provider.

What benefits and risks should be considered as a consequence of changing the REIT regime? (Question 11)

2.28 The Government remains keen to support the development and expansion of the REIT regime but equally is concerned about ensuring the REIT regime remains credible and that investors are protected.

Stakeholder response

2.29 As regards benefits that might be generated from changing the REIT regime, stakeholders reiterated those benefits already mentioned in paragraph 2.16.

What practical issues that affect implementation should be considered? (Question 12)

2.30 In the context of seeking views of potential reforms to the REIT regime to help support social housing providers; it is equally important to understand how these reforms could be implemented and how this interacts with other rules or requirements that social housing providers must observe. The purpose of this question was to seek views on the practical impact of implementing the REIT reforms suggested.

Stakeholder response

2.31 In terms of practical issues affecting implementation four concerns were raised. These are summarised in the table below.

Table 2.D: Issues affecting implementation

Issue	Explanation
Consent	Providers may need the consent of their lenders to transfer properties into a REIT, which may trigger a renegotiation of financing costs. Further, local authorities would require a positive result in a tenant ballot to transfer some or all of its housing stock. Questions were raised about the role government would play to encourage tenants to support this transfer.
Administration	It was suggested that introducing social housing REITs would generate additional administrative costs for Registered Providers who would need to set up independent Boards and possibly a separate internal management structure to govern their involvement in a REIT. It was also suggested that having a dual regulatory environment (for example social housing regulator and REIT requirements) would increase the cost and complexity of compliance.
Regulation	Providers of social housing must be registered with the social housing regulator. Recent reforms to regulation in England have allowed the registration of for-profit providers, but the way in which the regulator intends to manage the different requirements of these organisations is not yet defined. A REIT would by definition be a for-profit entity, and organisations are generally keen to understand the regulator's requirements before setting up a new entity. Some forms of REIT may not require regulation, but this would vary according to the way the REIT is constituted.
Governance	Two particular questions raised under this heading were (1) since most Registered Providers are charities, how would setting up a REIT impact on their charitable status (this is a problem common to any charity wanting to set up a for-profit arm, whether or not it is a REIT); and (2) what arrangements will be put in place to deal with non-performing properties. The second question was particularly focussed on the expectation of delivering a certain level of return and who would bear the burden if this was not realised. .

Are there particular social housing regulations that might be affected by the introduction of REITs? If so, please explain. (Question 13)

2.32 The provision of social housing is regulated across the UK. As such, it is important to consider how these regulations could potentially interact with the REIT regime.

Stakeholder response

2.33 The main issue raised was the treatment of embedded grant in existing properties when sold into a REIT[3]. In particular, Registered Providers wanted to know whether they would be liable for repayment of the grant if these properties were seeded into a REIT. Similarly, potential investors were interested in getting clarity on how this embedded grant would be prioritised compared to other liabilities, since this would impact how quickly investors would be compensated if there was a default. Representatives from the Scottish Government highlighted that they are currently piloting a new way of treating embedded grant to facilitate further investment in social housing.

2.34 In addition to the concerns around the treatment of grants, Registered Providers also raised concerns regarding the treatment of tenants. As a non-profit charitable organisation, organisations' motives usually relate to maximising social welfare. Consequently care is taken to protect the rights of tenants and include them in the decision making process. Concern was raised, however, that introducing a for-profit vehicle into the mix may undermine this social

[3] Under the current social housing regulatory regime, properties may only be sold with the permission of the regulator. The regulator is likely to impose conditions on the treatment of any grant embedded in the properties, and will seek to safeguard the level of affordable housing stock.

objective. In particular, stakeholders were worried that social housing tenants may not be as well protected in the cases of arrears and eviction because in cases where the REIT is the Landlord (rather than simply the provider of a funding mechanism) it might be more motivated to reacquire the property than ensure the tenant is housed.

What role should social housing regulators play in regulating REITs in this sector? (Question 14)

2.35 The Government is keen to protect the credibility of the REIT regime and the interests of its investors; it is equally concerned to ensure the sustainable provision of quality social housing. Social housing regulators have an important role to play in protecting the Government's investment in existing supply and the rights of tenants.

2.36 The aim of this question was to determine whether REITs, as for-profit investors, should be regulated by social housing regulators; and if so, how.

Stakeholder response

2.37 At present, England is the only jurisdiction which allows for-profit entities to register to provide social housing, and as this is a new permission it is not as yet clear how the English social housing regulator the Homes and Communities Agency (HCA) will regulate for-profit providers. The HCA intends to consult on this matter at the end of the year. Respondents questioned whether or not a REIT would need to be registered with the regulator, as a number of different business models are possible which would be viewed by the regulator in different ways depending on how the REIT interacts with the Registered Provider.

2.38 Responses suggested regulation is regarded as positive by lenders and investors to the social housing sector, as providers are monitored and the regulator has powers to step in when a provider gets into financial difficulty. Social housing regulation and planning laws restrict the sale of social housing, which accords with the REIT regime's aim of facilitating the provision of long term rented accommodation. However it was also suggested this may act as a disincentive to investors, who may be prevented from disposing of the asset in the event of difficulties.

Given that the REITs regime applies to the UK and social housing is a devolved matter, are there particular issues that should be considered? (Question 15)

2.39 The Scottish and Welsh governments were involved in the drafting of the consultation and attended a workshop to ensure their position was reflected. Responses to this question were limited however one respondent suggested that a REIT may only be feasible in Wales and Scotland if a number of registered social landlords jointly sell property to that REIT, since it would otherwise be hard to reach the necessary scale, and that a REIT would not be viable in Northern Ireland (although no specific evidence was given to support this view).

2.40 At present for-profit providers of social housing are not permitted in Scotland, and Northern Ireland. If an organisation wished to set up a social housing REIT in these areas, they would have to arrange their business in such a way that registration was not required by regulators or those jurisdictions would need to amend legislation.

2.41 The Welsh government position was that it does not intend to amend the current regime at this stage, that is, for-profit organisations that may provide or wish to in future provide social housing are not eligible to register with the Welsh Ministers as a social landlord. If an organisation wished to set up a social housing REIT in these areas, they would have to arrange their business in such a way that registration was not required by regulators and, for current registered social landlords, in a manner in which no adverse risk is placed on the financial viability of the registered social landlord or its social housing stock.

3 Government's response on the role for social housing REITs

3.1 The Government undertook this consultation to explore whether changes should be made to the REIT model to secure additional private finance for the affordable housing sector, while:

- Protecting the taxpayer from additional spending pressures, in particular increased Housing Benefit;
- Protecting existing social tenants; and
- Protecting the investment in the existing social housing stock.

3.2 The Government has taken into consideration all of the responses received, both written and through its workshops, and has subsequently assessed whether to make any changes to the REIT regime to facilitate the creation of social housing REITs.

Response

3.3 The low voids, economies of scale and low management costs of the social housing sector suggest that at least in theory, it might be possible to establish social housing REITs under the current REIT regime. The challenge, however, stems from whether these attributes are sufficient to offset the low returns (in the main from below market rents) in order to attract investors. During the consultation we met four stakeholders who believed that once the REIT reforms in Finance Act 2012 came into effect, they could establish a social housing REIT. Subsequently the first stakeholder intention to launch a social housing REIT was announced in August.

3.4 Further to this the responses to the consultation suggested the need for further changes to the REIT regime to support social housing REITs was seen as less pressing. The key messages that came out of the consultation were as follows:

- Availability of financing: while traditional forms of financing (e.g. bank debt funding) were still available, banks were only offering shorter terms and higher interest rates. Consequently, Registered Providers (RPs) are increasingly turning to alternative sources of financing - usually the bond markets and private placement schemes. To date these sources have proved most successful for large RPs, and we have recently seen even small organisations accessing the capital markets under their own names, as well as using aggregating vehicles such as The Housing Finance Corporation. Between January and October 2012 English registered providers raised over£3 billion on the bond market and through private placements.
- Attractiveness of the social housing sector for equity investors: those stakeholders not already seriously contemplating establishing a social housing REIT were concerned that housing at social rents alone (as opposed to a portfolio also containing affordable or market rented units) would be unable to generate sufficient returns to attract investors.
- Scale requirements: for many stakeholders a social housing REIT was not an option as they lacked sufficient scale and quality of stock. For those which did have

sufficient size raising funding via establishing a REIT was not the only funding option available.

3.5 The overall message was therefore that for some stakeholders the changes to the REITs regime in Finance Act 2012 were sufficient to enable them to set up a social housing REIT. However for those who did not feel social housing REITs were a viable option, further additional changes to the REITs regime would be unlikely to make difference to their thinking.

3.6 After considering all the responses received, the Government has therefore concluded that it does not intend to amend the regime at this stage.

3.7 Many suggestions for reforms were made, but these would require changes to other regulatory regimes. The HCA will shortly be consulting on regulating for-profit providers, which will help establish the interaction between the regulator and potential REITs.

4 Consultation responses on the tax treatment of REITs investing in REITs

Consultation process

4.1 Following the publication of its consultation document, the Government held one workshop specifically to discuss the tax treatment of REITs investing in REITs. REITs, advisors and industry representatives were invited to participate in the event. There were a total of 15 attendees present.

4.2 In addition to the workshop, views were also provided through written responses to the consultation document. A total of 15 responses were received addressing the issues of REITs investing in REITs.

4.3 There was unanimous support from stakeholders for amending the REIT regime to allow income earned from REITs investing in REITs to be tax exempt.

Consultation questions and summary of responses

4.4 This section sets out each REIT investing in REIT consultation question, why the question was asked and a summary of the responses received.

Is there a need for REITs to invest in REITs? Please explain (Question 16)

4.5 Under the current regime, REITs can invest in REITs. The income earned from such investment, however, is not tax exempt. This means that an investor investing in a REIT investing in a REIT will pay tax twice on the income it receives (i.e. the PID received by the investing REIT will be taxed in the hands of this REIT and then when distributed as a dividend to its shareholders, the shareholder will also pay tax).

4.6 In considering whether or not to allow the income received by the investing REIT to be tax exempt, the Government wanted to assess its impact against the broader REIT objective of encouraging more investment in the property rental market. The purpose of this question, therefore, is to assess the demand for this reform.

Stakeholder response

4.7 There was consensus that there is a need for REITs to invest in REITs. In particular, three reasons were given which are discussed below.

Permits investment diversification

4.8 A REIT may see an opportunity to partially divest and separately list part of its business as a new REIT, whilst retaining a stake in this new REIT. This would provide public market investors the opportunity to either take a direct investment in that specific part of the business via the new lower-tier REIT, or an indirect diversified investment via a shareholding in the upper-tier REIT.

Better cash management

4.9 If a REIT realises cash on the sale of a property but has yet to identify a suitable subsequent property investment, it currently has little choice but to place the cash on short-term interest bearing deposit earning little interest. REITs could make a better return on such cash if they could invest short-term in another REIT. This would promote greater liquidity in the property market and attract additional investment into the UK built environment. Similarly, new REITs holding excess cash whilst awaiting suitable direct investment opportunities could temporarily invest in other REITs, which may be a preferable short-term strategy.

Facilitates joint ventures

4.10 Over the past 5 years joint ventures (JV) have become more widely used within the property sector to reduce exposure to large investments in single assets and to facilitate access to overseas investors. Introducing the proposed measure would enable REITs to raise funds by seeding new JV REITs with existing property and raising equity finance for other investment opportunities. Additionally, it could improve liquidity in the real estate market and offer potential new investors specialised investment opportunities.

How would this measure be beneficial to your investment model? Please provide evidence to support your answer. (Question 17)

4.11 As well as asking whether there is a need for this reform, it is equally important to understand why there is a need for reform. The Government is keen to continue its support for the REIT regime and to see this market grow. As such, the purpose of this question was to understand how this measure would help the REITs sector more generally.

Stakeholder response

4.12 In addition to the answers given to question 16, stakeholders suggested that reforming the tax treatment of REIT in REIT investment would encourage existing off-shore units to move on-shore, particularly in conjunction with the reforms already introduced in Finance Act 2012. The justification given was that the cost of operating off-shore was starting to increase as the tax differential was no longer as advantageous as in previous years. This potential migration was seen as a benefit because it would reduce the administrative cost of running a property investment company and would result in greater tax revenue for the Exchequer as the fund moved onshore.

4.13 Stakeholders also suggested that this measure would introduce greater liquidity by providing investors and REITs with an exit strategy. For instance, a REIT can create another REIT which it then seeds with a particular property portfolio. Selling shares in this second REIT means that the original REIT reduces its exposure to the specific property portfolio. It also means that if it decides to divest its interest in this second REIT, it only needs to sell its shares rather than having to sell the underlying assets. This is considered attractive because selling shares is generally easier than selling property.

How do you think this measure will help the Government to achieve its wider objectives (e.g. encouraging further investment in the property sector)? Please explain. (Question 18)

4.14 As set out in the consultation document, any future reforms to the REIT regime need to be weighed alongside the Government's wider objective; ensuring that the underlying the stability of the REIT regime is not weakened and investor interests remain protected. The purpose of this question was to seek views on how changing that the tax treatment of REITs investing in REITs will support wider government objectives.

Stakeholder response

4.15 A number of responses suggested that this measure would help support the Government's wider objectives which include stimulating growth; simplifying the UK tax regime; and strengthening the REIT regime.

4.16 For the Government's growth objective, stakeholders suggested that introducing an ability to "break-down" a REIT into smaller, more marketable and tradeable units would reduce the entry price into property investment. In the longer term, it should improve pricing and stimulate a more active and liquid real estate investment market.

4.17 For the Government's tax simplification objective, stakeholders represented that removal of arbitrary legal distinctions (eg REITs and Property Authorised Investment Funds) which currently distort ordinary business decisions could reasonably reduce complexity within the tax system.

4.18 Finally, with regards to strengthening the REIT regime, stakeholders suggested that this measure alongside reforms introduced in Finance Act 2012 would encourage property investors and developers to consider the REIT brand. This is particularly true as the provision of another form of joint venture structure for REITs will provide wider investor choice.

What practical issues that affect implementation should be considered, including avoidance risk? How can these be addressed? (Question 19&20)

4.19 The Government is aware that amending the REIT legislation may have practical implications. Furthermore, it is concerned to avoid any additional administrative burdens where possible. The purpose of these questions was to seek guidance from existing REITs and advisors on the types of practical issues that might arise and how they might be addressed.

Stakeholder response

4.20 Stakeholders raised a number of issues with the existing REIT regime that could affect the implementation of this measure. These issues are discussed below.

Treatment of Profit Income Distribution (PID)

4.21 Under the existing REIT regime, a REIT is required to distribute 90 per cent of its profit as a PID to its shareholders. The Government shared concerns that an investing REIT would be unfairly advantaged if it were exempt from paying tax on the PID it received and then only required to distribute 90 per cent of this income to its shareholders. The advantage comes from the investing REIT enjoying 10 per cent of a tax free PID whilst other investors are liable to pay tax on the entire PID.

4.22 Stakeholders recognised this concern and suggested that the REITs legislation require the upper REIT to pay out all of the PID received from its investment as PID to its shareholders within 12 months of the end of the accounting period in which the PID is received. In addition, to ensure HMRC can track an investing REIT's income it is suggested that such REITs, in their summary reconciliation of distributable profits, be required to identify PID income from other REITs and show that it has been distributed in full to shareholders. Stakeholders advised that this would reduce any risk of avoidance and unfair competition issues.

Balance of business test

4.23 The balance of business test, as it applies to assets, requires that 75 per cent of a REIT's assets are involved in its property rental business. This test was also relaxed in Finance Act 2012 to include cash as part of the 75 per cent of assets of the REIT for the purpose of the balance of business test.

4.24 Stakeholders suggested that consideration be given as to how the balance of business tests for the upper-tier REIT should treat the investment in the lower-tier REIT. In particular, they recommended that the value of the shareholding in and the income from the REIT investment should be included in the balance of business test for the upper REIT and treated as good assets/income.

Exclusion of REITs in "institutional investor" definition

4.25 In Finance Act 2012 the Government relaxed the non close company requirement so that certain types of institutional investors would not make a company close for the purposes of the REIT regime. The amended legislation provided a list the types of institutional investors that would not make the REIT a close company. This list did not include REITs.

4.26 Stakeholders suggested that REITs should be included within the definition of "institutional investors" so that REITs have the flexibility of owning more than 50 per cent of a lower-tier REIT. They argued that this inclusion was essential for providing flexibility for REITs to enter into joint venture transactions and partial or staged divestments.

Holder of excessive rights

4.27 This rule limits a shareholder to holding no more than 10 per cent of a REIT and was introduced to prevent international shareholders from paying their share of tax on dividends received because of existing double taxation agreements.

4.28 Stakeholders have suggested that this rule undermines the new "institutional investor" definition introduced in Finance Act 2012 which enables an eligible institution to be a majority shareholder. Consequently, they propose that the "holder of excessive rights" rule should be relaxed so that such investors are not taxed for holding more than a 10 per cent share in a REIT.

Start date

4.29 Stakeholders recommended that the start date needs to be considered if this measure is enacted. It was suggested that it may be easier to apply the changes to accounting periods commencing after Royal Assent for the Finance Act which contains these provisions.

What risks to the REIT regime could arise from allowing REITs to invest in REITs? What risks to the wider governmental objectives could arise? How can these risks be minimised? (Question 21&22)

4.30 As previously mentioned the Government is keen to ensure that any changes to the REIT regime do not undermine the vehicles' reputation, expose investors to unnecessary risks, introduce avoidance loopholes, or undermine Government's wider objectives.

4.31 The purpose of these two questions was to understand what risks might arise in the REIT regime, and to wider Government objectives, as a result of changing the tax treatment of income derived from REITs investing in REITs; and how these risks can be mitigated.

Stakeholder response

4.32 It was repeatedly suggested that group REITs structure their property investments through many types of entities, including corporate subsidiaries, corporate joint ventures, partnerships and unit trusts. Therefore, REITs already predominantly invest indirectly in "bricks and mortar" in one form or another. Consequently, allowing them to invest indirectly by way of a share-holding in another REIT was not a fundamental change to policy but rather an incremental facilitation of good commercial practice already in place in the REIT sector.

4.33 In terms of risks, stakeholders did not believe that reforming the tax treatment of REITs investing in REITs would generate risks to the REIT regime nor to government objectives. There was a consensus that UK REITs are already subject to high levels of regulation and reporting is highly transparent for investors. In addition there is already provision within the current legislation to cancel any tax advantage and to terminate the REIT status if deemed appropriate.

4.34 As regards tax avoidance risks, responses made clear that the idea of using multiple tiers of REITs to defer the ultimate taxation of PIDs in the hands of shareholders for a number of years was unlikely because every REIT has to comply with existing REIT requirements. Finally, to monitor the Exchequer impact, it was suggested that REITs are already required to allocate distributions between five separate reserve "pots" based on the type of income/gains they represent. The Government could therefore introduce a new reserve pot representing distributions received from other REITs. In addition the REIT distribution rules could be amended such that a REIT is required to distribution 100 per cent of this reserve pot. This would then protect tax receipts.

5 Government's response on tax treatment of REITs investing in REITs

5.1 The Government undertook this consultation to explore what the benefits of introducing investment diversification are for both companies and wider government priorities.

5.2 The Government has taken into consideration all of the stakeholder responses received, both written and through its workshops, and has subsequently assessed the impact of reforming the tax treatment of REITs investing in REITs against specific REIT and wider Government objectives.

5.3 There was consensus that allowing the income from REITs investing in RETIs to be tax exempt would generate positive benefits both for the REIT industry and wider government objectives. Specifically, it was asserted that reforming the tax treatment of REITs investing in REITs would facilitate greater diversification, better cash management and easier access to joint venture financing opportunities.

5.4 The Government recognises that this measure would help support the REIT business environment and help remove potential barriers to further future investment activity. This reform would also help simplify the tax treatment of REITs entering into joint ventures.

5.5 In terms of reforms required, the Government acknowledges the need to ensure that income from REITs investing in REITs is income of the tax exempt property rental business and that the asset of that investment is an asset of the tax exempt property rental business for the purpose of the REIT balance of business test. In addition, an obligation on the investing REIT to distribute 100 per cent of the PID it receives from the REIT in which it has invested would need to be introduced to mitigate the risk of any potential tax loss. The Government also takes on board the need to consider the start date when enacting this measure.

5.6 Finally, the Government considered stakeholders' suggestions to relax the "holder of excessive rights" rule and to include REITs in the "institutional investor" definition. However, the Government believes that an investor can already overcome the holder of excessive rights rule by having different subsidiaries holding 10 per cent tranches of shares. Therefore there is no need to relax this rule, particularly as it could lead to a loss of tax revenue which would undermine the Government's fiscal deficit reduction objective. Similarly, including REITs as an institutional investor could introduce a risk of revenue loss as the Government would not be able to limit this definition to UK REITs. This means that foreign REITs would be able to enjoy tax free investment at the expense of UK taxpayers.

5.7 Overall, the reform of allowing the income from REITs investing in RETIs to be tax exempt and the potential benefits generated have been assessed as complimentary to the Government's objectives to support the REIT regime and encourage investment without undermining its objective to reduce the deficit. Consequently, the Government will draft legislation to amend the REIT regime accordingly.

5.8 Draft legislation is being published alongside this document for technical consultation for eight weeks, ahead of inclusion in Finance Bill 2013.

6 Next steps

6.1 As discussed, as regards social housing REITs, the Government has decided not to make any changes to the REIT regime at this point because it does not consider that changes would materially alter the returns possible on social housing and thereby open up access to new sources of funding. For REITs investing in REITs, the Government has decided to reform the tax treatment of such activity to allow the income from REITs investing in REITs to be tax exempt.

6.2 The Government remains committed to the provision of affordable housing. In September, as part of the housing and planning growth package, it announced that it will guarantee up to £10 billion of housing debt to reduce the cost of borrowing to attract long term investment in private rented and affordable housing across the United Kingdom. The Government hopes to announce further details of the guarantees soon. The September announcement also included £300 million additional funding for Affordable Housing and Empty Homes in England. The Government is also considering the options that will apply for the future funding of affordable housing beyond 2015.

6.3 The September announcement also included £300 million additional funding for Affordable Housing and Empty Homes in England. This is in addition to the Government's investment of £4.5 billion in the affordable housing programme between 2011 and 2015 which will lever in around £15 billion of private investment. The Government is also considering the options that will apply for the future funding of affordable housing beyond 2015.

6.4 For REITs investing in REITs, the Government has decided to reform the tax treatment of such activity to allow the income from REITs investing in REITs to be tax exempt. Draft legislation for amending the tax treatment of income derived from REITs investing in REITs will be published on 11 December for technical consultation. Eight weeks will then be provided for interested parties to comment on this draft Finance Bill legislation. Contact details for submitting comments will be provided in the Tax Information and Impact Note, alongside the draft legislation, which will also be published on 11 December.

6.5 The consultation entitled "Consultation on reforms to the real estate investment trust (REIT) regime: (A) to explore the potential role social housing REITs could play to support the social housing sector; and (B) to consider the tax treatment of REITs investing in REITs" is now formally closed.

A List of the respondents

A.1 There were 49 responses received to the consultation. The following businesses and representative bodies submitted responses. Please note, where submissions covered both social housing REITs and REITs investing in REITs, we have counted this as one response to avoid duplication. Responses from individuals were also considered, but not listed below.

Affinity Sutton

Altair

Ashurst LLP

B Line Housing Information Ltd

BDO LLP

British Land

British Property Federation

Bury Metropolitan Borough Council

Chartered Institute of Housing

Chartered Institute of Public Finance and Accountancy

Confederation of British Industry

Council of Mortgage Lenders

Derwent

Devonshires

Durham City Council

Ernst and Young

Grainger

Grant Thornton

Greater London Authority

Goldman Sachs

Home Group

Hyde Group

Investment Property Forum

Jon Watson Consulting

Keep Moat

Land Securities Group

Local Government Association

London Councils

Mazers LLP

Moat

National Federation of ALMOs

National Housing Federation

Pinsent Masons

PKF

Places for People

Property Industry Alliance

PWC

Quality Social Housing

Royal Institute of Chartered Surveyors

Royal Town Planning Institute

Sanctuary Housing Association

Savills

SEGRO

Southern Housing Group

Sovereign

Stephenson Harwood LLP

Trade Risks Ltd

Towers and Hamlins LLP

Waterloo Housing Group

Westminster City Council

Winckworth Sherwood

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-1-909096-39-4