

Report date: 17.07.2013

**Strictly Private & Confidential
Legally Privileged Information**

HEXAGON HOUSING GROUP LIMITED

DEVELOPMENT FOR SALE

1 Background and context of this report

- 1.1 Hexagon Housing Association Limited (**Hexagon**) is a registered provider of social housing which does not trade for profit (an **RP**), an industrial and provident society (**IPS**) and an exempt charity. By “exempt”, we mean that it is exempt from direct registration with the Charity Commission.
- 1.2 It is proposed that Hexagon will invest in its wholly owned subsidiary which will acquire land and carry out a limited amount of development of residential units which will then be sold on the open market. By invest, we include lending as a form of investment. This would be carried out solely to cross subsidise the delivery of new social housing which it could not otherwise afford to provide. The schemes on which these units are delivered may be carried out solely “for sale” or as part of mixed tenure schemes where a proportion of the output on the site may be social housing. We refer to this, in this report, as the **Activity**.
- 1.3 Hexagon has a subsidiary which is an IPS (with “not for profit status”), an RP but with non-charitable status called Horniman Housing Association Limited (**Horniman**). We understand Horniman owns 33 units of shared ownership in two schemes, 11 of which have fully staircased; so, it retains 22 units with unsold equity. You have not specifically valued the remaining equity shares in the properties but your officers believe they would probably be worth about £2m if you did. It has borrowings of about £52,000 with Nationwide Building Society and a £145,000 loan from Hexagon.
- 1.4 We understand the Horniman Board comprises the Hexagon Chair, Hexagon Vice Chair, Hexagon Chief Executive, Hexagon Finance Director, and one “independent” (currently filled by a local estate agent with experience of local property markets and sales of new build homes).
- 1.5 The purpose of this report is to set out the legal issues which would relate to the Activity as a briefing note for the board and senior management team of Hexagon, with a couple of case studies to work through the practical implications of the paper.

2 Scope and basis of report

- 2.1 This report has been prepared for the boards of management of Hexagon and Horniman by Devonshires in accordance with its terms of business. It is not to be disclosed, in whole or part, to any third party without the prior written consent of Devonshires nor may it be relied on by any third party. In preparing it we have relied on the information provided to us by Hexagon’s officers. It may however be disclosed to the Homes and Communities Agency as part of your regulatory engagement with them.
- 2.2 This report does not constitute advice by Devonshires on the suitability of the activities discussed in this report as an investment. We have not been provided with details of any of the proposed schemes so the advice contained in this report is generic in its nature and is a guide based on the scope set out above.
- 2.3 We have not advised on matters relating to tax in this report; and to the extent we have commented on them you should verify these with your tax advisers. If you would like us

to advise on tax, then we can do so.

3 Rules; objects and investment

- 3.1 Hexagon's permitted objects under its rule A2 include, for the benefit of the community, providing housing¹. Charitable social housing is the provision of housing for persons who are "charitable beneficiaries" i.e. people who are on low income and/or elderly and/or disabled. Development for sale would not generally fit within these objects.
- 3.2 However, under rules B2.5 and F17 Hexagon can invest its funds in any way its board thinks fit. This could include investment in property, including development for sale, or indeed other investments such as stocks and shares.
- 3.3 A financial investment need not in itself be an activity falling within Hexagon's charitable objects but under rule B1 it should be (at least indirectly) expedient to achieve its objects. That is to say, any surplus deriving from the investment should be used in line with Hexagon's charitable objects. The investment should not become a self-perpetuating activity.
- 3.4 In view of all this Hexagon needs to be able to say that investment in the Activity is either:
 - 3.4.1 directly in furtherance of its objects; or
 - 3.4.2 incidental or ancillary to a charitable activity; or
 - 3.4.3 a financial investment; or possibly
 - 3.4.4 a hybrid of the two: a "mixed motive investment" or a "programme-related investment".

4 Is the Activity charitable?

- 4.1 The Activity would not be a charitable one. It could therefore only be carried on as part of Hexagon's investment activities. Because of the taxable position of the Activities, they are generally carried on within a (wholly owned) commercial trading subsidiary. This structure is accepted by the Charity Commission for investment activities but subject to compliance with its guidance².
- 4.2 There can be instances where the Activity could be said to be capable of being carried on by Hexagon itself even if it was not charitable: for example, where the development is part of a mixed tenure scheme and the non-charitable element is not substantial (which would generally be considered to mean less than 10%).
- 4.3 However, in the great majority of cases housing associations have used their investment powers and trading subsidiaries to carry out these types of activity because profits generated from them will be taxable. If the profit arose in the charity then it would still need to declare and pay the tax. If the tax arises in a wholly owned trading subsidiary then the taxable profits can generally be gift aided to the charitable body, thus mitigating the liability to corporation tax.
- 4.4 In some cases,

¹ The order of the wording here follows your rules and is important

² Trustees trading and tax: how charities may lawfully trade (CC35)
<http://www.charitycommission.gov.uk/publications/cc35.aspx#sthash.bjrGogtw.dpuf>

- 4.4.1 it has not been possible to split the affordable and for sale elements of a development site or the number of for sale units has been very low.
- 4.4.2 it has been decided that it would be simpler to carry on the development within the charity and pay the tax arising – for example, because of the cost of obtaining lender consents.
- 4.5 In the following sections of this report we have therefore assumed that, as before, the Activity is carried on through Horniman. You should take tax advice about this choice of investment vehicle because of its “not for profit” status, which means it is not capable of distributing its profits to its shareholders but may be capable of making gift aid payments (again this should be confirmed with your tax advisers). Your officers have confirmed to us that this is the structure that was used when Horniman previously undertook housing for outright sale. As a matter of law, Horniman would be capable of paying over moneys on whatever terms it considers prudent subject to maintaining its ongoing solvency. Sometimes, because of the difference in calculation of accounting profit and taxable profits, a trading vehicle of this nature will still incur some tax liability.

5 When can a charity carry out some development of residential housing for sale?

- 5.1 As mentioned above, a charitable RP can carry on a limited amount of non-charitable trade on balance sheet on an ancillary or incidental basis – for example, it might include some development for sale within a mixed development. Where this is a trade (as opposed to an investment) it should remain a low proportion of the charity’s activity, on a scheme by scheme basis. The non-charitable trade should not undermine the body’s charitable purposes and should not pose a significant risk to the charity as a whole or to its charitable activity.
- 5.2 If a charity carries on non-primary purpose trading itself (whereby the trade is not within its charitable objects) and the income from that trade exceeds an exemption limit of £50,000 it will be subject to corporation tax (in the case of a corporate entity) on the profits from that activity³.
- 5.3 Non-primary purpose trading could include, for example a charity building properties with a view to outright sales. And tax could become payable even where they are sold at a loss.

6 Financial investment

- 6.1 We have seen that normally the Activity cannot be carried on as a “primary purpose” charitable one. We have also noted that Hexagon is able to invest its available reserves. As Horniman is an Industrial & Provident Society it is not open to Hexagon to invest in its shares (as they have no value). Therefore, it can only invest in Horniman through:

6.1.1 Making loans;

6.1.2 Transferring property on lower than arms value terms

In each case subject to appropriate security arrangements.

- 6.2 The Charity Commission have recently updated their publication “Charities and Investment Matters: A Guide for Trustees” (CC14). This confirms that property, including development, can be a financial investment.

³ section 482 CTA 2010

- 6.3 Hexagon does not currently have an investment policy as such, as its Treasury Strategy has to date served this role. As an output of your consideration of the Activities we would recommend that one is put together for the Group and each of Hexagon and Horniman and approved by the Board in order to comply with the Charity Commission's new guidance on investment and in anticipation of a similar requirement from the HCA.
- 6.4 For tax purposes the activity would we understand be considered a "trade" even though for legal purposes the argument would presumably be that it constitutes an investment.

Investment criteria/factors

- 6.5 The board needs to be satisfied of a number of factors in entering into a financial investment:
- 6.5.1 The board has overall responsibility for investment and is primarily responsible for strategic decisions about how to use the charity's assets to achieve its aims. The board may delegate day to day decisions about investment to a third party i.e. an investment manager and/or to a specialist team within Hexagon;
 - 6.5.2 Hexagon needs to consider whether investment in the Activity as a whole is appropriate and, separately, consider whether any particular investment is appropriate. In doing so it should take into account any other investments it has made or has committed to;
 - 6.5.3 Hexagon needs to consider and have regard to the need to diversify investments. As against this, it may take in account the fact that it has particular expertise in development of housing and so may be better placed to manage the investment and can expect a better return than (for example) a share portfolio in relation to which it has less expertise;
 - 6.5.4 Hexagon's board should take advice from people experienced in investment matters where it considers it needs it and to protect itself;
 - 6.5.5 Hexagon should review the investments and any investment manager from time to time and change them if necessary;
 - 6.5.6 Hexagon as a charity should set investment objectives. It should (for example) consider its immediate financial needs; future spending commitments; longer term organisational objectives; past and anticipated expenditure patterns; and the impact of unplanned changes in activity or external events. In view of this Hexagon should decide the level of funds which should be instantly available and which should be held in short, medium or longer term investments;
 - 6.5.7 Hexagon should consider the level of risk it is appropriate to accept, and identify that risk. The guidance identifies certain categories: capital risk; liquidity risk; market risk; valuation risk; counterparty risk (here, of defaults by a substantial number of tenants or by a major tenant); tax risk; and environmental, social and corporate governance risk; and
 - 6.5.8 Hexagon should have an investment policy setting out its investment objectives and how it intends to achieve them.
- 6.6 In resolving to invest in the Activity, the board will need to consider these factors and record in the minutes the reason why the portfolio is considered to be an appropriate investment.

7 Hybrids

7.1 Under the new Charity Commission investment guidance, the Commission talks about two additional types of permissible activity for a charity,

7.1.1 a “mixed motive investment” – which is one that contains both elements of a “primary purpose” investment i.e. one which achieves a charitable objective (such as Hexagon’s mainstream social housing activity), and elements of financial investment. This would be relevant on a mixed tenure scheme. However, the outcome of the guidance does not change the way in which the Activity would be structured, as set out in this report.

7.1.2 “Programme related investment” – which is an investment made with a view to generating a return (which may be lower than a full market investment return) but which also, in part, achieves some of Hexagon’s charitable objectives. Our initial view is that it is unlikely Hexagon would need to have recourse to this category for the Activity as this is aimed solely at a commercial investment return.

8 Regulation

8.1 As RPs, both Hexagon and Horniman are required to comply with the regulatory framework published by the HCA. The main regulatory standards which will be relevant are set out below.

8.2 **Governance and Financial Viability:** within this standard, the viability element is particularly significant. The “required outcome” is that an RP must manage its resources effectively to ensure its viability is maintained. The “specific expectations” on viability include the need to have effective controls and procedures to ensure security of assets; to identify and effectively manage risks to delivery of financial plans; and to have a robust and prudent business planning and control framework. An RP should ensure access to sufficient liquidity at all times; that financial forecasts are based on appropriate and reasonable assumptions; and it sufficiently considers the financial implications of risks affecting the delivery of plans. An RP must monitor, report on and comply with its funders’ financial covenants. So for example, in order to demonstrate compliance, you should therefore stress test any proposed structuring of the Activity and its impact of any failure on loan compliance in Hexagon and Horniman.

8.3 It is worthy of note that HCA do not expect RP’s to issue any form of guarantee for the non-social housing activities.

8.4 As Horniman is an RP itself, HCA may take an enhanced interest in its activities. However, it is clear that an RP need not solely conduct affordable housing activities. But as an IPS there is an expectation that Horniman would operate “for the benefit of the community” rather than as a commercial trading company. In addition, Horniman would need to show separately how it would comply with the HCA’s regulatory standards in respect of its own social housing assets. One potential way around this would be for Horniman to transfer these social housing assets to Hexagon, if Hexagon was willing to buy them. Clearly this could not be at a price which was higher than their market value; and a decision would need to be made as to whether the assets and related activities were suitable for Hexagon as a charity. One way to minimise risk here would be to consult with HCA about the Activities as part of your normal regulatory engagement with them.

8.5 There is a “governance expectation” that any non-social housing activity will not prejudice an RP’s ability to comply with the HCA’s standards. These include viability. It is poorly drafted but would appear to apply to Activity carried on within an RP. The HCA has

issued a pre-consultation discussion paper where it makes it clear that it intends to update the current regulatory position to one which more robustly demonstrates the preservation of social housing. The essential premise of HCA's starting position in the paper is that any non-social housing should be undertaken off balance sheet and should not be cross subsidised with the profits generated from social housing; with any interaction with the activity being on an "arms length" basis. HCA has already stated that this position was set out to stimulate debate and the result cannot yet be pre-judged; indeed, any final result is likely to be 12 months away.

- 8.6 **Value for money (VFM):** this standard emphasises the need for a comprehensive and strategic assessment of an RP's approach to value for money in achieving its objectives.
- 8.7 Some of the VFM "expectations" appear to be more geared to carrying on primary social housing activity than to holding a property investment. Nonetheless it would be prudent to take account of the VFM expectations. The ones most relevant to investment include:
- 8.7.1 Robust assessment of use of resources including "trade-offs" and "opportunity costs" (here, the extent to which resources are being invested in the Activity as opposed to social housing and how the investment is intended ultimately to increase social housing provision);
 - 8.7.2 An understanding of return on assets (measured against purposes and objectives);
 - 8.7.3 A need for effective performance management and scrutiny functions; and
 - 8.7.4 A requirement to demonstrate to stakeholders how Hexagon and Horniman is achieving value for money, including an annual robust self-assessment.
- 8.8 Again, the board should demonstrate that it has duly considered VFM implications of any investment.

9 Banking agreements and terms for any on-lending

- 9.1 We have inspected Hexagon's loan agreements to see whether there are any restrictions in them which would mean lender consent is required to enter into this activity. A copy of our report is annexed to this report. From this work we would note the following:
- 9.1.1 Where Hexagon on-lends, the consent of Santander is required where the amount exceeds 10% of Hexagon's net worth. Net worth is defined as your capital grant plus reserves (excluding revaluation reserves). We have been informed by your officers that this currently equates to £273,149,000 (which would mean you could on-lend up to £27.3m without requiring their consent). If you wish to get an extension to this cap, it is likely that Santander would wish to charge a fee and potentially impose additional terms as the lending market has deteriorated since the date of the loan.
 - 9.1.2 If a new trading company is preferred for the Activity for tax purposes then consent will be required from Santander but it cannot be unreasonably withheld.
 - 9.1.3 We have not seen the loan agreements entered into by Horniman which may contain additional relevant restrictions – and may need to be refinanced if Horniman is to be a suitable entity.

- 9.2 In making any investment Hexagon will want to comply with the requirements of HMRC to ensure that the loan is “qualifying”.⁴ If the loan is not treated as “qualifying” it will be treated for tax purposes as non-qualifying expenditure.
- 9.3 To be treated as “qualifying expenditure” the loan will need to be made “for the benefit of the charity and not for the avoidance of tax”. In basic terms HMRC will look to see whether HMRC will normally accept it is for the financial benefit of the charity where it:
- 9.3.1 carries a commercial rate of interest which is paid and actively pursued
 - 9.3.2 is adequately secured, and
 - 9.3.3 is made under a formal written agreement which includes reasonable repayment terms.

This is similar to the charity law and regulatory position.

- 9.4 Previously, Horniman was able to access private finance on attractive terms. You should obtain advice from a treasury adviser as to the availability of funds for this type of activity. Of the transactions of this nature which we are advising on at the moment, we can report that whilst funding has now become available, the financial costs and the level of equity required are considerably higher than was previously the case when Horniman borrowed from AIB. In addition, lenders are more forensic about protecting their rights in case the scheme is unsuccessful – looking for collateral warranties on all contracts and from the professional team and developer. Sometimes they also look for a commitment for the sponsoring RP to buy the units on completion if they can’t be sold at an acceptable price.

10 Other factors

- 10.1 Contractual obligations/restrictions: The terms of Hexagon’s agreements and documents should be checked to see whether they contain provisions relevant to this investment programme. For example
- 10.1.1 If the land is already owned by Hexagon, the terms of any section 106 agreements and nomination agreements would need to be checked to ensure these do not limit the use of the relevant properties.
 - 10.1.2 The titles to the relevant properties should be checked to ensure there are no covenants which would prevent use as Activity.
 - 10.1.3 Where land is acquired by Horniman without grant, our assumption is that SDLT would be payable.
- 10.2 You may wish to consider whether Hexagon could purchase the remaining shared ownership from Horniman and hold it as an investment (on the assumption that this could be objectively justified as such). The capital could then be used by Horniman for its “for sale” activities.

11 Case studies

- 11.1 Case study one

Horniman intends to develop out 8 units of housing for sale on a stand alone

⁴ see http://www.hmrc.gov.uk/charities/guidance-notes/annex3/annex_iii.htm

housing for sale scheme

- 11.1.1 Vires. The scheme could not be carried out by Hexagon as it is not a charitable activity. As a non-charity Horniman could carry on the activity.
- 11.1.2 Investment. Hexagon could invest in the scheme by way of loan (or, if the entity carrying out the scheme was a company, by investing in its shares). This would be subject to the scheme meeting Hexagon's investment criteria.
- 11.1.3 Banking. Should external funding be required for the scheme, the lender will require that a significant amount of the equity for the scheme comes either from Horniman (presumably via Hexagon) or direct from Hexagon. In either case that funding would need to rank after its own and would typically only become repayable after its debt has.
- 11.1.4 Construction. Sometimes a developer will ask for a parent company guarantee. A guarantee should not be issued to support an investment activity.
- 11.1.5 Regulation. Hexagon would need to consider and be able to demonstrate how the funds it invests in the scheme are not needed for it to meet the HCA's regulatory standards and the impact of a "loss" scenario. Horniman would be required to do the same in respect of its own activities.
- 11.1.6 Qualifying loan. The loan agreement between Hexagon and Horniman would need to contain arms length terms appropriate to the Activities and ideally security (for example, by way of floating charge).
- 11.1.7 SDLT. If the scheme is not grant funded, SDLT will be payable on the acquisition price for the land. There will be other tax implications which are outside the scope of this paper, including in relation to gift aid. If Horniman is not wholly owned by one or more charities then it will not be able to make gift aid payments in respect of a financial year after that financial year end; whilst if it was, it could make them up to 9 months after financial year end. Often the level of taxable profits is not capable of calculation until after the financial year end.

11.2 Case study two

Horniman intends to develop out 8 units of housing for sale from a mixed tenure scheme of 24 units with 1/3 each of outright sale Shared Ownership (which is capable of being considered charitable) and rent

- 11.2.1 Vires. In this case, there may be an argument that the scheme as a whole is capable of being carried out by Hexagon because the predominant purpose here may be the delivery of social housing (which is a charitable activity); but corporation tax would be payable on the taxable profits arising from the housing for sale. This tax leakage may mean it is more suitable for the activity to be carried out through a non-charitable entity.
- 11.2.2 Property acquisition structure. Generally it is not known at acquisition which units will be sold. Therefore, the land will generally be acquired by one entity in the group which, as explained above, may conceivably be a charity. If it is, when the units are identified, they could then only be transferred at their full value (which

would have increased, say if planning consent had then been obtained). This could mean a tax liability could still arise in Hexagon. SDLT would be payable as a “clawback” on the transfer, unless social housing grant had been made available for the scheme.

In this case, the entire scheme could be acquired, delivered and managed by Horniman especially if grant was payable for the social housing elements. A trading company would not be able to receive grant.

Where a scheme is capable of being split at acquisition, then care needs to be taken in relation to the construction and other contracts.

11.2.3 Banking. It may be that the scheme is too small for external debt in which case this could be funded by Hexagon. To the extent that the funding is required for charitable activities this could be made on a “ringfenced” basis at less than market value terms.

11.2.4 Regulation. The same principles apply as set out in the earlier case study.

Devonshires