

## CREATING A LOCAL HOUSING COMPANY

### A REPORT FOR EPPING FOREST DISTRICT COUNCIL

#### 1 Introduction

- 1.1 You have asked for some initial advice on the possibility of setting up a company that would purchase properties in the open market and let them to people nominated from the Council's housing register. The money for the purchase would come from the Council and the Council would see this as an investment opportunity, on the basis that at some point in the future the properties could be sold and in the meantime the income from them would exceed what it is getting by leaving the money on deposit with a bank.
- 1.2 In considering a project of this kind, the Council will have to consider its powers and duties and these issues are explored further below. Furthermore, the Council should consider whether there are other ways of achieving the same objectives. In order to demonstrate that the proposal is reasonable and beneficial to Council Tax payers and the community and that the Council is achieving best value, there should at least be some consideration given as to whether the Council could do this in a different way with an existing organisation rather than setting up its own company.
- 1.3 However on the basis that the Council sees this as primarily an investment activity and want to be able to regain the capital value of the homes when it wishes, it seems likely that setting up a vehicle for the Council itself will be the most appropriate route and the rest of this paper proceeds on that basis.
- 1.4 There are a number of transactions involved here. First of all setting up the Company, secondly lending the money to the Company, and thirdly the legal arrangements. The legal documentation would set out any services to be provided by the Council to the Company and ensure that the Council gets the nomination rights it wants and is able to dictate the sale of the properties at the appropriate moment. The legal agreements would also cover how the proceeds of any such sale would be paid to the Council, net of the Company's sale costs and the repayment of any outstanding loan attributable to that property, and how any other surpluses would be dealt with.

#### 2 Setting up a Company

- 2.1 Setting up a private limited company (either limited by shares or by guarantee) is a simple process. It can be done in a matter of days and indeed within the day with Companies House. All that would need to be done is that the Council would need to agree a name for the company, a set of articles (since the Companies Act 2006 was finally fully implemented in October 2009 companies now have articles only rather than memorandum and articles), and decide who are to be the first directors/shareholders (or directors/members in the case of a company limited by guarantee) and apply to Companies House. We can assist with the forms as necessary.
- 2.2 What sort of a company do you want? Companies limited by guarantee are governed by much of the same legislation as companies limited by shares but they have members rather than shareholders and the members undertake to pay a nominal figure (usually £1) in the event of insolvency. Companies limited by guarantee tend to be not-for-profit

organisations and are therefore often used to provide affordable housing where the purpose of the company is not to benefit its members. Such companies may also decide to operate as charities.

2.3 However on the basis of what we know of your plans and given the investment emphasis of this project, we suggest that while there will be tax disadvantages from choosing to be a for-profit company, if the Council wishes to be able to access the increase in capital values of these properties without problem in the future, it is important that the Company is not a charity and that the Company is in essence going to operate for profit. We therefore suggest on what we know at the moment, the Company should be set up as a company limited by shares. The Council will want to keep this issue under review as the project progresses. There are unquestionable tax costs to being non-charitable: a non-charitable company will pay corporation tax on its profits and stamp duty land tax on the purchase of properties. The Council will need to continue to consider whether the price of the freedom to access the capital in future is worth the additional tax.

2.4 You could use a limited liability partnership (LLP). The principal advantage of using an LLP over a limited company is the way in which it is treated from a tax perspective. The LLP is treated for tax purposes as a traditional partnership, and members are treated as traditional partners. Therefore, unlike a limited company, it is tax transparent and any trade, profession or business carried on by an LLP with a view to profit will be treated as if the LLP were a traditional partnership. Since the tax status of the partners determines how much tax is paid, the Council's share of any profits should be corporation tax free.

An LLP requires a minimum of 2 partners so the Council could not have a 100% interest. One option (in theory at least) could be for the Council to have, say, a 99% interest and the other 1% interest could be vested in a management company set up and wholly owned by the Council.

However, it should be noted that the use of an LLP for this type of vehicle would raise a vires (powers) issue. The Council cannot set up the Company as an LLP solely for the reason of tax efficiency; there must also be a commercial reason for using an LLP. There would therefore need to be a reason why a partner is required. For this reason we prefer the company limited by shares model which does not require what could be regarded as the legal device of a partner with a nominal share.

### 3 **Your specific questions**

Taking the specific questions outlined in your brief one by one:

#### **Statutory powers**

3.1 There is regrettably still confusion about the statutory powers that councils can use to set up companies. However, despite recent case law casting doubt on the wellbeing powers, the wellbeing powers in the Local Government Act 2000 can still be used where it is clear that the purpose of the company being set up is to benefit the local community. However there is concern from the LAML case (concerning the power being used to set up a mutual insurer) that simply raising money which the Council can then use for beneficial purposes is not sufficient to use the wellbeing power. We would therefore recommend that, based on our understanding of your current plans, if the Company is not being set up directly to contribute to the wellbeing of the local community through its activities (having regard to the aims set out in the Council's community strategy) and the money which the Company

raises is not being ring-fenced for a specific beneficial purpose, the Council should not rely on the wellbeing power here.

- 3.2 For this project, as the houses when let would count as privately let housing for the purposes of Sections 24 and 25 of the Local Government Act 1988, we would suggest that you could use the Local Government Act 1988 powers which give you wide power to provide assistance for privately let housing and assistance can include purchasing shares. The disadvantage of the Section 24/25 powers is that exercising them requires the Secretary of State's consent and while there are a number of general consents, there is no general consent for acquiring the shares in a company.
- 3.3 Under these initial proposals we anticipate that the Section 24/25 powers would be appropriate but this needs to be kept under review as the proposal develops. If neither wellbeing nor the Local Government Act 1988 powers turn out to be appropriate we could also review the extent to which the council's investment powers can be used. In short, we are sure that it will be possible to identify adequate powers to set up the Company. Local authorities have been setting up companies for various purposes for many years, long before the wellbeing power was invented and it is usually possible to find an appropriate power.

### **Consents**

- 3.4 As said above if the 1988 Act powers are used then consent is required for the taking of the shares in the Company. The consents would come from CLG. The creation of the Homes and Communities Agency and the movement of some staff who used to deal with consents from CLG to the HCA has caused some confusion over consents. If on further reflection the structure of the Company does require consents we would suggest an early discussion with CLG to ensure that this is not an overly complex route for this size of project.

### **The role of the Directors and the Secretary**

- 3.5 Directors have important legal duties in relation to any company. The fact that the Company would be a wholly owned subsidiary of the Council makes no difference to the directors' duties. The Companies Act 2006 sets out in some detail what these duties are and we can provide a full note as and when necessary. In essence the directors have to act in the best interests of the company when exercising their powers as directors and that is true even if they are appointed by the council. For a profit making company the best interests of the company means the best interests of the shareholder, which here would be the Council.
- 3.6 We understand that the directors of the Company may include the current holders of a particular office in the Council and, when the officeholder changes, it would be expected that the new officeholder would become a director of the Company. In deciding to appoint as directors members who also hold key Council posts, you would need to consider conflicts of interest (see paragraph 3.13). Similarly, it may be that if a director of the Company ceases to be a Councillor the expectation would also be that they are removed from the board of the Company. Although it is technically possible to insert provisions in the Company's articles dealing with these points, we would suggest that the Council this should not be enshrined contractually or constitutionally as the Council may in some circumstances want the flexibility for a particular director who ceases to be a Councillor or officeholder to remain on the board for a while longer (for example if the Company is in the

middle of a transaction). However, the Company's articles could state that the Council will remove and appoint directors from time to time and the Council could have a statement of intention that the Company's board would comprise specific officeholders and a number of other Councillors. In this way the Council's intentions would be set out but it would have the flexibility to make case-by-case assessments.

- 3.7 As mentioned above, the Company's articles could specify that the Council may appoint and remove directors at any time. The appointment or removal would be stated to take effect upon the Council giving written notice to the Company. This constitutional power would allow the Council to appoint new directors when there is a vacancy and to remove a director for any reason. The articles could also provide for other circumstances where a director would automatically cease to hold office – for example, bankruptcy or disqualification as a person who is able to be a director at law. There would be no cost implications associated with the appointment and removal of board members as we envisage that they would be voluntary board members (see below) with no employment rights.
- 3.8 The issue of remuneration of directors raises a number of issues as this would involve paying elected members of the Council. Section 80 of the Local Government Act 1972 disqualifies a person from local authority election and membership if that person "holds any paid office or employment (.....) appointments or elections to which are or may be made or confirmed by the local authority". This would need to be considered in detail and it would be a matter for the individual councillors on the board to decide what to do. Given that if Section 80 were deemed to apply then he/she would be automatically disqualified from being a member, we would encourage such individuals to obtain their own advice, presumably from the Council Solicitor. It would of course be possible for board members to be reimbursed in respect of properly incurred expenses.
- 3.9 Having discussed the issues regarding remuneration, in our experience LHCs of this size have unpaid boards. The exception may be where an LHC appoints a specialist for the purpose of running the company. To take another comparator, even boards of substantially larger wholly Council-owned companies such as ALMOs are mostly unpaid.
- 3.10 In respect of the term of office for directors of the Company, it is technically possible to set limits in the Company's articles for the minimum and maximum terms of office (subject to the Council's right to remove a director at an earlier point and the automatic cessation provisions) but, again to maintain the Council's flexibility, we would suggest that this should not be enshrined in the articles. However, at the very least the articles could provide that directors would be appointed for an initial set term of, say, three years in order that the Council will consider the board composition from time to time.
- 3.11 It is important that any member or officer agreeing to be a director of the company fully understands that they will have real liabilities and responsibilities. The point of limited liability companies is to limit the responsibilities of directors, and so long as they act within their powers they have no personal liability for the debts of the company. Directors can however have personal liability if they trade while knowingly insolvent and in relation to certain health and safety risks.
- 3.12 There is now no legal requirement to have a company secretary. However most of our clients find some kind of company secretarial function is useful to ensure the good governance of a company. It is for the directors to set and agree the duties of the

company secretary but they generally relate to ensuring annual returns are properly filed, board meetings are properly called and that the articles are complied with. The company secretary can be someone who is not an employee of the Council or the Company or they could be a Council employee.

### **Conflicts of interest for councillors**

- 3.13 There is clearly a potential for conflicts of interest and councillors will have to have regard to your own code of conduct. Any councillor who is also a director is likely to have to declare their interest and not participate in any meetings which concern the company. We would therefore strongly suggest that in selecting members to be directors the Council avoids members who are likely to need to want to make key decisions about the Company.

### **Indemnities**

- 3.14 It would be open to the Company to purchase its own insurance for director's liabilities. Equally the Council may be able to offer suitable indemnities under the Local Authorities (Indemnities for members and officers) Order 2004, subject to the restrictions in that Order. These restrictions prohibit the provision of an indemnity in relation to any act or omission by a member or officer which constitutes a criminal offence or is the result of fraud, other deliberate wrongdoing or recklessness. An indemnity may be provided in relation to the defence of any criminal proceedings brought against the member or officer but if they are convicted and that conviction is not overturned following any appeal, the member or officer in question must reimburse the Council (or insurer) for sums expended in relation to those proceedings. Further, an indemnity is not permitted in relation to the making by the indemnified member or officer of any claim relating to the alleged defamation of that member or officer, although an indemnity may be provided in respect of the defence by a member or officer of any defamation allegation made against him.

### **Documentation**

- 3.15 As said above, what is needed by way of Company documentation is a set of articles. Normal practice nowadays is to have very general articles giving wide powers and if this is a for-profit company the objects would also be general. Clearly if you wanted the Company to be a not-for-profit or indeed a charity then the articles would need to be restricted to demonstrate charitable objects or not-for-profit objects and to restrict the distribution of profit to the shareholder or member which in this case would be the Council. As mentioned in paragraph 1.4 above, the transactions involved in this project would also require an agreement to be put in place between the Council and the Company setting out the rights and obligations of each party.

### **Requirements to hold board meetings and AGMs**

- 3.16 There is no longer any legal requirement to have annual general meetings and so long as the articles do not require annual general meetings there do not need to be any. For a very small company of this kind, I would suggest you do not need to have an AGM. You do need to have board meetings. How often they are and how they are held is a decision for the directors and normally the articles would prescribe a minimum number.

### **Filing requirements**

- 3.17 The Company would have to file annual returns with Companies House and failure to file annual returns gives rise to fines and ultimately to the Company being struck off the register at which point its property vests in the Treasury Solicitor. It is vitally important if a company is set up that everyone understands this and proper arrangements are made for the filing of annual returns. This raises a question not in your list which is where should the registered office of the Company be. It is very important that the registered office is an office where people will understand that formal letters delivered for the Company there need to be dealt with promptly. This will relate not just to Companies House letters but also to HMRC and potentially to notices received from tenants. The Council's offices could be the registered office of the Company and that is true for many companies set up by Councils. If it is going to be run out of the Council's offices then it is important that proper arrangements are put in place for the delivery of post to the appropriate person.

### **Audit of accounts**

- 3.18 The extent to which audited accounts are required will depend upon how many homes and the level of income of the Company as there are less complex audit requirements for smaller companies. PKF are better placed to advise on this than we are. As a wholly owned subsidiary of the Council, the Company's accounts would need to be grouped for certain purposes with the Council's accounts. It is no longer true that any borrowing by the Company is counted as Council borrowing but as a subsidiary it is still true that the accounts of the Company and the Council have to be grouped together.

### **Statutory requirements in respect of managing the Company and finances**

- 3.19 As outlined above the directors have legal duties to act in the best interests of the shareholder which here would be the Council, as well as a range of other legal duties and clearly it would be vitally important that directors manage the finances of the Company so as to achieve profit for the shareholders. Equally the directors can delegate all these duties to appropriate managing agents – but please note that delegation does not remove the legal responsibility.

### **The costs of setting up a Company and its running expenses**

- 3.20 The actual set up itself, if it is easy to agree a set of articles, need not cost more than £2,000 or £3,000. The actual fee for registering the new Company with Companies House is £50. In terms of running expenses and assuming the directors are not being paid for being directors, then as the Company would be a landlord it will need proper insurances as a company and not just directors liability insurance, you will need to look at personal liability, public liability and so forth. Whoever deals with insurance at the Council should be able to give a view of likely costs for this. With a company this small we assume it will not employ anyone at all but someone is going to have to supply company secretarial services, organise meetings etc. This may well be done from within the Council but you would expect the Council to make a charge for these services. The directors will need to meet from time to time and there are costs to having the meeting room, papers for the meeting and so forth. It is extremely difficult to give an estimate but it would be possible to build up a budget of likely costs over a year and simply putting a finger in the air one would expect it to be difficult to ensure that the issues above were covered for less than say £5,000 a year but that is a very rough estimate.

## Tax advice

- 3.21 In terms of VAT liability, the Company will not be able to recover VAT for repairs in the way that the Council does. The Council's ability to recover VAT depends on special rules that apply to councils. Normal landlords pay VAT on repairs that are carried out to their houses. They cannot recover the VAT because renting out properties is an exempt activity for VAT purposes and therefore there is no output VAT to set the input VAT against. You may be aware of various schemes that exist within the local authority sector that enable landlords working with councils to access the Council's ability to recover VAT for repairs. However these schemes all assume that the Council owns the houses in the first place and is transferring them over to a company. If as you are intending to do the homes are being purchased on the open market it is not likely to be possible to recover the VAT and the VAT on repairs is a real cost. Clearly the extent to which this is an issue depends on the kinds of property you are intending to buy. If the Company buys good quality property then day to day running repairs would not normally be huge.
- 3.22 We have been asked to confirm whether Council Tax would be payable by the Council whilst any of the purchased properties are empty. Our understanding of the current proposal is that the Company, rather than the Council, would purchase the properties and it would therefore be the Company, rather than the Council, as the owner of the property who may be liable to pay Council Tax. There are some potential exemptions for unoccupied properties but these would need to be looked at carefully as their applicability will depend upon factors such as the state of the property and whether it is furnished. Furthermore some of the exemptions only apply for a limited time, after which, if the property still remains unoccupied Council Tax would be payable by the Company.
- 3.23 In terms of other taxes the key issue here is the nature of the Company. Assuming a for-profit company limited by shares then the Company will be liable for corporation tax on any surpluses it makes on each year in the way that any private landlord would be and liable for capital gains tax when it disposes of properties in say 5 years' time. The interest that the company pays the Council for the money lent to it should be capable of being offset against the surpluses. However, with the Council as sole shareholder the transfer pricing rules will need to be borne in mind. On the assumption that there is a straightforward loan agreement between the Council and the Company (with the Council's right to dictate the sale of the properties etc provided for elsewhere) and the loan is used exclusively for the purpose of the Company's business, there is a risk that the transfer pricing rules would apply to limit the interest deduction offset against the Company's surpluses for corporation tax purposes to the amount of interest which the Company would have paid to an independent lender.
- 3.24 This means that the amount of interest bearing debt which the Company can claim as deductible is limited to the amount which a third party would lend (e.g. possibly only 60% loan to value) and, in addition, the rate of interest must not be higher than would have been paid on arms' length terms. As an example, if a bank would lend £50 at 4% per annum then if the Council lent £60 at 4% then the interest payable on the extra £10 would not be deductible. Similarly if the interest charged was 5% then the interest deduction allowed would only be 4% on £50. The terms of the debt (e.g. repayment terms and security) should also be arms length to prevent a restriction on interest deductibility. If a third party would not lend at all, then the transfer pricing rules would stop any deduction from being available. The Company would need to consider its position and have evidence to justify its tax deductions. There are some exceptions to the transfer pricing rules, so it is

possible that they would not apply and we could advise further if necessary, but the starting point is to assume that they are applicable.

- 3.25 The Company would pay Stamp Duty Land Tax on the purchase of the properties assuming they are not below the Stamp Duty Land Tax threshold which is currently £125,000 for residential property and £150,000 for non-residential property (where six or more properties are being bought from the same vendor or persons connected with that vendor at the same time this is classified as non-residential).
- 3.26 The activities of the Company would not affect the Council's own VAT position.

#### 4 **Key terms of the loans**

- 4.1 A key issue on the loans would be to ensure that you are not caught by any state aid rules. State aid occurs when any public body gives subsidy to another body. Whether there is subsidy or not depends on the rate at which the loans are made. There is a set of reference rates published by the European Commission from time to time and so long as you charge more than the reference rates, and we suspect the Council would want to, there is no issue of state aid. The latest reference rates can be found on the European Commission's website at [http://ec.europa.eu/competition/state\\_aid/legislation/reference.html](http://ec.europa.eu/competition/state_aid/legislation/reference.html). As at the date of this paper the current UK reference rate is 1.16% but this is subject to weightings based on the credit rating of the company and collateral offered, as described in the Commission Notice 2008/C 14/02 which is also available at the above website address.
- 4.2 If for some reason you are charging less than the relevant reference rate then there is an exemption for support for social housing and assuming that you are letting to people off the waiting list it may be that this would be social housing. However from the general nature of the scheme we would suggest that you will come outside state aid by charging a market rate of interest which is at or higher than European Commission reference rates and therefore no issue of state aid would arise. There is no upper limit in respect of the interest rate which the Council may charge the Company but obviously the directors of the Company would need to be satisfied that it can meet its repayment obligations, including repayment of interest, and there may be corporation tax implications due to the application of the transfer pricing rules (described above), which will need to be borne in mind.
- 4.3 In terms of the nature of the loan generally, in order for the Company to be able to function properly, it will need to be a term loan i.e. not the type of overdraft facility which the Council can withdraw at any time or demand repayment at any time. You would effectively lend the money out on a mortgage secured on the properties with terms very similar to those that a high street lender would expect to have. You would expect the security to restrict the use of the properties, to ensure they cannot be sold without you knowing about it and to restrict lettings to ones which the Council approves of. Normal terms of loans also require the borrower i.e. the Company to insure the properties and to keep them in a good state of repair. We can assist with the preparation of the loan documentation in due course.
- 4.4 In terms of interest payments and interest setting you need to consider whether the interest would be fixed or variable and if variable by reference to what rates. You also need to consider whether you would let the Company repay the Council loan and refinance with someone else. It seems unlikely they would want to and indeed for so long



as the Council completely controls the Company, it is not very likely anyone would want to lend to it but it is something you would want to be clear about.

## **5 Initial start up costs**

- 5.1 Councils often set up companies like this with small loans and in effect sponsor the set up to get it up and running. The company would not trade until it had the properties and up until that point all liabilities would stay with the Council. If the Council wants to give the Company a grant for the company to meet its own set up costs the power is again Section 24 of the Local Government Act 1988 and it would need consent.

## **6 Key risks**

- 6.1 One of the major risks is that the properties that are bought do not increase in value in the way that members hope they will. If that happens the capital gains that the Council is hoping for would not be there. Other risks are that the Company is unable to let properties, there are long void periods or it suffers from a limited rental flow.
- 6.2 One point which is important to note is that because the Company will be letting these properties it would let them on assured shortholds (we would assume). As tenants of a private landlord, tenants who cannot afford to pay the rent themselves will be on local housing allowance not on housing benefit. The impact of this under current rules is that the local housing allowance is paid direct to the tenants and there are only very limited circumstances where it can be paid direct to the landlord. This is leading in some places to higher levels of rent arrears. The business model for the Company needs to make prudent risk assessments in terms of voids and bad debts to ensure that the assumptions being made about what income the Council might be able to obtain in return for its loan is realistic.
- 6.3 Clearly all properties purchased would need to be surveyed in the normal way to ensure there are no unlikely costs that have not been included in the business model.
- 6.4 If the value of the properties goes down then the Council may no longer have adequate security for their money. However even if the value of the properties go down the Council might still be receiving significant income from the properties if they are properly rented out

## **7 The Council's responsibilities to creditors of the Company**

- 7.1 No parent of a company, as the Council would be here, is automatically liable for the debts of its subsidiary. In principle if the Company became insolvent it could be wound up as an insolvent company and the Council would not be liable to its creditors. Clearly in those circumstances the Council might also not recover its loan, though assuming that you take security over the properties for your loans you would be first in line for any money that is there. However there are significant issues of reputational risk if the Council just let the Company go down particularly if it owed money, perhaps to small local contractors.
- 7.2 Secondly to the extent that the Council tells the Company what to do, it is possible for the Council to be considered to be a shadow director and an aggrieved creditor might try to assert that the directors of the Company had simply been doing what the Council told them to do and therefore the Council should be liable as a director. We cannot advise on the likelihood of success if a claim of this type was made as it will depend on factors such as how much the Council becomes involved in the day-to-day management of the

Company and the extent to which the directors are permitted to perform their duties without interference. However, the more the subsidiary appears to be a shell, the greater the likelihood of the Council being found to be a shadow director. Of course, the Council is bound to want to exercise a certain level of control over the activities of the Company. Overall, the Council should try to restrict its interference so far as possible but should not feel that it is unable to carry out the standard functions of a parent. It will not become a shadow director simply through passing legitimate resolutions of its own which have implications for the Company, or by including in group accounts or other publications statements of policy applicable to the Company.

- 7.3 The Council can help to minimise the risk of being considered a shadow director by ensuring that it appoints people with appropriate experience to the Company's board and by putting in place appropriate reporting mechanisms back to the Council. This should help enable the Council to be comfortable with the Company's directors managing the day-to-day affairs of the company and to limit its involvement in the running of the Company to dealing with problems identified through the reporting mechanisms. In terms of personal liability of directors and hence liability of a shadow director there should still be no liability so long as the directors are careful never to trade while knowingly insolvent, to take proper advice and to act within the scope of their articles and not otherwise.

## 8 Administration or receivership

- 8.1 If the Company goes into administration or receivership again so long as the Council has taken security for its loans, the Council would be in the driving seat in terms of what happens.

## 9 The agreements between the Council and the Company

- 9.1 The first and most important agreement would be the Loan Agreement and Charge over the properties and these have been outlined above. Secondly there would be a Nomination Agreement to ensure that the properties are let to people that you choose. Thirdly there may be agreements for services.
- 9.2 You have asked about restrictions on municipal trading which might restrict the Council's ability to provide services to the Company. This Company would not fall within any of the organisations listed under the Local Authority (Goods and Services) Act 1970 and therefore this power could not be used. The ability of all councils to trade and to charge for services under the Local Government Act 2003 has been widened, and it is likely we will be able to pick our way through the statutory provisions to enable charging for services. Further if you decide to use wellbeing powers to establish the company there are further powers to provide services linked to the wellbeing power.
- 9.3 We have dealt with state aid above. In terms of EU procurement, we suspect the contracts that the Company would be letting are likely to be below the EU threshold for service contracts. If the Company were ever to let a contract above the EU threshold, which is about £135,000 for the total value of the contract (not per year), then if the Company is entirely funded through a loan from a local authority it is likely to fall within the definition of a contracting authority and would have to follow EU procurement processes to let the contract. It should be noted that under the EU procurement rules there is no exemption from the requirement to follow EU procurement processes in the case of the Company receiving services from the Council. Although an exemption, known as the "Teckal exemption", may apply in respect of any services provided by a subsidiary to its

parent (depending on the level of control exercised by the parent over the subsidiary), the Teckal exemption does not apply in reverse (i.e. it does not apply to services provided by the parent to the subsidiary).

## 10 **How does the Council get the profits from the business**

10.1 If this Company is set up as a company limited shares then as the sole shareholder the Council would be entitled to all the profits from the business as the Company declares dividends from time to time and if the Company were to be wound up solvently at some point in the future then the Council would be entitled to the entire benefit of the assets and profits of the Company (subject of course to any creditors and tax having been paid). The process for solvent winding up involves various resolutions being passed by directors. The key issue is always ensuring that all liabilities have properly been accounted for and indeed paid before any assets are distributed and PKF would always be able to assist with that. If you were to go down a not-for-profit route, if the Company was not-for-profit but also not charitable it would be possible to enter into an agreement with the Company whereby the Council could require houses to be sold and the profits made given to the Council or shared with the Council.

10.2 If the Company were a charity this would be much more difficult to achieve. Any profits made by the charity would need to be used for charitable purposes and it would be much more difficult to enable them simply to be returned to the Council. The Council might be able for example to structure its loans so that rather than simply taking interest they had an equity interest loan which would give the Council a share in increased value of the properties as properties are sold. But if the Council decided that it wanted the Company to be a charity it would need to be aware first that the Company would need significant operational independence from the Council in order to achieve charitable status and that apart from making arrangements for equity loans or such like, any profits generated within the charity would have to be retained for proper charitable purposes and not simply paid to the Council. We do often see public bodies wanting to set up charities because they are unhappy about the tax liability of the Company if it is not a charity but then wanting to retain all of the profits in a way that it is exceptionally difficult to achieve with the charity.

## 11 **General information**

11.1 We have been asked to clarify whether the Council could impose conditions on the Company as to the rent levels it may charge tenants to restrict them to Local Housing Allowance rates. Such a condition could be imposed on the Company through a contractual provision in the agreement between the Council and the Company.

11.2 You have also asked whether we know of any other local authorities that may be undertaking a similar project. As you will know from the housing press, London Borough of Camden have considered a wholly-owned subsidiary model which would receive void properties from the Council for letting by the subsidiary and we are currently working with another London borough on the setting up of a wholly-owned subsidiary to receive properties from the Council to be let by the subsidiary at intermediate rent levels. We have also assisted a number of ALMOs on the setting up of subsidiaries to carry out new build, including Your Homes Newcastle and Rochdale Borough Wide Housing. Although these projects are in some respects different in size and purpose from the Council's proposals, they do raise some of the same issues regarding consents and company set-up.

11.3 With regard to problems faced by other authorities, we would advise that it is very important to ensure that the proposals work financially and to keep retesting this as the proposals develop.

11.4 You have also asked whether we have any information which would suggest that there is any effect of the Council distorting the local renting market, contrary to state aid rules. So far as the Council lending money to the company at commercial rates is concerned then, as discussed above, there is no issue of state aid. As the proposal develops we should be happy to review state aid considerations further.

12 **Conclusion**

We would welcome the opportunity to explore the issues outlined above in a meeting. We suggest that following such a meeting we could focus the advice on the approach that the Council wants to take. We can then assist with any or all of the documents needed as required. The key issue will always be to ensure that the Council is clear about its aims for the project and that everyone bears those key aims in mind as the project progresses.

**Towers & Hamlins LLP**

**January 2010**

## Local Housing Company Cabinet Committee

### PROPOSED TERMS OF REFERENCE

1. To consider all issues relating to the formation and operation of a Local Housing Company (LHC), that would receive mortgages from the Council to purchase properties from the open market, to let on assured tenancies at market rents to nominees from the Council's Housing Register ("the Initiative"), including:
  - (a) The proposed Articles of Association for the LHC;
  - (b) The options available for the key terms of loan (mortgage) agreements between the LHC and the Council, including proposals on the maximum amount of mortgages to be provided and how these should be funded by the Council;
  - (c) The detailed arrangements and key terms for a Services Agreement between the LHC and the Council, and the services to be procured from external providers, for the Initiative;
  - (d) The key terms for a Nominations Agreement between the LHC and the Council for the Initiative
  - (e) The proposed policy on the purchasing and letting of properties for the Initiative;
  - (f) Any tax implications for the LHC and/or Council in respect of the Initiative;
  - (g) The identification, recording, monitoring and mitigation of the key risks of the Initiative for both the Council and the LHC; and
  - (h) The detailed issues set out in the attached Work Plan.
  
2. To make recommendations to the Cabinet on all required decisions, including (with (d)-(f) being reserved to the full Council):
  - (a) The provision and key terms of the proposed mortgages to the LHC;
  - (b) The terms of the proposed Services Agreement with the LHC;
  - (c) The terms of the proposed Nominations Agreement with the LHC;
  - (d) The proposed Articles of Association of the LHC;
  - (e) The total and/or maximum amount of mortgages that should be granted to the LHC and how these should be funded by the Council; and
  - (f) How the Council should monitor and scrutinise the performance and finances of the LHC, following consultation with the Overview and Scrutiny Committee.

## **Work Plan for the Local Housing Company (LHC) Cabinet Committee**

### **(1) Setting up of the Local Housing Company**

#### *(a) Consideration of:*

- The Council's statutory powers to establish a Local Housing Company (LHC)
- The consents required by the Council
- The type of company to be formed (i.e. Company limited by shares – based on T&H's advice)
- The role/duties of directors – Trowers and Hamlin's note of duties to be attached
- Directors' liabilities, including whether the Council should obtain liability insurance/indemnities for directors and the type
- EFDC's powers/ability to appoint/remove directors
- The legal requirements for the LHC to file documents and associated fines
- The legal requirement to group the LHC's accounts with EFDC's accounts
- EFDC's responsibilities to creditors (if any)
- The budget provision for set up, including:
  - Estimate of set-up costs
  - Estimate of initial running costs
  - Consideration of whether EFDC should provide either a small loan or a grant

#### *(b) Recommendations to be made to the Cabinet on:*

- How EFDC should monitor and scrutinise the performance and the finances of the LHC, following consideration by the Overview and Scrutiny Committee
- Whether the LHC should actually be formed

### **(2) Articles of Association**

#### *(a) Consideration of:*

- The name of the LHC – Epping Forest Homes ?
- Issues relating to the appointment of Directors, including:
  - No. of directors
  - Potential conflicts of interests for directors
  - Whether or not a Company Secretary should be appointed
  - Whether or not there should be any remuneration (or EFDC special responsibility allowance) for directors
  - How the Chairman of the LHC should be appointed/elected
- Whether or not the LHC should pay dividends
- Where the Registered Address should be
- Whether or not the LHC should hold AGMs and the minimum number of board meetings per year
- Who should be invited to act as auditors to the LHC

#### *(b) Recommendation to be made to the Cabinet:*

- That the Council should actually set up the LHC
- On the final version of the Articles of Association

### **(3) Loan (Mortgage) Agreement**

#### *(a) Consideration of:*

- The options available and the preferred option for the mortgage agreement(s), based on advice/appraisal from the Director of Finance & ICT
- When/how cash should be (flexibly) drawn down
- Whether the mortgage should be on a repayment or interest-only basis
- The key terms of the mortgage, including :
  - Whether to have a term loan – mortgage secured on properties
  - How interest should be charged, including consideration of:
    - Whether the rate should be fixed or variable
    - How the interest rate should be set
    - State Aid Rules
  - What restrictions (if any) should be made on the use of properties
  - Insurance requirements

#### *(b) Recommendations to be made to the Cabinet:*

- That the Council provides mortgage(s) to the LHC
- On the key terms of the Mortgage(s)
- On what should be the total/maximum amount of mortgages and how these should be funded by EFDC ?

### **(4) Services Agreement(s) with the Council**

#### *(a) Consideration of what services should be provided to the LHC by EFDC, including:*

- Housing management / repairs / asset management – Housing Directorate ?
- Company secretariat – Democratic services ?
- Accountancy/financial management – Finance & ICT ?
- IT – Finance & ICT ?
- Audit – Internal Audit (if not external) ?
- Meeting rooms – Corporate Support Services ?
- Legal advice – Corporate Support Services, Trowers & Hamlin or another firm?
- Conveyancing – Corporate Support Services or a local solicitors ?
- Insurance – Finance & ICT ?
- Fee structure for services

#### *(b) Recommendations to be made to the Cabinet:*

- That the Council enters into a Services Agreement with the LHC
- On the key terms of the Services Agreement with the LHC

### **(5) Services from other organisations:**

#### *Consideration of:*

- Whether or not services for the LHC should be sought from external agencies for the following, if not EFDC:
  - Accounts
  - Estate agents
  - Audit
  - Insurance

## **(6) Nominations Agreement**

### *(a) Consideration of:*

- The level of nominations to EFDC
- The existing District-wide agreement with Preferred RSL Partners to be used as a basis
- Whether properties should be advertised through choice based lettings ?

### *(b) Recommendations to be made to the Cabinet:*

- That the Council enters into a Nominations Agreement with the LHC
- On the key terms of the Nominations Agreement

## **(7) Purchase/Renting of Properties**

### *Consideration of:*

- Any preference of property age— New/relatively new or existing
- The type of property surveys required
- Any preference of property type - Houses or flats (note need for service charges for flats)
- Any preferred location of purchased properties
- Any maximum purchase price
- Who should negotiate and agree the purchase price
- Whether properties should be furnished or unfurnished
- Rent levels, including:
  - Whether rent should be charged monthly in arrears to assist tenants in receipt of Local Housing Allowance
  - Whether rents should be set no higher than Local Housing Allowance
  - Whether damage deposits should be charged – If so, which national insurance scheme should be used
- Whether references should be obtained for potential tenants
- The process for eventual sale of properties, including:
  - Whether that should be a policy
  - Whether there is any role for /agreement from EFDC
  - What should happen to the capital receipt

## **(8) Financial & Tax implications**

### *Consideration of:*

- The tax implications for both EFDC and the LHC, including corporation tax:
- Whether there should be any dividends paid
- Issues relating to capital gains tax
- How the the LHC's accounts should be approved – especially bearing in mind that they must form a part of EFDC's accounts

## **(9) Key risks (and mitigations)**

### *Consideration of the key risks, including the following:*

- Liabilities of directors
- What if there is a lack of interest amongst members to be a director
- Implications of directors being negligent or irresponsible
- What if the mortgage interest becomes less than EFDC's usual investment interest
- What if property values decrease



- What if the LHC's expenditure is greater than income, including cash flow and insolvency issues
- What if the LHC's rental income is less than the mortgage repayments
- EFDC's liability for losses
- Estimation of loss of rental income – for voids and bad debts
- What is the effect of tenants in receipt of the Local Housing Allowance – can this be mitigated ?