Appendix 6

CIPFA Technical Information Service for Local Housing Companies Extract[1]

It is important to be clear from the outset what are the objectives of setting up the company. The objectives will influence the structure of the company and enable the council to evaluate whether setting up a company is the best solution or whether other approaches might achieve the same aims.

Options for Company Structure

Options for the company structure include the following:

- The most usual and straight forward option is to create a company wholly owned by the council. The company may be limited by shares (cls) or by guarantee (clg). The cls structure is generally seen as most flexible for companies wishing to expand but the clg structure is most often adopted by charitable companies.
- A joint venture company with a private sector developer or with a housing association. Most commonly each party holds a 50% stake. Where the council contribution is largely in the form of land these are referred to as local asset backed vehicles (LABV).
- Joint ventures between local authorities are possible.
- A joint venture may be set up as a limited liability partnership (LLP). However, see legal issues below.
- The company may be set up as subsidiary of the arms-length management organisation (ALMO) if it exists.
- The company may set up further subsidiary companies, wholly owned or joint ventures. This is currently unusual and might be expected at a later stage if the original company has grown
- The company may seek registration as a housing association (private registered provider).
- The company, or a subsidiary, may be set up as a charity.

Reasons for Setting Up a Company

Many councils' spending on development or redevelopment for the Housing Revenue Account (HRA) is limited by the cap on HRA borrowing. Spending by the company will be outside the cap.

A company can act more quickly and in a business like way than is usually possible for a local authority.

The company may enable development or redevelopment to proceed where it seems otherwise development will be slow or not take place at all. This can be the case for particular sites, or it may be that the council thinks that housing development in the area generally needs to be accelerated

The company will be free to set rents and tenancy terms without any of the controls or restrictions which apply to HRA tenancies. For instance, the company may set rents higher than HRA rents but below market, or adopt a mix of rent levels. The company can buy and sell property and is not subject to the conditions applying to public sector land transactions. The company will still be subject to landlord and tenant law and to market pressures on rents and the need to meet its financial objectives.

Properties are not subject to the right to buy, but note comments in "Right to Buy" section below. Councils are warned that avoidance of the right to buy should not be made the major objective of setting up a company.

[1] Document sourced from TISOnline Information stream – Local Housing Companies (update 2018)

The company may assist the council in providing temporary accommodation for homeless families.

The company may provide a revenue income to the council. This is likely to arise from the terms of lending to the company. Additional income may result if the company is profitable and returns some or all of its profits to the council.

To the extent that development is accelerated, or would not otherwise take place, then the council will benefit from additional council tax, new homes bonus and planning gain.

In the long term, the company may provide the council with a valuable property asset which may in turn provide a capital receipt or a revenue income.

The company may require services and support from the council, for which it will pay a price.

The various possible advantages must be weighed against one another. For example, the objective of securing revenue income is likely to work against the provision of lower rented property.

Key Risks and Issues

Set up costs can be significant. In theory a company can be created very quickly and cheaply. In practice most authorities appear to have found that setting up a housing company requires significant time and cost, and commitment to this objective.

The company will be subject to all the business risks of operating in the market. For instance rents and property values may fall, although few people think this is likely. Development costs may rise, and most people think this is very likely. Interest costs are likely to vary.

The company will pay VAT on most of its expenditure, including services contracted from the council, and it is likely most of this input tax will be irrecoverable. The result will be that running costs will be significantly higher than for a similar council owned activity.

The company will be liable to corporation tax if it is profitable which will reduce potential returns to the council.

There will be some additional costs incurred in running the company, for instance insurance and external audit.

The company may take land for mixed tenure development which in future might have been used for wholly affordable housing, for instance if the HRA borrowing cap were lifted.

The council is not able to use retained right to buy receipts to fund development by a wholly owned company. This is a requirement of the legal agreement with the MHCLG governing use of these RTB (right to buy) receipts.

Future changes in regulation or legislation may affect the position of these companies, see for instance sections below on “Right to Buy” and “Taxation” (on corporation tax changes).

Legal powers

Local authorities in England and Wales can set up trading companies in areas relating to their existing functions under the Local Government Act 2003.

The Localism Act 2011, Section 1, gives local authorities power to do anything an individual can do – the ‘general power of competence’. This is subject to any restrictions or limitations in preceding legislation, and any which might be introduced by future legislation. Therefore for a trading company, the authority is advised to comply with the requirements of Section 95 of the Local Government Act 2003. It is also necessary to consider the Local Government Act 1988, Sections 24–25, which places limits on the provision of financial assistance to any person for the provision of privately let housing, subject to secretary of state consent of which a general consent

has been given with conditions. The council should not use the Localism Act 2011 power solely or mainly to avoid RTB (right to buy) entitlements or the HRA debt cap.

Section 4 of the Localism Act 2011 requires that if the authority uses Section 1 for a commercial purpose this must be done through a company or a 'registered society' (previously known as an Industrial and Provident Society)

It appears therefore that a council may not directly become a partner in a LLP for a commercial purpose. It may consider the LLP route if the objects are non-commercial or indirectly by forming a company which then becomes a partner, for instance in a joint venture.

The decision of the High Court in Peters v Haringey LBC (2018) is helpful in this regard. Haringey proposed a joint venture company to redevelop council estates. The council hoped for a commercial return but its predominant purpose was to promote its housing and employment objectives. The court agreed that in this case the purpose was non-commercial and that the council could enter into a LLP company for this purpose. Haringey subsequently decided not to proceed with this project but it is possible the decision may be appealed.

Governance and Appointment of Directors

The council will appoint the directors of the company, or expect to appoint a due proportion if the company is a joint venture. The directors may be elected members of the council, or council employees, or outside independent directors, or a mix of these types of people.

The directors must be aware of their duties when acting as directors, see Companies Act 2006, Part 10, chapter 2. Directors must act in the best interest of the company. They must avoid conflicts of interest, and declare any interest in a proposed transaction. Directors are unable to vote in certain conflict situations in which case decisions can be made by the other directors (Companies Act 2006, Section 180(4)). The council should consider the potential for conflicts of interest when appointing directors, and are generally advised to minimise these potential conflicts.

The council must make arrangements for monitoring and control of the company. For instance if there are no elected members on the board of directors then it is common to create a shareholder committee and/or scrutiny arrangements.

The arrangements for LLPs are somewhat different but the same principles should apply.

Financing

The company may be financed entirely by borrowing from the council. Alternatively, some companies have sought direct commercial funding and/or an equity stake from the council. The funding route will have implications for the company's costs directly and also influence the interest rate charged by the council under state aid rules.

Councils must take into account the Prudential Code for Capital Finance in Local Authorities and Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes published by CIPFA in December 2021 and the revised **Statutory Guidance on Local Government Investments** issued by DLUCH (or formerly MHCLG).

A council may invest in a company by providing land or finance. Powers to invest are contained in the Local Government Act 2003, Section 12. Councils must take account of government guidance under Section 15. Guidance published on 2 February 2018 (**Statutory Guidance on Local Government Investments, 3rd edition**) and effective from 1 April 2018, which applies to both financial assets and non-financial assets held primarily or partially to generate a profit and specifically includes loans to wholly owned companies, associates, joint ventures and third parties. The latest updates from Government since 2018 have sought to further tighten controls on commercial activities of local authorities and specifically borrowing from the PWLB.

Borrowing powers are in Section 1 of the Local Government Act 2003. Councils can borrow to meet expenditure which is treated as capital expenditure under proper practices or as a result of a capitalisation direction (Section 16), for example under paragraph 25 of the Local Authorities

(Capital Finance and Accounting) (England) Regulations 2003, as amended. Councils must take into account the Prudential Code for Capital Finance in Local Authorities, latest edition published by CIPFA in December 2021. The code advises against borrowing "in advance of need" to invest in revenue generating assets. The government's recent guidance on investments (above) also draws attention to this point.

However, authorities may make the case that investment in housing companies may not be primarily aimed to generate profits. See above the similar argument concerning use of LLPs.

Investment by provision of land brings into consideration the requirements about transfer of land, see "Land Acquisition" below and "State Aid", also below.

State Aid (new UK terminology required?)

The council and the company will almost certainly wish to avoid the risk that any transaction with the company can be interpreted as state aid. In particular, the council will need to consider the terms of lending to the company, any guarantees provided to the company or its creditors, and any services provided or transfers of assets, such as land, to the company. The definition of state aid is a broad one and the consequences of a breach of the rules can be severe.

If part of the company's activities is to provide 'social housing', then this part may fall within the definition of activities exempt from state aid rules, known as services of general economic interest (SGEI). This is a complex area, for instance, if applied to social housing which may be required under planning policies. Conditions must be met to qualify for this exemption, including clear separation of the accounts of the exempt activities.

The **State Aid Manual** published by the Department for Business Innovation and Skills (BIS) provides more information. It advises consultation with the BIS State Aid team if planning to use the SGEI exemption.

For many companies, the key issue will be the rate of interest it must pay on loans from the council. Commercial lenders typically make available loans either at a variable rate at a margin over a base rate (typically London Inter-bank Offered Rate (LIBOR)) or fixed rate loans at a margin over gilt (government bond) rate for the same maturity. In either case, the margin will take account of the risk of the investment including factors such as the track record of the company, the degree of security, and the stage of development. It is common for there to be additional one-off fees at the initial stages and sometimes also termination fees. Property development loans are normally medium-term and it is likely to be in the company's interest to refinance when construction is complete, at which stage an element of risk is removed and a more favourable rate is to be expected.

Lending to a company will not constitute state aid if it complies with the market economy operator (MEO) test – in essence, the terms must be acceptable to a commercial provider. The most robust way to demonstrate this is to actually bring in a commercial lender on a 50:50 basis, but this has rarely proved possible. In the absence of an actual investor before entering into the arrangement, the council must obtain and retain evidence that the terms would be commercially acceptable. For instance, the council may commission advice from a commercial advisor. The European Commission has published guidance on interest rates, but this is not mandatory if the council has alternative evidence to support the terms which it has chosen.

Land Acquisition

The company can purchase land for development on the open market; or acquire property on the open market, for instance for use as temporary accommodation.

In many cases companies initially develop land which was council owned. Land transfer may be leasehold or freehold. The latter is likely to be essential if private sale of houses is planned. The company will be likely to require an interest of substantial value or there will be an adverse effect on the security it can offer and the rate of interest it is likely to pay on borrowing.

If the council transfers land with requirements to provide a certain type of development then this may be viewed as a public works contract. However, this may be excluded from the requirement

to follow the Public Contract Regulations by the Teckal exemption which applies if the council exercises control over the company and more than 80% of the company's activities are carried out to further the council's objectives.

The council can dispose of general fund land under Section 123 of the Local Government Act 1972. This should be at 'best consideration' unless secretary of state consent is obtained for disposal at a lesser price. A general consent allows for disposal at an undervalue up to £2m if disposal is for the promotion or improvement of economic, social or environmental wellbeing in respect of the whole or part of the council's area or of any people in the area. HRA land disposal can be made under Section 33 of the Housing Act 1985, and again there are general consents including consent A3.2 of 2013 permitting disposal of vacant HRA land without any conditions as to price or other factors.

Disposal of land to a company building housing for rent must also comply with Sections 24 and 25 of the Local Government Act 1988. This applies to general fund or HRA land. Disposal at less than market value requires consent. A general consent was issued in 2013 but various conditions apply.

Transfers at less than market value must also consider state aid issues (see above).

Taxation

The council must seek specialist advice taking account of its own particular proposals. The areas to consider include the following:

- **VAT -** the company must register for VAT in its own right. It can recover VAT to the extent that it makes taxable supplies. A company mainly engaged in renting property is likely to be unable to recover much of its input tax. If the company builds property for sale, this activity is zero rated and input tax on related costs can be recovered. If land is transferred to the company, the council should consider the option to tax in the light of the council's partial exemption position but opting to tax will result in a tax charge of 20% on the value of the land transferred. Transactions between council and the company must be correctly treated for VAT, e.g., if the council provides services to the company the charge will be VATable. If the council provides land and the company builds property which is returned to the council, this will be a barter arrangement for VAT purposes.

- **Corporation tax** – a company will be liable to corporation tax on its revenue profits. Principal repayments of loans do not count as expenses in this calculation. Capital appreciation of asset values will also be liable to tax at the point of sale or transfer (e.g., to the council). In some circumstances there may be advantages in the council retaining ownership of assets which are leased to the company. The tax position of LLPs is quite different and may be advantageous as they do not pay tax in their own right but the liability falls on the partners. Distribution of dividends to the council as shareholder will not incur any further tax liability. Some companies may be affected by corporate interest restriction under the Taxation (International and Other Provisions) Act 2010 and the Finance (No. 2) Act 2017. The rules apply from 1 April 2017. Groups with net interest expenses and other financing costs of less than £2m per annum will not be subject to any deduction. Other groups will be subject to restriction of the net interest included in their tax calculation to 30% of taxable earnings before tax-interest, depreciation and amortisation. There are a number of exemptions and limitations, including for public infrastructure companies. However, it does not appear that affordable housing will qualify as public infrastructure. HMRC published detailed guidance on the working of this measure in March 2017 (**CIR Guidance**), updated February 2018. However, at 577 pages, this is not an easy read.

- **Stamp Duty Land Tax** (SDLT) land transfers between a council and a wholly owned subsidiary are expected to be exempt from SDLT. However, the council will

obviously want to take advice to be sure on this point and in more complex situations.

- **Construction Industry Scheme (CIS)** – if the company directly develops then it will be required to register and operate the CIS for payments to sub-contractors. The company will also need to consider impact of Domestic Reverse Charge (DRC) for CIS in accounting for VAT if the conditions for this are met.

Right to Buy

Company tenants will have the same rights and responsibilities as private sector tenants, which will depend on the terms of the tenancy agreement. Company tenants will not have the rights of council tenants, in particular they will not have a right to buy. Extension of the right to buy to tenants of local authority housing companies would be a major risk for many companies to the point where many might prove unviable. Extension of the right to buy to local authority controlled companies would require new legislation. The government has made various statements on this subject over the years. This topic has been raised again in the last few months.

Accounting

Authorities will need to consider carefully how the relationship with the company is reflected in the council's accounts and in the group accounts (if the size of the company makes it material such that group accounts are required).

For more information on the above issues, see the "Financing" section on borrowing and investment in the company.

A loan from the council to the company which is used for capital expenditure will count as capital expenditure by the council and may require a minimum revenue, with provision to be charged to the general fund. Acquisition of share capital by the council will count as capital expenditure and may require a Minimum Revenue Provision (MRP). Authorities must take into consideration the revised **Statutory Guidance on MRP** issued by the MHCLG on 2 February 2018. However, authorities can depart from the statutory guidelines if they can justify an alternative approach is also prudent in the light of the nature of the asset.

The introduction of IFRS 9 from 1 April 2018 will require local authorities to review their financial assets including investments in companies against new tests. There may be a need to reassess the risk of default and calculate loss allowances on the new model.