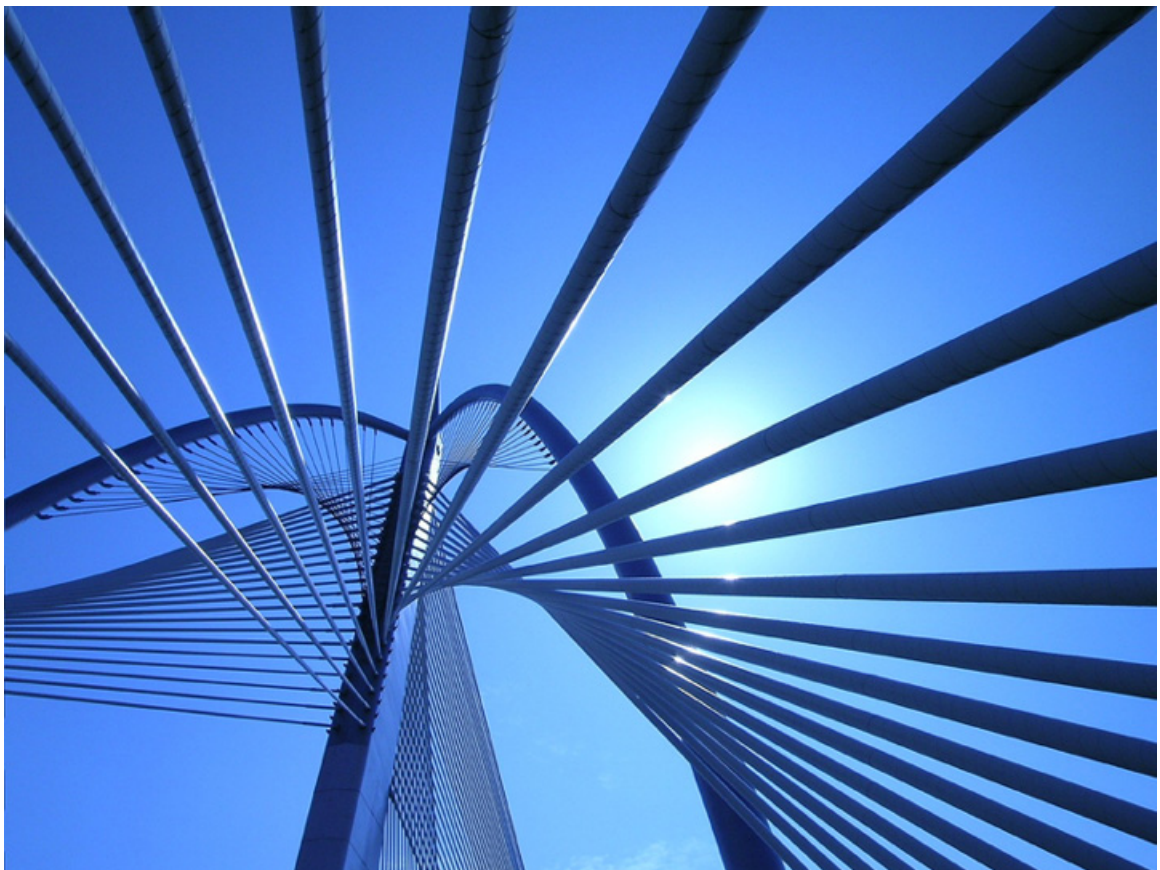


Derby Homes



Review of Future Activities

March 2006

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1 Executive Summary

- It will be important to review forecast levels of trading and expected surpluses to identify whether an extended structure is appropriate.
- In the event that the level of trading is expected to be substantial, in order to mitigate any risk of liability to corporation tax, our recommendation would be for trading activities to be separated from council activities into a separate trading entity. In particular if the anticipated taxable profit is over £110k the use of a subsidiary company and a charity should be considered.
- HMRC (H M Revenue and Customs) have not yet published guidelines concerning the taxation of ALMOs (Arms length Housing Management Organisations). However, we understand that they will treat activities carried on by an ALMO on behalf of its parent Council as outside the scope of corporation tax. It is not clear what this means for additional activities.
- Given the current uncertainty regarding the taxation of ALMOs and the wider activities of Derby Homes Limited, we suggest that the company should consider entering into discussions with HMRC regarding its tax status.
- The Inland Revenue part of HMRC has historically been more flexible in applying legislation than the Customs part. For example, the Revenue allows de minimise levels of trading to be carried on tax free in charities and NHS Foundation Trusts. Given this attitude we would recommend discussing the future proposals with the Revenue.
- Derby Homes currently recovers all of its VAT. If it starts to rent out its own housing this full recovery of VAT will be restricted.
- The potential transaction with Lovells is likely to bring Derby Homes into the charge to corporation tax on at least the profits from this activity if not all of its surpluses. It will also restrict the VAT recovery on c 1% of the company's overhead costs.

2 Scope of Report

Derby Homes Limited is an Arms Length Management Organisation ("ALMO") incorporated during 2002 by Derby City Council as part of the Government's 'Decent Homes for All' Initiative. This initiative was established to enable council's throughout the country to secure additional resources with which to deliver improved social housing.

The role of each ALMO, including Derby Homes Limited, is to manage, repair, improve and maintain the Council's housing stock, whilst ownership of the stock remains with the Council. Funding for these services comes from the Council's Housing Revenue Account and from the Council's borrowing.

Derby Homes Limited has virtually achieved the specified target in respect of improvements to council housing under the ownership of Derby City Council. It is currently considering potential opportunities which would enable it to sustain its activities into the future.

The scope of our report is to consider these potential opportunities in relation to corporation tax and VAT implications which may arise as a result of their implementation. This report could then be used as a basis for discussions with HMRC.

As part of this report, we have given some consideration to the use of Special Purpose Vehicles in undertaking additional activities.

Following discussions with management, we do not feel that it is appropriate for a company that is controlled by a Council to be engaged in aggressive, high risk tax planning and so have not addressed any such opportunities in our report.

3 Corporation Tax status of ALMOs

An ALMO is a separate legal entity from its Local Authority. In consequence, it does not automatically benefit from the tax exemptions granted to local authorities.

To date, H M Revenue and Customs (HMRC) have not published their detailed opinion concerning the corporation tax status of ALMO organisations. This opinion was expected to be published in Autumn 2005, and at this stage we do not have a revised date for publication.

Without further guidance, at this stage the general opinion concerning HMRC's view is that, provided the ALMOs Memorandum and Articles of Association are set up such that:-

- Any monies held by the ALMO are applied solely towards the promotion of its objects as specified in the Memorandum of Association (ie it is not allowed to distribute any profit to its members);
- And the ALMO operates in such a way that either any surplus funds must be paid or transferred back to the Council's housing revenue account or funds are only drawn down to the extent that work is performed.

Then the transactions between the ALMO and its Council member will not amount to trading, and as such will be outside the scope of the charge to corporation tax.

Trading activities with third parties

It is however expected that HMRC will view services provided by the ALMO to third party organisations for reward as being trading transactions. In these circumstances, any profits arising from such transactions would be liable for corporation tax.

There is a risk that this could taint the whole of the activities of the ALMO so that all of its surpluses would become liable to corporation tax.

4 Current Income Streams of Derby Homes Limited

At present, the company receives the following income streams for work specifically undertaken on behalf of Derby City Council:-

- Housing revenue account management fee.
- Commission for capital works managed
- Grants from supporting people funds
- Other grant income from various sources, such as New Deal in the Community, and Neighbourhood Renewal Funds.

In addition, it generates income from the following activities currently undertaken on behalf of other organisations:-

- Management of properties on behalf of Housing Associations.
- Consultancy to other ALMOs,
- Repair services offered to 450 leaseholders of council homes.

Appendix 1 shows the relative levels of these income streams.

5 Corporation Tax and VAT implications in respect of Current Activities

VAT Position

Currently, Derby Homes' VAT profile is straightforward in that it accounts for VAT on its income and therefore recovers VAT in full on its costs.

Corporation Tax Position

For corporation tax purposes, and looking at each of the income streams in turn:-

5.1 Income from activities specifically undertaken on behalf of Derby City Council

As advised above, HMRC have not yet published their detailed opinion concerning the corporation tax status of ALMO organisations.

On the basis that all income in respect of activities undertaken on behalf of Derby City Council are applied solely to its objectives and not distributed to a shareholder, we understand that HMRC will treat any surplus arising on such transactions as outside the scope of corporation tax.

We understand that, since Derby Homes Limited is only paid for services as they are provided to Derby City Council, in general no surplus funds are built up or held by the company. The payment from the Council does not include a profit element.

5.2 Income from activities currently undertaken on behalf of third party organisations

At present, income generated from activities outside the remit of Derby City Council represents a small proportion of the overall income of the ALMO.

Current estimates suggest that approximately 1% of total income is generated from external services. (*Appendix 1 provides a detailed summary of calculation*)

As advised above, it is expected that HMRC opinion of services provided by an ALMO to third party organisations for reward should be treated as trading transactions subject to corporation tax. However, we would expect there to be a de minimus limit (similar to the £50,000 turnover exemption for charities) such that where such activities are not substantial they would continue to be treated as exempt income and so remain outside the scope of corporation tax.

At this stage, no formal definition exists concerning the measurement of substantial activities for these purposes. Given that income from activities outside Derby City Council remit represents approximately 1% of total gross income at present, we would not expect this to be treated as substantial, such that any profits on such income are expected to remain outside the scope of corporation tax.

It is also possible that only the taxable activities would be taxed, although case law is moving against this interpretation. HMRC are currently seeking views on potential legislative changes on this point. However there is no guarantee that this will come to pass.

6 Proposed future income streams of Derby Homes Limited

Derby Homes Limited was one of the first ALMO organisations to be established as part of the Decent Homes for All Initiative. Given that it has virtually completed the objective of improvements to the Council housing stock of Derby City Council, it is considering opportunities available to ensure that business is sustainable into the future.

The following potential opportunities have been identified for future growth of the business:-

6.1 Related to existing activities provided on behalf of the Council

We understand that a new contract between Derby Homes Limited and Derby City Council is to be negotiated and put in place from April 2007. As part of the negotiations, discussions may be held with the Council regarding the provision of the following services:

Regeneration of existing Council housing estates, involving the development of housing and new build solutions

- Including the maintenance spend from the HRA into the Derby Homes management fee from the City Council.
- Management of other Council services if the Council wish this, such as the Care link service, Derby Homefinder, housing advice, homeless services, elderly persons homes

In addition, Derby Homes wishes to seek approval from the Council for management services from Derby Homes Limited to be extended to councils operating within other boroughs – the current thoughts are to extend services to Derbyshire, Leicestershire, Nottinghamshire and Staffordshire (ie neighbouring authorities). Given that these are also Councils, It is not clear whether this would be treated as Council or third-party type income for corporation tax purposes.

6.2 Related to existing activities provided to third party organisations

The following projects are in varying stages of negotiation with the parties involved:

- Project with Lovell's (housing development company) for development and retention of ALMO houses At the Derbyshire blocks site in Spondon

We understand that the current proposal involves land being sold to Derby Homes Limited for £1 from Derby City Council.

The land would be developed by Lovell's with funding provided partly by means of housing grant, partly from profits generated on sale of non ALMO housing by Lovell's and by the Council borrowing c £9,000 per unit which would be repaid by Derby Homes. The development will provide mixed tenure housing (some for sale, some shared ownership and some rental properties).

A funding bid has been submitted for review and approval and a decision is currently being awaited from the Housing Corporation.

Approximately 30 properties would be retained by Derby Homes Limited for future rental. We understand that Derby Homes Limited would retain responsibility for setting the level of rent, although tenants would be chosen from the existing waiting list of Derby City Council.

A second similar proposal has also been submitted for approval at the Isle of Wight blocks in Alvaston.

- Property management services provided to owner occupiers, private landlords and leaseholders.

The intention of this project is to provide management and repair services to owner occupiers, private landlords and leaseholders in addition to the services currently being offered to existing tenants. The project will be operated on a commercial basis, with an expected mark up of 20% on costs.

- Acquisition of private housing.

We understand that there is a proposal to acquire affordable housing to rent to those in need.. In particular, a proposal is under discussion concerning the acquisition of various empty properties (7 properties currently owned by Northern Counties Housing Association have been identified) from one or more Housing Associations.

- Continued management of properties on behalf of other housing associations.

Derby Homes continues to discuss with housing associations the possibility of their managing their stock or providing specific services as such security patrols.

As a result of the above proposed activities, the expectation is for services provided by Derby Homes Limited for non council purposes to expand significantly.

7 Corporation Tax and VAT implications in respect of additional activities provided to Derby City Council

Undertaking some/all of the above services would represent additional income in accordance with its objectives specified in its Memorandum of Association.

VAT Implications

This would mean that as the monthly management fee increases, VAT should be applied on the full, increased amount by Derby Homes.

Any charges made by the City Council in relation to this activity, e.g. for staff, resources etc will also be liable to VAT and the Council should account for VAT accordingly.

Corporation Tax Implications

For corporation tax purposes, an increase in management fee should remain in line with the expected guidelines from HMRC. In consequence, we would expect the expansion of activities provided to the Council by Derby Homes Limited would continue to remain outside the scope of corporation tax.

8 Tax implications in respect of activities provided to third party organisations

Corporation Tax Implications

As advised above, it is expected that services provided by Derby Homes Limited to third party organisations for reward would be treated as trading transactions by HMRC, with the consequence that any profits arising from such transactions being liable to corporation tax.

As a result of this proposed expansion of external services by Derby Homes Limited, it creates a risk that the exemption available in respect of minimal levels of trading transactions may be breached.

In this event, and assuming that all transactions continue to be accounted for within Derby Homes Limited, not only would any profits from the trading transactions be subject to corporation tax, but it should also bring into the charge to tax all other services provided, regardless of whether they are normally exempt from tax.

VAT Implications

From a VAT perspective, certain of the proposed activities will be exempt. Unless HMRC see each activity as being separable for tax purposes as noted above.

In respect of each of the proposals, consideration is given to the corporation tax and VAT issues related to each:

8.1 Project with Lovell's (housing development company) for development and retention of ALMO houses

Corporation Tax

The above project is similar to Council housing arrangements. However, it represents a separable activity for the following reasons:-

- The property is under the ownership of Derby Homes Limited rather than Derby City Council.
- Level of rents are expected to be at a higher level (£80 - £85) than charged for council homes (£45 - £80)

For tax purposes we consider that the resultant income and profits would be treated as "trading" such that they should fall within the remit of corporation tax.

VAT

For the purposes of VAT, rental of domestic property by Derby Homes Limited will be an exempt activity for VAT purposes. That means that VAT will not be charged on the rental income. However, this exempt activity will lead to a restriction in the levels of VAT recoverable by Derby Homes Limited. In essence, the restriction will arise in two areas:

1. VAT on costs which are directly attributable to the rented property will be irrecoverable. The impact of this will be dependant upon the level of VAT incurred in relation to the property, but this will include any repairs and maintenance undertaken on the property, any legal fees or surveyors fees

incurred in connection with the rental of the property and general costs of upkeep of the rented property; and

2. A proportion of Derby Homes Limited overhead VAT may need to be restricted as a result of this exempt activity. The level of restriction will be determined by the method of VAT recovery (referred to as a “partial exemption” method) that Derby Homes Limited implements. As the estimated level of income from exempt activity is in the region of £175,000 per annum, using the standard method of partial exemption and assuming that taxable income is in the region of £14M, this would result in a restriction of VAT on overhead costs of 1.25% (or 1% if the standard partial exemption method is used). Overhead costs will include the running costs of the Derby Homes Limited office.

We also understand that Derby Homes Limited may enter into shared ownership arrangements, where the occupier purchases a dwelling at a proportion of its value and then pays rent to cover the share in the retained equity. Occupiers then have the option of purchasing a further share related to the current value of the property. The initial payment by the occupier for his share of the equity can be zero-rated (the first grant of a major interest in a dwelling by the person construction is zero-rated) but subsequent rental payments and an additional equity payments are exempt from VAT. The key difference is that VAT incurred by Derby Homes on costs attributable to the initial sale should be recoverable in full, however any VAT on costs attributable to the ongoing rental will not be recoverable as it will relate to the ongoing exempt income.

8.2 Repair services provided to owner occupiers and leaseholders

Corporation Tax

Since the project will be operated on a commercial basis, the expectation is that the resultant income and profits would be treated as trading and hence subject to corporation tax.

VAT

Where Derby Homes offers a repairs service, the VAT should be applied to income at the standard rate. This therefore means that all VAT on costs associated with the repairs will be recoverable in full.

8.3 Management of acquired housing

Corporation Tax

As above for the Lovell's proposal, the properties would be directly owned by Derby Homes Limited rather than Derby City Council, and levels of rent charged would be above that charged to a council tenant.

We would expect the income stream to be “trading” and as such any profit would be chargeable to corporation tax.

VAT

From a VAT perspective, the issues as highlighted above on the Lovell's project would be relevant.

8.4 Management of housing stock on behalf of existing housing associations

Corporation Tax

Strictly, this income is likely to be taxable. However at current levels of activity we expect this income to fall outside the scope of corporation tax for the reasons specified above.

However, with the increase in activities that could arise, it is likely that the combination of all activities will become significant.

VAT

The VAT issues arising from Derby Homes Limited extending their current management activities to other landlords should mirror the current VAT treatment applied to the City Council and housing associations. That is, Derby Homes should charge and account for VAT on the income received and VAT incurred on costs incurred in relation to this supply should be recoverable in full. It should be noted that whilst the City Council can recover any VAT incurred in relation to its housing stock, housing associations or private landlords generally cannot recover VAT on costs.

8.5 Management and maintenance of private sector housing

The comments under 8.2 apply equally here.

9 Opportunities available in mitigation of liability of Corporation Tax

As highlighted above, in circumstances where Derby Homes Limited undertakes trading at a more substantial level, a risk exists that corporation tax is applied to all activities, regardless of whether they would ordinarily be exempt from corporation tax.

The level of corporation tax payable may be mitigated by implementation one of the following options:

9.1 Establishment of a subsidiary company for the purpose of undertaking trading transactions currently carried on by Derby Homes Limited

If established as a subsidiary of Derby Homes Limited, Derby City Council would retain ultimate ownership of the business. This is shown diagrammatically in Appendix 3.

Activities undertaken on behalf of Derby City Council (and other Local Authority bodies) would continue to be accounted for within Derby Homes Limited.

This separation of activities would ensure that no tainting of exempt income would occur.

Profits of the trade would be subject to corporation tax on the trading subsidiary – the rate applicable would be dependent upon a number of factors, including the actual level of profits. The maximum rate of tax payable would be 30%.

In the event that the company makes a gift aid payment to a charitable organisation, it would be entitled to a tax deduction equal to the amount of gift aid paid during the relevant year. This charity could be established by Derby Homes with tightly defined objectives but it must be an independent body as noted in 9.3.

In consequence, it may be possible to reduce to nil any liability to corporation tax, provided sufficient funds are available to the company.

9.2 Establishment of a charitable body which in turn establishes a subsidiary company for the purpose of undertaking trading transactions currently carried out by Derby Homes Limited

This is shown diagrammatically in Appendix 4.

As above, activities undertaken on behalf of Derby City Council (and other Local Authority bodies) would continue to be accounted for within Derby Homes Limited such that this consequential separation of activities would ensure that no tainting of exempt income would occur.

Profits of the trade accounted for within the subsidiary would ordinarily be subject to corporation tax.

However, on making a gift aid payment to its charitable parent, the company would be entitled to a tax deduction equal to the amount paid up to 9 months after the end of the accounting period.

Given the independence requirement for the charity (referred to below) it may be more beneficial not to have a charity as the parent. There may also be a cost involved in transferring activities out of Derby Homes to a subsidiary of a charity.

Accordingly we do not recommend this option.

9.3 Matters to consider in establishing a charitable organisation

The guidelines published by the Charity Commission provides a detailed view concerning whether Charity Law enables a government authority to establish a charitable organisation. The guidelines make it clear that this can be done, provided that certain key matters are addressed.

The most important element in establishing a charitable body is that the purpose of the new body should be exclusively for charitable purposes and, in addition, the charity must be independent.

Therefore, in circumstances relevant to Derby Homes Limited, the charity must exist to carry out charitable purposes rather than specifically for the purpose of implementing policies or directions of Derby City Council or Derby Homes Limited.

In determining whether a charity is independent of the government body involved in its establishment, it should have the following characteristics in terms of its day to day operations:

- The trustees would have a choice about whether or not they accepted funding on the terms proposed by the governmental authority;
- They would take their own legal and financial advice;
- They would draw up their own policies and business plan;
- They would conduct arm's-length negotiations with the governmental authority;
- A trustee who was subject to a conflict of interest would not participate in discussions;
- The funding arrangements would preserve the trustees' fundamental discretions as to the selection of beneficiaries and the provision of services;
- The trustees would not commit themselves simply to giving effect to the policies and wishes of the governmental authority;
- The trustees would not agree to conditions that undermined the confidentiality of their discussions (such as the presence at their meetings of any observer from the governmental authority); and
- The trustees would be free to make their own decisions on matters outside the scope of the funding arrangement.

Although it is not essential for all characteristics to be met, the fewer the number of characteristics shown by the trustees of the charity, the less likelihood of independence from the government body.

In consequence, it would not be possible for Derby City Council to retain ultimate control of the charity, although it could retain some presence on the Board of

Trustees. As you will appreciate, this represents a complex area requiring careful consideration at the implementation stage.

Two recent cases heard by the Charity Commissioners in respect of charities established by Trafford and Wigan Councils respectively established that they were sufficiently independent from the local authority in providing services for the benefit of the community.

9.4 Establishment of a special purpose vehicle to undertake some/all of trading transactions

We have explored above the possibility of setting up a subsidiary in order to undertake certain trading transactions. If another party were involved then another vehicle that could be used is a partnership and in particular a limited liability partnership (LLP).

Partnerships are transparent for corporation tax purposes and so any profits or losses are assessed directly on the partners in accordance with the partnership agreement.

An LLP can register for VAT in its own right and the extent to which VAT is due depends on the specific transaction as noted in the examples above.

It does not seem that any of the current proposals involve a partnership or joint venture type arrangement and so this has not been considered further.

9.5 Cost benefit analysis of opportunities to Derby Homes Limited

In determining whether the options highlighted above would provide any benefit to the continued operations of Derby Homes Limited, it is important to undertake a Cost Benefit analysis. This will enable the company to decide whether the extra costs of running a different structure outweigh the tax costs that would otherwise be incurred.

Appendix 2 estimates the costs involved under each of the scenarios. This assumes annual costs of c£33k.

At this stage, we have not been provided with detailed forecast information concerning the level of income/profits for each of the proposed activities.

In order to have a tax liability of £33k the profit (at 30%) would need to be £110k. At 19% this becomes £174k.

10 Appendix: 1

Summary of current income streams from services provided by Derby Homes Limited

Source of income	£'000	Council/Non Council(C/NC)
Council Revenue Account management fee	11,000	C
Commission for capital fee income	1,000	C
Supporting people	1,500	C
Management of properties on behalf of Housing Associations	114	NC
Consultancy to other ALMO's	40	NC
Grant income	<u>100</u>	C
	<u>13,754</u>	

Percentage of income arising from non council activities is c 1% (being 154/13,754)

11 Appendix: 2

Expected costs in respect of an extension to the group structure

Expected costs are based on the following assumptions:

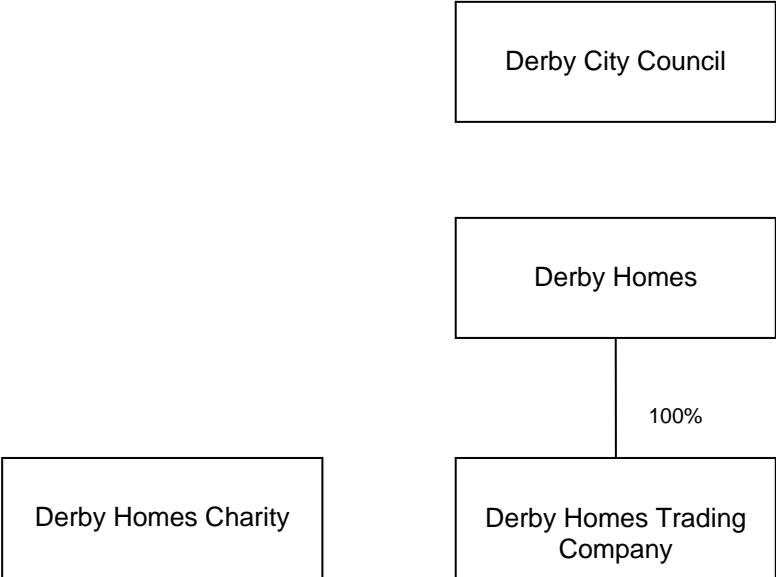
- Compliance costs related to the operation of a small firm represents c 5% of turnover (based on the findings of a paper published by the Federation of Small Businesses).
- Audit and tax fees in respect of a charitable body together with its trading subsidiary would be c£20,000 (this is indicative only and not a formal quote)
- Calculations are based on a level of turnover of (say) £250,000 per annum

	£
Administrative costs	12,500
Audit and tax fees	<u>20,000</u>
	<u>32,500</u>

In the event that all activities are accounted for within Derby Homes Limited, with an expected tax charge expected to be in excess of £32,500, it may be beneficial to consider the establishment of an alternative structure.

12 Appendix: 3

Potential Structure using a subsidiary for a charity



13 Appendix: 4

Potential Structure for trading activities

