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LONDON BOROUGH OF MERTON

OPTIONS REPORT RELATING TO CHAS 2013 LIMITED

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Contents

1 INTRODUCTION

1.1 London Borough of Merton (**Council**) is considering how it most effectively structures the ownership of CHAS 2013 Limited (**CHAS**) and potential further companies and other vehicles in the future.

1.2 This paper sets out the following:

1.2.1 the objectives of the Council and the context surrounding those objectives;

1.2.2 the factors that will shape each group structure option;

1.2.3 a summary of the group structure options available to the Council together with a comparison of each of the options, including advantages and disadvantages; and

1.2.4 a recommended model.

1.3 The primary focus of this report is on CHAS and how it would fit into a group structure. The impact of any structure on future companies and other vehicles is of secondary importance.

2 OBJECTIVES AND THE COUNCIL CONTEXT

2.1 The Council is undertaking a range of activity as part of an overarching programme of commercialisation. This includes the establishment and operation of wholly-owned companies, like CHAS, and jointly-owned companies. As part of this activity, the Council wants to ensure it has a suitable structure in place to facilitate the effective and appropriate operation of activities within CHAS and other companies and vehicles which it owns. This overall objective can be considered more specifically under a number of headings which any new structure should achieve:

2.1.1 provides for member oversight where that is currently in place but does not change the position in respect of companies where it is not currently in place, and keeps governance tiers proportionate (**Governance Objective**);

2.1.2 provides a suitable framework for managing risk across the different companies and future expansion of CHAS in terms of service lines and geography (**Risk Objective**);

2.1.3 that it presents a financial and tax efficient structure for the Council across the different companies (**Finance and Tax Objective**);

2.1.4 is suitable for effectively accommodating additional corporate entities, either wholly or jointly-owned in the future (**Future Flexibility Objective**).

2.2 As a common backdrop to all decisions and objectives the Council's preference is to go with established and proven models / structures rather than anything of a more novel or questionable nature.

3 CHAS

3.1 CHAS is a company limited by shares, wholly-owned by the Council. It currently provides a desktop health and safety assessment for contractors and ongoing support to contractors to increase their health and safety standards.

3.2 CHAS and the Council have expansion plans, initially to include the provision of assessments and guidance relating to compliance of laws relating to employees, asset management services and digital requirements, to the construction, utility and safety management sectors. At a later date services could be extended to offer a full suite of supplier risk management solutions as well as potentially expanding geographically.

3.3 CHAS has adopted model articles for companies limited by shares. There is a shareholder agreement in draft form which we understand the parties - to an extent - treat as being in force. This provides the Council with control over the company through a list of reserved matters and the need for CHAS to act within the parameters of a business plan approved by the Council.

3.4 We understand CHAS would not fall within the Teckal exemption (because irrespective of the level of control exercised by the Council, more than 20% of its activities are for with the Council) and is not a contracting authority.

3.5 CHAS has share capital of one ordinary fully paid share of £1. The profit and loss account for March 2018 shows a turnover of £7,836,321. It is funded through payment of services provided to customers.

4 OTHER AREAS OF ACTIVITY

4.1 The Council may in the future wish to incorporate additional companies or other vehicles, as either wholly-owned subsidiaries of the Council or joint venture entities. Such companies and other vehicles may form part of an existing group structure e.g. may be a subsidiary or sister entity of CHAS or may form a group structure owned by the Council but nevertheless independent of any existing Council company.

4.2 As noted above, the primary focus of this report is not on other potential areas of activity, but rather on CHAS.

4.3 For convenience, we use the term "company" in this report to mean companies and other vehicles.

5 FACTORS THAT SHAPE OPTIONS

5.1 In considering what different options there are and how well they meet the objectives of the parties, the following key points need to be considered.

Objective	Key Points
Governance Objective	• If the Council intends to award works, goods or services contacts to any company without conducting an open competitive procurement process, then the company in question will need to benefit from the Teckal exemption. • Teckal is the shorthand name for the procurement exemption that exists allowing public bodies to award contracts to entities which it owns without an open procurement process where the public body controls the key and strategic decisions over the controlled entity <u>and</u> the controlled entity undertakes at least 80% of its business with the public body. • Those companies intending to benefit from the Teckal procurement exemption should not be owned by a company that is a non-Teckal, privately orientated company. • Linked to the Teckal concept, is the concept of a "contracting authority". This is a term used to define entities that are subject to the Public Contract Regulations 2015. The test for whether an entity qualifies as a contracting authority is separate from the Teckal test though in practice the two are quite closely aligned in that a Teckal entity would typically meet the contracting authority test. A Teckal company needs to be controlled (which in practice is almost synonymous with ownership) by a contracting authorities or authorities.
Risk Objective	• Risks within a company can be ring-fenced to that separate company. Where there is activity that presents a material additional risk, the Council should consider establishing a new company to ring-fence risk associated with such activity. • This key question (of when it is proportionate to establish a separate company to house existing or proposed activity) will need to be considered on a case by case basis and will be dependent on the specific facts of each such case. Factors and scenarios that are likely to merit establishing a new vehicle include: ○ Operating in a new jurisdiction or country where the legal, tax and regulations governing the activity will be different to the operations within England. Use of a separate company in such circumstances is normally going to be appropriate. ○ Undertaking a material level of activity that the parties want to isolate from risk of other activity or presenting risk to other activity. For example, undertaking a new material development site where the parties want risk associated with the development to not affect the viability of other sites and vice versa, or separating the risks associated with development of sites from the rental of developed units.

	○ Activity that is subject to material funding from third parties. For example, if secured third party funding was secured for a development site. ○ Undertaking a different type of activity that merits a separate board, tailored to the demands of the specific area, focused on the task of managing and running that business. ○ Tax reasons. For example, using a separate development company to a rental company in respect of newly developed rental properties. • The Council will, as a shareholder of limited companies, have the benefit of limited liability, but may incur liabilities in other capacities (for example as a provider of parent guarantees).
Finance and Tax Objective	• A holding company is required to allow corporation tax losses from the groups to be shared. Although this company does not necessarily need to be limited by shares, it is generally simpler for tax purposes to use a company limited by shares where possible. • Dividends received by a UK company are exempt from corporation tax where the UK company controls the paying company. • Unlike corporation tax groups, VAT groups and Stamp Duty Land Tax groups can be formed with a local authority as the parent entity. • Further tax analysis would be required on a case by case basis, including if a company within the Council's group intended to become a residential landlord or acquire commercial property.
Future Flexibility Objective	• Individual companies and businesses can be added to the structure either through incorporation or acquisition and either wholly or jointly-owned with third parties. • If wholly-owned by the Council, the company can either be governed separately as an independent company or independent group structure or integrated into a group company structure with similar control of the Council. If owned jointly with third parties, the control of the Council will differ to that of wholly-owned subsidiaries.

6 MATERIAL OPTIONS

6.1 We have categorised the material options as follows:

6.1.1 **Direct Relationship Model** – CHAS and all other companies are direct subsidiaries of the Council.

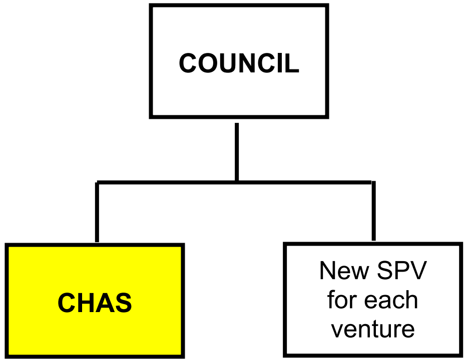
6.1.2 **Separate Groups Model** – the CHAS group and any other groups have separate direct relationships with the Council via their own holding companies.

6.1.3 **Single Parent Company Model** – the CHAS group and any other groups all owned by a common holding company that then produces a single direct relationship with the Council.

6.2 Within each material option there is an almost infinite range of variations in terms of level of control over companies and the number of companies that could be used. The purpose of the headline options is to establish a clear decision on the overall structure and the reasons for selecting it. Once there is that clarity the more detailed decisions around how that structure is established, operated and expanded in the future can be developed further as part of implementation.

7 DIRECT RELATIONSHIP MODEL

7.1 The Direct Relationship Model can be summarised as follows:

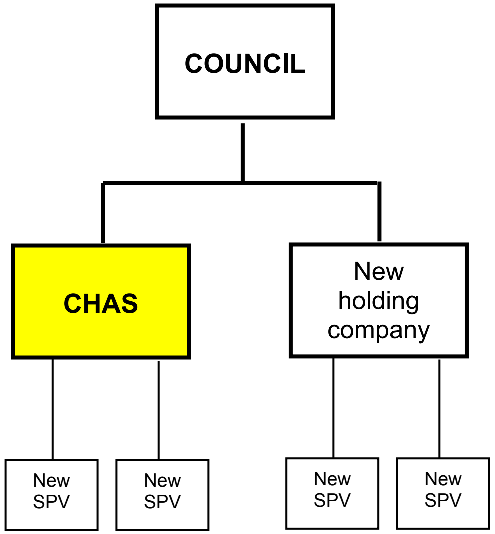


	ANALYSIS
Overview of structure	• CHAS and each company will be set up as a direct wholly-owned subsidiary of the Council and will not have any subsidiaries of its own.
Governance Objective	• As each company is governed directly and separately by the Council, there is no risk that the Council's control over any other company will be replicated in the governance structure of CHAS and so it could be simple to structure separate governance structures for separate companies. The Council would end up needing to directly manage multiple companies which could present the Council with more of an administrative task than other structures and may make it harder to establish different relationships in practice. • As companies are not grouped together, the activities of one company will not affect the procurement status of another and a company falling within the Teckal exemption can be awarded contracts directly by the Council without having to partake in a procurement process. • There is a range of ways in which the Council can control each company. This would be shaped by the governance documentation (e.g. shareholder agreement) rather than the corporate structure. As each company is separate, this option could facilitate the Council having different governance arrangements with each company, recognising as above that this could present difficulties to manage.

	• This option does not provide the Council with the opportunity to group together companies with similar governance requirements and so could result in multiple governance arrangements.
Risk Objective	• The key question would be when it merits establishing a separate company to house existing or proposed activity. • Under this model each company would become an additional direct subsidiary of the Council. This could make it harder to easily manage the group effectively and could work against effective risk management as: ○ the Council may be reluctant to establish additional companies that it will then have to directly oversee; and ○ it would be harder for a group of companies to be effectively managed in a coordinated way as the only co-ordinating entity would be the Council and directors of companies who are not also officers or members would not be a position to effectively manage across group companies, even when there are clear benefits of doing so.
Finance and Tax Objective	• Where the companies are directly owned by the Council, dividends will arise directly in the hands of the Council and so will not be subject to tax given the exemption from corporation tax on income for local authorities. • However, direct ownership by the Council would mean that the companies could not form a group for corporation tax purposes and so would not be able to surrender losses between each other. Although the tax losses would be available for carry-forward, it may take longer to utilise those losses than would be the case if the companies could exchange them within a group. • In contrast, direct ownership by the Council may not preclude the companies forming a group for VAT and SDLT purposes. If a VAT group can be formed, services can be provided between group entities without a VAT charge arising which would generally provide a cash flow advantage. Membership of an SDLT group would mean that real estate assets could be transferred without an SDLT charge, subject to potential clawback provisions in certain cases where the real estate is subsequently sold.
Future Flexibility Objective	• Individual companies and businesses can be added to the structure either through incorporation or acquisition and either held by the Council as a wholly-owned subsidiary or jointly-owned with third parties by way of a joint venture.

8 SEPARATE GROUPS MODEL

8.1 The Separate Groups Model can be summarised as follows:



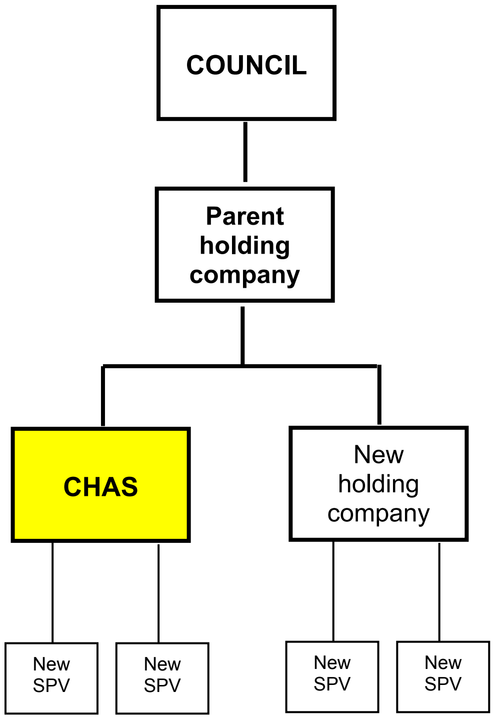
	ANALYSIS
Overview of structure	• Companies will be formed in groups, e.g. a CHAS group (with CHAS as the mid-company at the "top" of its group) and a group for possible new linked ventures in the future. Each group will consist of a mid-company (being a wholly-owned subsidiary of the Council) and set of subsidiaries to the mid-company, as appropriate. • The detail of the mid-company will depend on the detail of the activity in question. The mid-company could purely hold the subsidiary or subsidiaries in which all activity is held or could undertake activity itself. • Each group of companies will have separate direct relationships with the Council, as the ultimate parent and owner of the mid-company. Council can also own individual companies without subsidiaries held directly by the Council.

Governance Objective	• The clear separation of groups could facilitate clarity about different groups having different levels of governance oversight and control when compared to the Single Parent Company Model. The presence of a single relationship between the Council and the companies in the Single Parent Company Group Model could make it harder in practice to then establish different levels of control and influence even if that is desirable. • The Council's control over the mid-company is likely to also include that of its subsidiaries and so companies will need to be grouped in accordance with levels of Council control, i.e. if the Council requires close control of a subsidiary that is likely to also be required of the mid-company. • The Council would need to directly manage all groups, which could add to the requirements of decision making and management of companies within the Councils compared to the Single Parent Company Model. • It expected that the different groups would (in the main) contain consistent Teckal and contracting authority status positions, for example all CHAS companies being non-Teckal entities. Where the Council intends to operate both Teckal and non-Teckal or non-contracting authority companies within a particular business area there will be a question of whether such different entities should operate in the same group. The risk is the potential for one subsidiary of a mid-company to affect the procurement status of another, which could for example lead to a company losing its Teckal exemption status. The parties should consider this as part of the detail of any proposed additional company.
Risk Objective	• There will be the same question as other models in terms of when does it make sense to establish a separate company. • The presence of the mid-companies could facilitate the creation of separate vehicles and the effective subsequent management of those and through that could improve the risk management across the activity.
Finance and Tax Objective	• The mid-company of each group can receive dividends (for example, CHAS receives dividends from its subsidiaries, which it can then distribute to the Council, subject to availability of reserves for that purpose). • Dividends paid by the mid-company will arise directly in the hands of the Council and so will not be subject to tax given the exemption from corporation tax on income for local authorities. Accordingly, the existence one or more mid-companies should not increase the tax costs on dividends received by comparison to direct holding of trading companies by the Council. • However, the ownership by the Council would mean that the two groups could not form a larger group for corporation tax purposes and so would only able to surrender losses within the smaller groups. Although any net tax losses within a group would be available for carry-forward, it may take longer to utilise those losses than would be the case if the companies could exchange them within a larger group.

	• In contrast, the separate group may not preclude the companies forming a larger group for VAT and SDLT purposes. If a larger VAT group can be formed, services can be provided between group entities without a VAT charge arising which would generally provide a cash flow advantage. Membership of a larger SDLT group would mean that real estate assets could be transferred without an SDLT charge, subject to potential clawback provisions in certain cases where the real estate is subsequently sold. • As considered in section 5 it may be preferable to establish a separate rental and development company for VAT efficiency purposes. The detailed scope of such modelling is outside the scope of this paper but further separate advice could be provided.
Future Flexibility Objective	• Individual companies and businesses can be added to the structure either through incorporation or acquisition and either wholly-owned by the Council as direct subsidiary or subsidiary of a mid-company or jointly-owned with third parties as a joint venture. • Joint venture companies can be held directly by the Council to enable the Council to benefit from the corporation tax exemptions but note the inability to share corporation tax losses. • Alternatively it may be beneficial to add JV companies with similar businesses to those of an existing group, to that group, to manage governance and risk arrangements but note dividends received by mid-company or holding company from JV company will not be exempt from corporation tax if the mid or holding company doesn't control the JV company.

9 SINGLE PARENT COMPANY MODEL

9.1 The Single Parent Company Model can be summarised as follows:



	ANALYSIS
Overview of structure	• Similar model to that of the Separate Groups Model, but the difference being that the Council would just have a single corporate relationship with the holding company which would then have separate direct relationships with the group companies. CHAS would remain the mid-level holding company for its group but would not have a direct subsidiary relationship with the Council.
Governance Objective	• The overall holding company could be given the role of managing the group and therefore having a meaningful role in managing the group and providing a single point of relationship to the Council. This could streamline governance from the Council's perspective. It could also risk a dilution of the direct relationship between the councillor groups acting on behalf

	of the Council as shareholder and the operational entities, as the relationship would be indirect via the overall holding company and its board. • The holding company could have a transparent governance role, existing for tax purposes but not taking on a substantive governance role, meaning the position would be the same as CHAS and any other mid-level holding company in the Separate Groups Model. It could in practice be harder to establish different working practices of governance arrangements with different groups given all would be managed either by a single holding company board and / or the Council. • The holding company would in effect need to operate as a contracting authority to allow both Teckal and non-Teckal entities to be formed below. • As with the Separate Groups Model, control over a mid-company is likely to also include that of its subsidiaries and so companies will need to be grouped in accordance with levels of required control, i.e. if the Council requires close control of a subsidiary that is likely to also be required of the mid-company. • It expected that the different groups would (in the main) contain consistent Teckal and contracting authority status positions, for example all CHAS companies being non-Teckal entities. Where the Council intends to operate both Teckal and non-Teckal or non-contracting authority companies within an area there will be a question of whether such different entities should operate in the same group. The risk is as considered above for the Separate Groups Model and should be considered as part of the detail of any proposed additional company.
Risk Objective	• Same as for Separate Groups Model.
Finance and Tax Objective	• The holding company can receive dividends without a corporation tax charge. Dividends paid by the holding company will arise directly in the hands of the Council and so will not be subject to tax given the exemption from corporation tax on income for local authorities. Accordingly, the existence of a holding company should not increase the tax costs on dividends received by comparison to direct holding of trading companies by the Council. • Having a group under a single holding company would establish a group for corporation tax purposes so that losses could be surrendered between group companies in the most tax efficient manner. • The companies could also form a group for VAT and SDLT purposes. If a VAT group can be formed, services can be provided between group entities without a VAT charge arising which would generally provide a cashflow advantage. Membership of an SDLT group would mean that real estate assets could be transferred without an SDLT charge, subject to potential clawback provisions in certain cases where the real estate is subsequently sold.

Future Flexibility Objective	• Individual companies and businesses can be added to the structure either through incorporation or acquisition and either wholly-owned by the holding company as a direct subsidiary or subsidiary of mid-company or jointly-owned with third parties. • It may be beneficial to add JV companies with similar businesses to those of an existing group, to that group, and to manage governance and risk arrangements but note dividends received by mid-company or holding company from JV company will not be exempt from corporation tax if the mid or holding company doesn't control the JV company.

10 CONCLUSION AND RECOMMENDED MODEL

10.1 The Separate Groups Model is recommended as the most appropriate model for the Council to adopt in respect of CHAS and any other vehicles in the future for the following reasons:

10.1.1 It continues the current direct governance link between the Council as shareholder and the different operational businesses / groups, including CHAS.

10.1.2 We understand that the benefit of the corporation tax group associated with the Single Parent Model is not expected to be material enough to outweigh the other benefits of the Separate Groups Model. The ability for CHAS or another company to carry forward losses means that the benefit of forming an overall corporation tax group for all businesses and sharing losses within year is limited to the cash flow benefit of reducing tax exposure in the shorter term rather than over a longer term period within the same company / group (assuming a profit is made in the future). Further detailed tax analysis would be required to confirm the position.

10.1.3 The Separate Group Model allows for group structures for the different businesses which enables more effective management of risk. CHAS would be structurally ring-fenced from other Council businesses and the risks they take.

10.1.4 It allows for profits from trading to be received in the hands of a company that provides flexibility for whether funds are returned to the Council or reinvested with the potential for returns as dividends to be received as income to the general fund within the Council. Again the treatment of profits should be subject to further detailed tax analysis.

10.2 The creation of additional group entities should be considered on a case by case basis in light of the particular circumstances at the time with there being clarity at the board level as to the overall framework for considering options and sensible triggers for new companies.