LOOKING AT LATCOs

Chancellor's Budget : Update

The pandemic has had a huge economic cost, seeing government debt rise to its highest level since 1963. Perhaps unsurprisingly, the build up to this year's budget and what **Rishi Sunak** (now a household name) was going to implement to repay the debt, whilst in a period of recession, was widely anticipated. The budget was delivered on the 3rd March 2021 with a three-part plan to protect the jobs and livelihoods of the British people.

Continued overleaf

Ensors

Making you more than just a number

Chancellor's Budget : Update *continued*

There are several points that are key for the LATCO industry, one of which was the unwelcome increase of Corporation Tax. The UK has enjoyed a Corporation Tax rate of 19% since 1st April 2017, one of the lowest in the G20. This is set to change.

The Chancellor announced that this rate will remain until 1st April 2023 and will continue for companies whose profits are below £50,000 but will increase to 25% for companies with profits over £250,000. Profits between these amounts will be reduced from the main rate by a taper relief.

This rate increase needs to be factored into budgets and cash flows, not forgetting deferred tax assets and liabilities which are measured at the rate they are expected to reverse at (where this rate has been enacted or substantively enacted). This could see a huge hike in provisions when the finance bill, that will approve these rates, is passed.

In contrast, and on a more positive note, a temporary extension was announced for taxable losses for accounting periods ending in the period 1st April 2020 to 31 March 2022. Trade losses can now be carried back for three years, instead of one, to facilitate a reduction or repayment of Corporation Tax. (This relief is capped at £2million pounds of losses.)

Another available 'relief' is for companies investing in plant and machinery. The Chancellor announced a new 'super deduction' providing an allowance of 130% on most new plant and machinery that would have ordinarily qualified for the 18% rate and a first year allowance of 50% for new plant and machinery that would have ordinarily qualified for the 6% allowance such as integral features (in certain circumstances). These new rates are for the period 1st April 2021 to 31 March 2023.

For LATCOs in the residential property sector, a time extension of the temporary increase in the Stamp Duty Land Tax nil rate band of £500k to 30th June 2021 is welcome to encourage sales. From 1st July 2021 to 30 September 2021 this will be reduced to £250k, reverting back to £125k on 1st October 2021.

Commercial property lets have been difficult particularly with tenants in the retail, hospitality or leisure trade. Therefore an announcement of the continuation of the 100% business rates relief for eligible businesses until 30 June 2021, followed by a 66% relief from 1st July 2021 to 31st March 2022 (capped at £2m per business) together with the extension of the 5% VAT rate to 30 September 2021 and a reduced rate of 12.5% to 31 March 2022, is welcome for tenants struggling to pay their rent.

Finally, the announcement of a new economic zone, Freeport East, was a welcome boost making it easier and cheaper to do business in the East Anglian area.

How can the Council extract profit?

Many local authorities set up LATCOs with the intention of generating financial returns. Over the last 12 months Council funding has faced unprecedented pressure, and so the question of how best to extract profits from the LATCO has never been more pressing.

DIVIDENDS

Paying dividends up to the parent body is the default mechanism for profit extraction. However, dividends can only be paid out of retained profits, so if the LATCO has made losses at any stage there could be a restriction on the amount of dividend that can be paid. It is important not to pay more than the available reserves as that would result in the dividend being unlawful.
In addition, dividends are paid out of taxed profits, so do not reduce tax leakage. However, there are other methods of profit extraction to consider before dividends.

MANAGEMENT CHARGES

In many cases, the LATCO will receive support from the Council, particularly with management, finance and administration services. The Council should charge the LATCO for these services and, provided the charges are not excessive, they will be deductible in calculating the LATCO's tax position.

TRANSFER PRICING

When LATCOs charge for services provided, Councils need to be alert to the transfer pricing rules. These mean that the LATCO's tax calculation has to apply arm's length pricing for its transactions with the Council; if the Council charges more than a commercial rate for the services, the tax deduction is restricted to the lower, arm's length amount. Generally, for support services, an arm's length charge could be calculated by reference to a mark up on the Council's costs or to a commercial hourly rate.

LOAN INTEREST

Many Councils provide initial funding to their LATCOs in the form of a loan. Interest paid on the loan is tax deductible, subject to the application of the Corporate Interest Restriction cap (currently £2 million spread across all related companies).

Transfer pricing principles also apply to funding arrangements, so the tax deduction for interest payable is restricted to an arm's length amount. This means it is important to consider would an unconnected lender have loaned that amount, at that interest rate and with that security? To answer that question, a thin capitalisation review looks at commercial rates of interest, loan to asset value and interest to profit ratios.

AND FINALLY...

An important point to remember is that the LATCO must be left with sufficient reserves to fund its activities, whatever method is used to return profits to the Council.

Going Concern considerations

A director's appointment to a LATCO comes with extensive legal responsibilities. One area that is heightened in this current environment is the director's responsibility to consider the LATCO's ability to continue as a Going Concern. As well as managing the company's ongoing trading, there are likely to be additional disclosures required in the accounts and there is also the legal risk that if you continue to trade with the knowledge that the business is insolvent, you could be charged with wrongful trading!

Most local authority owned companies will have the comfort of support from their respective parent Council, however increased costs and limited availability of additional funds during the pandemic might mean that even this may be less certain. When creating a LATCO the intention is to have a trading subsidiary that can support itself and generate an income to the Council rather than a Company that requires support. In this current environment local authorities are under increased pressure to show that their trading companies are performing as they should.

The government have at least acknowledged the increased uncertainty directors are facing surrounding the pandemic and, to ease this, have enacted emergency legislation to ensure that the directors are not personally liable.

Full details can be found here:
(The suspension was extended on 26 November 2020 to 30 April 2021)

https://www.gov.uk/government/publications/corporate-insolvency-and-governance-bill-2020-factsheets/suspension-of-wrongful-trading-liability

This is helpful, but it is temporary legislation and specifically targeted at businesses that are most affected by the pandemic and national lockdowns.

When preparing your year-end statutory accounts, Going Concern is a concept that describes a company which can continue to operate without the threat of liquidation. The Going Concern status is specifically referenced in the audit report and, if the ability of the company to operate for the next 12 months following the date the audit report is signed is in question, this needs to be disclosed.

Therefore, it is essential that management have developed an approach to assess whether their entity is a Going Concern. This approach will be different for every LATCO and will be dependent on the sector it is operating in, the size of the company and the complexity and history of profitable trading.

All companies are encouraged to reverse stress test their business models and forecasts; this involves identifying events that may have a low probability but are enhanced during the current pandemic.

An example would be a prolonged national lockdown or the withdrawal of government support. They would then need to identify the combination of events that would make the business model becoming unviable and what could be done to mitigate or counter the negative effects.

If, after completing the assessment, management conclude that there are uncertainties the next step is to consider if these uncertainties were disclosed in the accounts and could they reasonably affect the economic decisions of the shareholders or any other users of the financial statements. As the situation is so fluid at the moment, this assessment must also be revisited at the point the accounts are authorised.

Ultimately, disclosing material uncertainty about a company's ability to continue as a going concern could lead to a modified audit report. This does not necessarily indicate crisis. This demonstrates the directors being transparent about uncertainty.

Partial Exemption explained

Partial Exemption is an area of tax that many LATCOs overlook. Quite simply, if your LATCO makes both taxable and VAT exempt supplies it is classified as 'partially exempt' and VAT on costs may only be recoverable in part.

Generally, a VAT registered business can recover VAT incurred on expenditure that relates to:

- taxable supplies it makes (or intends to make);
- 'foreign supplies' (supplies made outside the UK that would be taxable if made in the UK); or
- 'specified supplies' (financial services supplied to persons belonging outside the UK or directly related to an export of goods, insurance services supplied to persons belonging outside the UK or directly related to an export of goods, and the making of arrangements for these specified supplies).

VAT incurred on expenditure that directly relates to exempt business activities is irrecoverable.

Business activities that may fall within VAT exemption include supplies of:

- Insurance
- Education
- Finance
- Health and welfare
- Certain supplies of membership
- Residential lets
- Certain supplies of land/buildings where an option to tax has not been made by the supplier

Where VAT does not relate directly to taxable or exempt activity (for example VAT on general overhead costs) it can be partly recovered. Partial exemption is complex and businesses making both taxable and exempt supplies may need additional support to calculate how much VAT incurred they can recover.

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- **Management accounting**
- **Governance/Director training**

Ensors are proud to be working closely with the LATCO network – "the first membership organisation founded entirely by LATCOs for LATCOs to provide a sector voice and enable support to members delivering public services commercially." **https://latco.network/**

We are providing the Network's members with initial free-of-charge meetings from across our comprehensive range of accounting and tax professionals.

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