Commercialisation of Council-owned Beach Huts

Bournemouth Christchurch and Poole Council

July 2022

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Glossary

BCP	Bournemouth, Christchurch and Poole Council
CPI	Consumer Price Index
CFADS	Cashflow Available for Debt Service
DSCR	Debt Service Coverage Ratio
DSRA	Debt Service Reserve Account
GBP	Great British Pound
GEPOC	General Power of Competence
GF	General Fund
HMT Green Book	Her Majesty's Treasury Green Book
ICMA	International Capital Markets Association
KPMG	KPMG LLP
LBH	London Borough of Haringey
NPC	Net Present Cost
NPV	Net Present Value
OBR	Office for Budgetary Responsibility
PWLB	Public Works Loan Board
RPI	Retail Price Index
SDLT	Stamp Duty Land Tax
SPV	Special Purpose Vehicle
Subsidiary	New council-owned subsidiary for the Beach Huts
VAT	Value-added Tax
WALL	Weighted Average Loan Life

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Important Notice: About this Report

This report has been prepared on the basis set out in our engagement letter addressed to Bournemouth Christchurch and Poole Council ("the Client") dated 14th of April 2022 (the "Engagement Letter") and should be read in conjunction with the Engagement Letter.

Please note that the Engagement Letter makes this report confidential between the Client and us. It has been released to the Client on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent (except as specifically permitted in our Engagement Letter). Any disclosure of this report beyond what is permitted under the Engagement Letter will prejudice substantially this firm's commercial interests. A request for our consent to any such wider disclosure may result in our agreement to these disclosure restrictions being lifted in part. If the Client receives a request for disclosure of the product of our work or this report under the Freedom of Information Act 2000 or the Freedom of Information (Scotland) Act 2002, having regard to these actionable disclosure restrictions the Client should let us know and should not make a disclosure in response to any such request without first consulting KPMG LLP and taking into account any representations that KPMG LLP might make.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed. Nothing in this report constitutes legal advice or a valuation.

This report has not been designed to be of benefit to anyone except the Client. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Client, even though we may have been aware that others might read this report

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In particular, and without limiting the general statement above, since we have prepared this report for the benefit of the Client alone, this report has not been prepared for the benefit of any other local authority nor for any other person or organisation who might have an interest in the matters discussed in this report.

Our work commenced on the 14 of April 2022 and the report was completed 23 of June 2022. This report is a follow on from our previous report dated February 2022.

In preparing our report, our primary source has been information received by the Client and representations made to us by management of the Client. We do not accept responsibility for such information which remains the responsibility of management. Details of our principal information sources are set out in page 24 and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

1 Executive Summary

1.1 Background

To support the delivery of Bournemouth, Christchurch and Poole Council's ("BCP" or "the Council") Seafront Strategy, as well as its wider regeneration and transformation programmes, the Council has identified significant opportunities to improve the value generated by its Beach Hut assets.

This includes opportunities to increase revenues, diversify the product offering, improve the management and operational performance of the Beach Huts, and facilitate wider improvements to seafront facilities and infrastructure.

It will require investment to deliver these benefits and improve the quality of provision.

A commercial structure has been developed based on establishing a new wholly owned subsidiary specifically set up to purchase and manage the Beach Hut assets. Transferring the Beach Hut assets into a wholly owned subsidiary is expected by the Council to provide benefits compared to operating the assets within the Council, including:

- Enabling the raising of investment capital to further invest in Beach Hut assets over time to improve their quality and amenity, without this capital using up Council capital budgets.
- Allowing a streamlined decision making and governance structure, creating a more agile organisation able to respond more efficiently to changing market conditions.
- Streamlining the use of Council management and Councillor time.
- Ring-fencing of risk within a subsidiary with limited recourse to the Council for non-core commercial activity.
- Increasing potential to generate additional revenue, in part through price harmonisation across BCP beach front assets.
- Generating capital for the Council through the sale of the assets to the subsidiary, to allow the Council to invest in core capital projects or other transformation activities.

1.2 Scope of Report

KPMG financial and accounting analysis provided in a February 2022 report indicated that there is the potential to generate additional revenue from the Beach Hut assets that could benefit the Council and residents.

The February report set out that circa £50m of third-party debt could be raised against the income generated from the Beach Hut assets and that this, less an allowance for transaction costs, could be paid to the Council as a Capital Receipt to contribute to the wider need for Council capital budget. Based on an estimated value of the Beach Hut Assets of £67m, the purchase would therefore be funded through a combination of £51.6m of third-party debt plus £17m of shareholder loans (deferred capital receipt) provided to the subsidiary by the Council on commercial terms, after allowing for transaction costs and establishing cash reserves within the subsidiary.

Since the February 2022 report BCP has undertaken further research into the additional revenue potential and investment needed in the Beach Hut assets and has been developing a business plan for the subsidiary.

KPMG has been engaged by BCP to provide further commentary on BCP's identified structure and financing of the potential transaction. This report sets out:

- An update on the corporate form of the proposed subsidiary, i.e. the choice between a limited company structure and a limited liability partnership (LLP), following legal advice.
- Updated indicative financial forecasts for the subsidiary considering:

- Updated revenue, operating and investment projections provided by BCP
- Updated financing terms and an optimised debt structure reflecting the changes in BCP assumptions and market movements in debt terms.

- Updated net present value calculations of the forecast returns to the Council if the Transaction proceeds, to assist BCP with value for money deliberations.
- Further detail on the likely tax impact for the subsidiary and the Council.
- Further detail on the accounting treatment of the subsidiary, in particular the treatment of the sales proceeds as a Capital Receipt

1.3 Headlines

Corporate form	Following legal advice, the option of a limited liability partnership has been ruled out as the Localism Act requires commercialisation activity to be carried out through a company.
Council scenarios	The Council has provided KPMG with two scenarios that forecast the expected revenues, operating costs and investment associated with the Beach Hut assets: - a “Base Case” scenario that assumes harmonisation of pricing/fees across the Beach Hut portfolio within the first five years of the subsidiary being established, with an increased rolling annual capital investment spend to improve and maintain the assets, financed by debt and shareholder loans over a 25-year debt term; and - a “Base Case Plus” scenario that assumes an acceleration of the revenue increases within the first two years and capital investment programme from year 1, with quicker repayment of debt over a 22.5 year debt term. The debt term is shorter under the Base Case Plus scenario because the increased financial performance allows the debt to be repaid quicker. The Council has stated that it wants to prioritise repaying the debt quickly rather than borrowing more money over a longer term. Both scenarios forecast an upfront capital receipt to BCP of £50m.
Quantitative value for money using HMT Green Book Method	The HMT Green Book provides guidance to public sector organisations on conducting investment appraisal. For asset sales, the HMT Green Book provides three tests to indicate value for money, which are helpfully summarised in a National Audit Office report[1] into the sale of the Government student loans portfolio: - the [Council] should satisfy itself that an efficient market exists for this asset and that this market appears to be functioning efficiently at the time of sale; - the [Council] should ensure that sales are structured and executed in such a way as to promote efficient pricing; and - the sale price needs to exceed or be broadly neutral when compared with the retention value to [the Council]. Applying this logic to BCP’s proposed Beach Hut transaction, the first two tests are broadly satisfied because: - The sale will be at a market value with that valuation being subject to independent valuation by the Council. The independent valuation will help to determine the sale price to ensure it is in line with the market and that the price is not deflated or risk adjusted due to the market not functioning efficiently. - Any deferred proceeds for the sale (amounts not paid by the subsidiary at the point of sale) will be on market terms with an arm’s length interest rate applied. The combination of these points indicated that the Council will receive a purchase price that represents fair value for the assets.

[1] The sale of student loans (nao.org.uk), The Sale of Student Loans, National Audit Office 20 July 2018

	In assessing whether the sale price exceeds or is broadly neutral with the retention value (the "Do Nothing" option), the HMT Green Book suggests a discounted cash flow approach is used as follows: - A real discount rate of 3.50%, or 6.09% nominal. This represents the Social Time Preference Rate estimated by HMT, being the general preference of society to consume today rather than tomorrow. It does not represent the cost of capital to the public sector. - That the tax differential between options is not considered, as this is an intra-government cash flow. In the table below, the NPV benefit or deficit compared to the Do Nothing option using a 6.09% nominal discount rate is presented:

Case	Do Nothing NPV (£m)	Transaction NPV (£m)	Benefit/(deficit) £m
Base Case	74.7	92.4	17.7
Base Case Plus	67.9	93.3	25.5

Using HMT guidance methodology for investment appraisal the transaction therefore shows significant potential to generate positive value for money.

The Council also intends to require the subsidiary to invest an additional £450k per annum into the Beach Front Hut assets compared to the Do Nothing option, increasing amenity.

Note that the NPV of the Do Nothing scenario differs under the Base Case and Base Case Plus as the NPV is assessed over the debt term and the debt term differs under each case. This is because the Council has stated their preference to repay outstanding debt as quickly as possible rather than increase the level of debt raised (which would be possible under the Base Case Plus). The period for the full repayment of debt represents an appropriate period to assess value for money over as at the point of full repayment the Council will own unencumbered assets in a wholly owned subsidiary and has flexibility to reassess the ownership structure at that point.

Net Present Value using Council cost of capital

The Council's actual cost of capital is lower than a nominal rate of 6.09%. The rate of PWLB borrowing over an equivalent term, perhaps the best proxy to the actual cost of Council borrowing, is approximately 3.50% (at the time of the analysis).

Whilst tax is an intra-government cash flow, it is a real cash flow for the subsidiary and would therefore reduce the direct financial returns to BCP.

Using the PWLB rate as a discount rate and including the cost of tax under the subsidiary option, the net present value benefit or deficit in the latest forecast cash flows is as follows:

Case	Do Nothing NPV (£m)	Transaction NPV (£m)	Benefit/(deficit) £m
Base Case	101.4	91.1	(10.3)
Base Case Plus	89.4	90.6	1.2

Using a PWLB discount rate and including tax, the Base Case is not expected to provide a Net Present Value benefit over the initial debt term. Under the Base Case Plus there is expected to be a Net Present Value benefit.

Under this discounting methodology, significant levels of corporation tax are forecast to be paid by the subsidiary – with an NPV of £17.1m and £17.7m in the Base Case and Base Case Plus respectively.

Using gift aid to mitigate tax cost

The subsidiary company will be liable for corporation tax on profits. The Council have asked KPMG to consider the possibility for this tax cost to be mitigated by the subsidiary. This involves using gift aid to donate profits to local charitable organisations and the tax cost reduced to zero. Indicative calculations suggest that to reduce the corporation tax to zero, the subsidiary would need to donate roughly £4m on average each year. To save £25 of corporation tax the Council would need to donate £100 of profits, post the change to corporation tax rates to 25% in 2023.

The Council has suggested it may be possible to make donations to organisations linked to the Seafront Strategy, and that these donations would benefit residents. Donations are a gift and once made the ability to control how they are spent is challenging. The subsidiary board, acting independently of the Council, would need to take a view each year that donating profits was a suitable use of funds. Nonetheless, gift aid may be part of the toolkit deployed by the subsidiary to improve seafront assets that complement the Beach Hut assets in a tax efficient way.

Capital receipt

As the transaction will involve the Council relinquishing ownership & control of the assets to its subsidiary for a 'true sale' to occur, the £50m cash payment received by the Council will be treated as a capital receipt and contribute towards the capital budgets of the Council. No such capital receipt is received under the Do Nothing option.

Impact on Council revenue budgets

Revenue budget

In the table below, we present the total revenue budget to the Council in the first ten years of the Transaction. A detailed breakdown can be found in section 5.6.

Revenue (£m)												
Year	0	1	2	3	4	5	6	7	8	9	10	Total
Do Nothing	0.00	4.32	4.44	4.57	4.69	4.82	4.98	5.15	5.32	5.50	5.68	**49.47**
Base case	0.00	1.84	1.83	1.90	1.90	1.91	1.90	1.89	1.88	1.87	1.86	**18.78**
Base Case Plus	0.00	1.85	1.88	1.88	1.87	1.87	1.87	1.86	1.84	1.83	1.81	**18.56**

Capital budget

In the subsequent table, we present the capital receipts to the Council in the first ten years of the various scenarios. The capital receipts consist of the £50m cash payment to the Council once the Transaction closes and the shareholder loan principal repayment to the Council over the life of the Transaction. We provide a detailed breakdown in section 5.6.

Capital Receipt (£m)												
Year	0	1	2	3	4	5	6	7	8	9	10	Total
Do Nothing	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	**0.00**
Base case	50.00	0.00	0.00	0.01	0.07	0.13	0.16	0.20	0.24	0.28	0.32	**51.40**
Base Case Plus	50.00	0.00	0.02	0.08	0.12	0.18	0.22	0.27	0.32	0.37	0.42	**52.01**

Governance	The nature of the commercial and governance arrangements between the Council and its subsidiary is crucial to achieving an optimal balance of segregation of activities and control. This will allow the Council to continue to focus on delivering its core services and allow the subsidiary to operate within a more commercially driven governance structure. The optimal model needs to demonstrate a sufficient transfer of risk, responsibility and accountability to the subsidiary with appropriate protections, Council step-in arrangements and governance framework in the event of changes/issues. We set out the key governance considerations in section 6 of the report

2 Background

2.1 Background

This report is a follow up to the KPMG report dated February 2022, Commercialisation of Assets. That report explores potential commercial structures that BCP considered to improve the commerciality of Council owned income-generating assets.

Bournemouth Christchurch and Poole Council ("the Council" or "BCP") has identified its current portfolio of Beach Huts as a portfolio of assets where opportunity exists to generate further financial return, whilst also improving the quality and amenity of the assets for residents and visitors.

The February 2022 report provided commentary on an option being explored by the Council to sell 3,461 Beach Huts (1472 Council owned Beach Huts and 1989 privately owned Beach Huts (site licenses)) to a wholly owned subsidiary of BCP, with that subsidiary borrowing third party finance secured against those assets to fund the purchase ("the Transaction"). We understand from the Council that these Beach Huts are mostly on Council freehold land but with some leasehold title interest, owned and/or managed by the Council.

KPMG financial and accounting analysis provided in the February 2022 report indicated that circa £51.6m of third-party debt could be raised against the income generated from the Beach Hut assets and that this, less an allowance for transaction costs, could be paid to the Council as a Capital Receipt to contribute to the wider need for capital budget within the Council. Based on an estimated value of the Beach Hut Assets of £67m, the purchase would therefore be funded through a combination of £51.6m of third-party debt plus £17m of shareholder loans (deferred capital receipt) provided to the subsidiary by the Council on commercial terms, after allowing for transaction costs and establishing cash reserves within the subsidiary.

The February 2022 report provided indicative financial analysis based on assumptions provided by the Council of the subsidiary being a wholly owned limited company and of setting up a limited liability partnership ("LLP"), potentially with other organisations owning Beach Huts in the area. The LLP option showed a marginal financial benefit because of the tax efficient nature of the entity. BCP has since sought legal advice on the deliverability of the LLP structure.

2.2 Scope of work

Since the February 2022 report BCP has been undertaking further research into the additional revenue potential and investment need in the Beach Hut assets and has been developing a business plan for the subsidiary.

KPMG has been engaged by BCP to provide further commentary on the BCP preferred structure and financing of the potential transaction. This report sets out:

- An update on the corporate form of the proposed subsidiary, i.e. the choice between a limited company structure and a limited liability partnership (LLP), following legal advice.
- Updated indicative financial forecasts for the subsidiary taking into account:
  - Updated revenue, operating and investment projections provided by BCP
  - Updated financing terms and optimised debt structure reflecting the changes in BCP assumptions and market movements in debt terms.
- Updated net present value calculations of the forecast returns to the Council if the Transaction proceeds, to assist BCP with value for money deliberations.
- Further detail on the likely tax impact for the subsidiary.
- Further detail on the accounting treatment of the subsidiary, in particular the treatment of the sales proceeds as a Capital Receipt

It is part of the Council's process to develop the business case and the value for money assessment that will guide its decision making. Please note, this report is not a business case nor a value for money assessment but provides analysis that will contribute towards those considerations.

2.3 Information provided

To assist KPMG in delivering the scope of work. BCP has provided the following primary sources of information:

- Beach Huts Income and Expenditure – Historical (2015-2016) and forecast (2021 - 2025)
- Beach Hut database v7 MASTER (including Harmonisation Data)
- Beach Hut database v9 MASTER (including Harmonisation Data)(Base Case Plus v1.0) (Sent to KPMG 160622)
- Commercialisation of Beach Hut Assets through Special Purpose Vehicle V1 (Sent to KPMG 190522)
- SSL TORs DRAFT V02
- Seafront Budget 2122
- BCP's Commercial companies structure chart.
- BCBL Incorporation Articles 15 12 14
- Seascape Shareholder Agreement Signed 1.4.2015; and
- Seascape South Resource Agreement - 1 Apr 2015

Previous KPMG reports on the commercialisation of income generating assets prior to this report include:

- Commercialising and Financing Options Structuring; September 2021.
- Commercialisation of Assets; February 2022.

3 Corporate Form

3.1 Limited company or LLP option

The KPMG February 2022 report provided analysis on both a wholly owned limited company structure and a limited liability partnership, with the partnership likely being with other Beach Hut owning operators in the area or other organisations linked to the protection and amenity of the seafront.

Legal advice subsequently obtained by the Council suggests the LLP option is not possible because the underlying objective of the transaction is a commercial one. The Localism Act 2011[2] states that when a Local Authority uses its General Power of Competence (GEPOC) for a commercial purpose, it must do so through a company.

Exceptions to this have been successful, with the most quoted example being the London Borough of Haringey (LBH) who won the case brought against them by a resident for using an LLP structure. However, that case relied on the commercial objective being secondary to the primary objectives of the partnership. In BCP's case, it is felt that commercialisation is a primary objective of the proposed entity and hence the LLP option is not permissible.

As such, the Council has concluded that the corporate form of the new entity will be a limited company guaranteed by shares, which is wholly owned by the Council. All subsequent financial analysis in this report assumes this structure.

An illustration of the structure can be found in Appendix 1.

It is understood that the Council has also considered the use of a Teckal company. A Teckal company is a company where a local authority controls all of the shares, exercises effective day-to-day controls over the company's affairs and at least 80% of the turnover of the Teckal company comes from its public sector owners. We note that BCP Council has formed the view that the subsidiary would not be a Teckal company primarily due to the amount of non-BCP income exceeding the allowable threshold (20%) plus the need for a Teckal company to be independent and not under significant control from the Council.

[2] Localism Act 2011; https://www.legislation.gov.uk/ukpga/2011/20/contents/enacted

4 Commercial Rationale

4.1 BCP's commercial rationale for exploring the Transaction

The Council has explained that, like most UK local authorities, it is facing financial challenges. This is due to various factors including the recovery from the global pandemic, high costs of social care and the current cost of living crisis. As such, the Council is seeking to maximise the income generation from Council owned assets and, where appropriate, realise capital receipts through asset sales to fund further investment. The sale of assets to a wholly owned subsidiary recognises a capital receipt whilst the Council, through its ownership of the subsidiary, retains ultimate control of the assets.

Furthermore, the BCP Seafront Strategy aims to establish a world-class seafront fully aligned with the Council's Big Plan for the conurbation and supports a wide range of Corporate Strategy priorities. As part of the Seafront Strategy, the Council has outlined a 5-year investment plan to improve infrastructure and essential amenities to enable the seafront to become "world-class" in quality. It is understood that the Beach Huts subsidiary is part of this strategy.

4.2 Benefits of commercialisation

The Council considers the key benefits of the commercialisation of the Beach Huts to include:

- **Increased revenue and harmonisation:** The Council has stated that harmonising the policies of the Beach Huts across the BCP area is still outstanding, and there are opportunities to enhance the financial return through more investment in the assets, ongoing maintenance and a dedicated team focussed on maximising revenue potential from the assets. The subsidiary will act on a commercial basis and adjust prices to align with market demand. It is felt that a subsidiary operating on an arms' length basis will have greater ability to implement investment and price reviews more swiftly than if undertaken directly by the Council.
- **Capital investment**: The Council is not currently allocating any funds for capital expenditure to improve the Beach Huts within constrained Council capital budgets, other than those already approved. After the Beach Huts are sold to the subsidiary, the subsidiary business plan assumes it will reinvest at least £450k annually from its income for capital improvements to the Beach Huts. This will not require ongoing capital budget from the Council.
- **Ringfencing of risk**: The use of the ringfenced subsidiary will enable the Council to insulate itself from some of the financial and operational risks associated with owning the Beach Huts and any borrowing secured against them. In the event of default or insolvency, creditors can only claim against the assets of subsidiary as it is a legal entity separate from the Council. The use of limited recourse entities for commercial activity to provide a degree of insulation to parent company balance sheets from non-core activity is a common commercial practice. This benefit is tempered by the intended financial guarantee that the Council will have to provide to senior debt providers of the subsidiary whilst the credit worthiness of the entity in its own right is established through trading history.
- **Decision making**: The Council's decision-making processes, whilst thorough and democratic, do not lend themselves to managing assets such as Beach Huts on a day to day basis in a commercial way, particularly where swift action may be required. Understandably, the optimal management of Beach Hut assets is not top of Council management team or Member priorities. A subsidiary will have a separate management team (either directly appointed or purchased under a management agreement from the Council) that can make decisions on managing the Beach Huts with this being its core purpose, through delegated authority within certain limits set by the Council. This will enable the subsidiary to respond quickly to market conditions with the Council retaining input on key matters through pre-agreed reserved matters.
- **Time saving**: Currently, it is understood that there is a dedicated team of four individuals who currently administer the Beach Hut business across the conurbation, with the support of ancillary teams. The Council forecasts that moving the Beach Huts into the subsidiary (within reasonable

delegated authority limits) will save the Council's management team time, freeing them up to focus on other core Council activities.

- **Procurement advantages**: At present, the Council has to run open competition for items such as works undertaken as part of capital projects. In some cases, this can take a few months. The Council has considered that the subsidiary could be structured such that there is savings in the procurement process through various methods such as call-off frameworks. This would be particularly advantageous if there was a wider investment need/capital programme.

5 Quantitative Analysis

5.1 Introduction

This section provides an update to the indicative financial forecasts of the subsidiary using the updated revenue, operating cost and investment assumptions provided by the Council following its further work into the Beach Hut commercialisation opportunity. These assumptions can be found in Appendix 2. While the key debt assumptions are in Appendix 3.

The financial analysis assesses how much third-party debt can comfortably be raised by the subsidiary secured against Beach Hut net income and the impact of the transaction on the Council cash flows and financial statements.

For the purpose of this analysis, it has been assumed that the Beach Huts will attract a sale price of £67m and revenues from the Beach Huts can service a debt amount that will result in a £50m capital receipt for the Council, in line with the report of February 2022 and the target figure for the Council given other capital commitments. BCP is seeking a formal valuation of the assets to verify the £67m assumption. In this financial analysis the debt term is flexed to maximise the speed at which debt is repaid whilst maintaining the initial £50m capital receipt, i.e. all else being equal, if revenue projections improve the model repays the debt earlier rather than allowing an increase in the amount borrowed.

The Council has provided two revenue and cost scenarios:

- **Base Case**: price harmonisation (similar price for Beach Huts assets with similar characteristics) in five years and capital investment programme from year 1; and
- **Base Case Plus**: involves acceleration of the price harmonisation to two years and capital investment programme from year 1.

Both key scenarios are compared to the financial outcome if the Council chose to “Do Nothing”. The “Do Nothing” scenario assumes the Beach Huts remain with the Council under existing management and ownership arrangements.

5.2 Debt capacity

Table 1 shows the amount the subsidiary could raise in the Base Case and Base Case Plus. The £51.6m debt amount includes £50m which will be paid to Council as a capital receipt under both scenarios. The additional £1.6m is sufficient to cover expected transaction costs and create a cash reserve to support certain potential downside scenarios should they arise.

The Base Case results in a required debt term of 25.25 years while the Base Case Plus allows for debt to be repaid over a shorter 22.5 year term:

Table 1: Debt raise summary

	Base Case	Base Case Plus
Pricing	Gilts + 1.05% (105 bps)	Gilts + 1.05% (105 bps)
Debt term (tenor)	25.25 years	22.5 years
Allowances for cash reserves	£0.8m	£0.9m
Transaction cost	£0.8m	£0.8m
Upfront capital receipt to BCP	£50.0m	£50.0m
Senior debt amount	**£51.6m**	**£51.7m**

5.3 Application of HMT Green Book in assessing quantitative value for money

As part of the Council's consideration of the value for money of the Transaction, the principles set out in the HMT Green Book (which provides guidance for public sector investment appraisal) have been applied.

For asset sales, the HMT Green Book provides three tests to indicate value for money, which are helpfully summarised in a National Audit Office report[3] into the sale of the Government student loans portfolio:

- the [Council] should satisfy itself that an efficient market exists for this asset and that this market appears to be functioning efficiently at the time of sale;
- the [Council] should ensure that sales are structured and executed in such a way as to promote efficient pricing; and
- the sale price needs to exceed or be broadly neutral when compared with the retention value to [the Council].

The logic behind the HM Treasury suggested approach can be summarised as if there is a well-functioning and liquid market for the asset class and there is otherwise no administrative or public policy reason to suggest that the assets will perform better in public ownership then the obtaining of a true market value for the assets is the overriding indicator of value for money.

Applying this logic to BCP's proposed Beach Hut transaction, the first two tests are broadly satisfied because:

- The sale will be at a market value with that valuation being subject to independent valuation by the Council. The independent valuation will help to determine the sale price to ensure it is in line with the market and that the price is not deflated or risk adjusted due to the market not functioning efficiently. There is a risk that as a relatively novel asset class that a premium will be applied to required return on capital by an investor, reducing its value from equivalent more established assets. Any reduction in value due to an inefficient market would need to be ignored when establishing a purchase price (i.e. a higher price paid) in order to indicate value for money.
- Any deferred proceeds for the sale (amounts not paid by the subsidiary at the point of sale) will be on market terms with a market determined interest rate applied.

The third of the NAO tests considers whether the value of the cash flows to the Council exceed or are broadly neutral following sale compared to the status quo, referred to as the "Do Nothing" scenario.

The HMT Green Book suggests a discounted cash flow approach to determining this and provides guidance on the discount rate to apply, suggesting a real discount rate of 3.5%, or 6.09% nominal. This represents a Treasury estimate of the Social Time Preference Rate, being the general preference to consume benefits now rather than later. Further detail is provided in appendix A6 of the HMT Green Book[4]. Importantly, it does not represent as estimate of the cost of capital for government or the public sector more broadly but an economic assessment of the time value of consumption.

In the analysis below, the HMT Green Book discount rate of 6.09%has been applied to the cashflows in the "Do Nothing" scenario and the Base Case. Following the HMT Green Book, the tax differential between options is ignored as this is an intragovernmental cash flow (as set out in paragraph A4.8 of the HMT Green Book). This is sometimes referred to as competitive neutrality, in that public sector organisations should not use their advantage from being non corporation tax paying entities in considering public versus private delivery options.

The net present value analysis includes an increase in asset value at the end of the period arising as a result of further investment in the Beach Huts. The value of the Beach Huts in a few years is inherently uncertain and no attempt has been made by KPMG to forecast a valuation in line with any formal

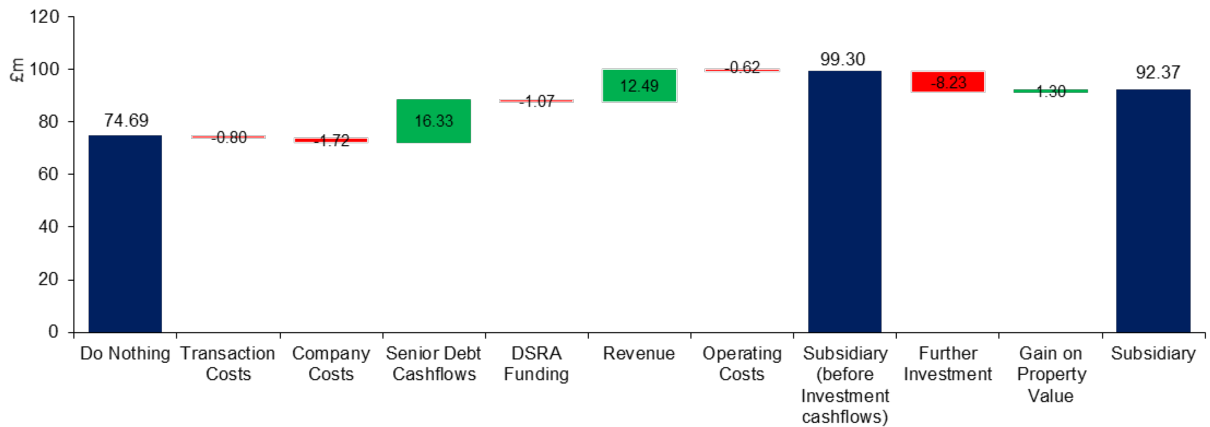
[3] The sale of student loans (nao.org.uk), The Sale of Student Loans, National Audit Office 20 July 2018

[4] The Green Book (publishing.service.gov.uk)

property valuation standards. A yield of 8% to net income of the Beach Huts has been applied at the end of the appraisal period to estimate the residual value of the assets. BCP may wish to seek further valuation advice on this although it is not material to the overall outcome. It is understood that the Council is in the process of securing a valuation.

We present the outcome in Figure 1.

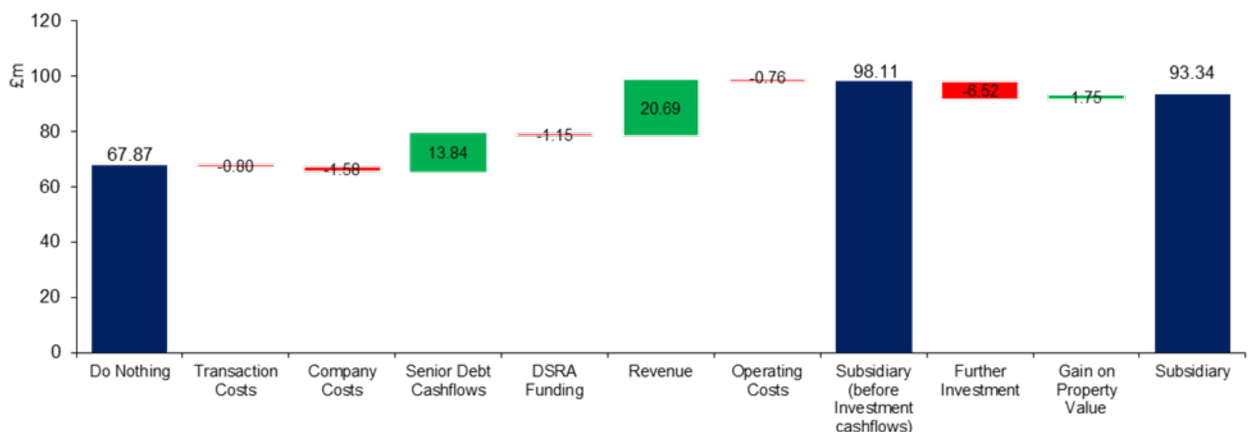
Figure 1 - Base Case 25 years (HMT Green Book)



The Base Case generates a NPV of Council cash flows of £92.4m vs £74.7m of the Do Nothing. This is primarily driven by enhanced revenue from commercialisation generating £12.5m of additional revenue and the added benefit of raising external debt financing at a lower cost of finance than the 6.09% discount rate.

In Figure 2, we present the outcome of the analysis for the Base Case Plus.

Figure 2 – Base Case Plus 22.5 years (HMT Green Book)



*We note that the NPV in the Base Case Plus scenario is slightly higher than the Base Case due to the lower tenor for the NPV analysis as a result of the debt being paid off quicker. However, if the tenor is the same as the Base Case (no debt for last 2.5 years) the NPV will be £99.7 vs £92.4 in the Base Case.

The Base Case Plus generates a NPV of £93.3m vs £67.9m. This is driven by lower debt rates generating positive returns for senior debt of £13.8m and enhanced revenue from commercialisation, generating £20.7m of additional revenue.

Using the HMT Green Book discount rate and suggested approach of neutralising the impact of tax, both the Base Case and Base Case Plus assumptions result in a material NPV advantage over Do Nothing.

Note that the NPV of the Do Nothing scenario differs under the Base Case and Base Case Plus as the NPV is assessed over the debt term and the debt term differs under each case. This is because the Council has stated their preference to repay outstanding debt as quickly as possible rather than increase the level of debt raised (which would be possible under the Base Case Plus). The period for the full repayment of debt represents an appropriate period to assess value for money over as at the point of full repayment the Council will own unencumbered assets in a wholly owned subsidiary and has flexibility to reassess the ownership structure at that point.

5.4 Alternative discounting approach

Whilst the HMT Green Book suggests a discount rate in calculating NPV of 6.09% nominal, this does not represent the actual cost of capital to the Council. The Council considers a more appropriate representation of its internal cost of capital is the cost of borrowing from the Public Works Loan Board (PWLB) for an equivalent duration.

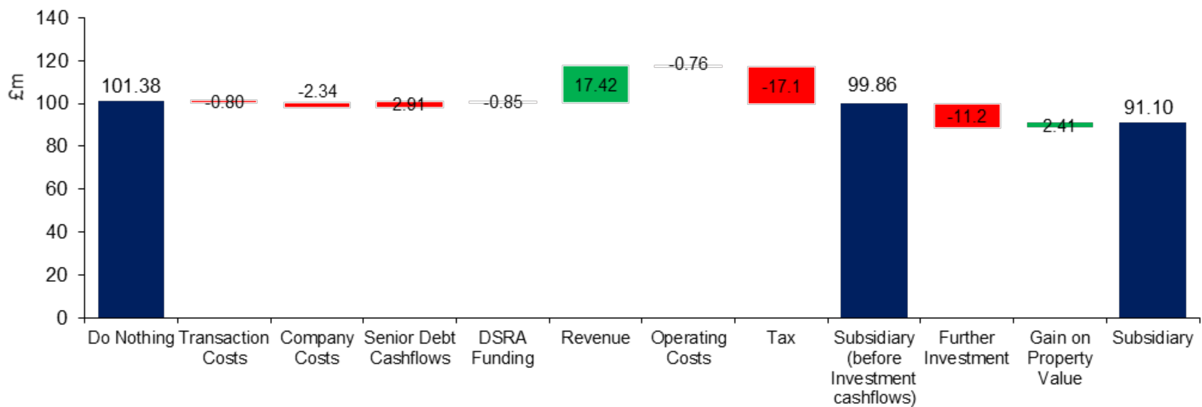
Whilst the HMT Green Book also neutralises the impact of tax, any tax paid by the subsidiary is a real cost to the subsidiary and therefore reduces return to the Council as its shareholder – regardless of whether this is ultimately payable to another public sector institution.

To assess the impact of the Transaction at the Council level KPMG has also provided an NPV analysis including the cost of tax within the subsidiary and using PWLB rates as the discount rate. This analysis benefits over the HMT Green Book assessment from being based on a better proxy for the actual financial costs and benefits to the Council. However, the use of the PWLB rate as a discount rate also has disadvantages:

- It is not necessarily a true cost of capital for the Council, in that it is not a market driven rate but a notional rate set by the Debt Management Office.
- Using a discount rate that is based on the cost of capital for the owner of the asset rather than the risk profile of the asset itself (i.e. the estimated return an investor would require for investing in the assets, after adjusting for any market illiquidity or inefficiency) can lead to unintended consequences. This is particularly acute for UK local authorities who have a very low cost of capital because of their large asset base and essentiality of service provision. Discounting assets held primarily for commercial reasons at a local authority cost of capital has the unintended consequence of resulting in a higher NPV for riskier assets which typically offer higher returns to compensate investors for higher risk. In other words, just because a local authority can borrow cheaply and invest in assets expected to generate higher returns doesn’t mean it should. This has been a well-discussed issue in recent years following an increase in local authorities borrowing cheaply and purchasing commercial assets for income generation purposes.

The cashflows from the Do Nothing scenario and the Transaction are discounted to present value at the PWLB rate of 3.50%.

Figure 3 – Base Case 25 years (PWLB)

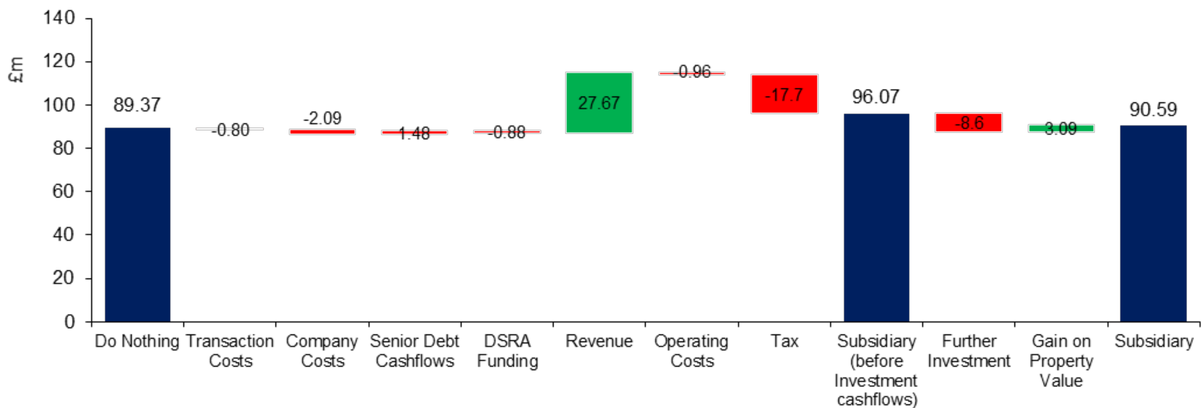


The above chart illustrates that the Council's returns generated in the Base Case result in an overall NPV deficit of £1.5m compared to the Do Nothing case before additional capital investment is made into the assets, and £10.3m once this further investment and gain on property value is taken into account.

The difference is mainly driven by a tax charge of £17.1m which offsets the additional revenue benefit.

Figure 4 shows the outcome of the Base Case Plus case using the PWLB borrowing rate as the discount rate.

Figure 4 - Base Case Plus 22.5 years (PWLB)



*We note that the NPV in the Base Case Plus scenario is lower than the Base Case as the debt is paid off quicker and hence assessed over a shorter period. However, if the tenor is the same as the Base Case (no debt for last 2.5 years) the NPV will be £99.4 vs £91.1 in the Base Case.

The Base Case Plus results in an overall NPV surplus of £6.7m in the Council's returns compared to the Do Nothing option before further investment into the Beach Hut assets is taken into account and £1.2m after this investment and the gain in property value.

5.5 In- House Harmonisation

The Council has also considered retaining the Beach Huts within the Council i.e., assuming they were not sold to the subsidiary, but attempting to better commercialise the running of the Beach Huts harmonise policies and prices.

This option would not generate a capital receipt to contribute towards Council capital budgets.

The Council considers that it would face more challenge to the increase in pricing as compared to an independent subsidiary.

5.6 Tax mitigation

Both the Base Case and the Base Case Plus result in a considerable level of corporation tax being payable by the subsidiary. The figures below show the projected tax charge incurred by the subsidiary. Further detailed tax analysis is found in section 8.

Figure 5 - Base Case tax charge

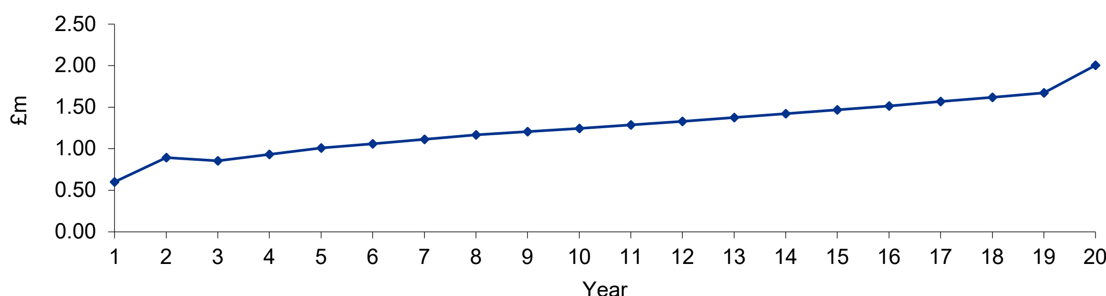
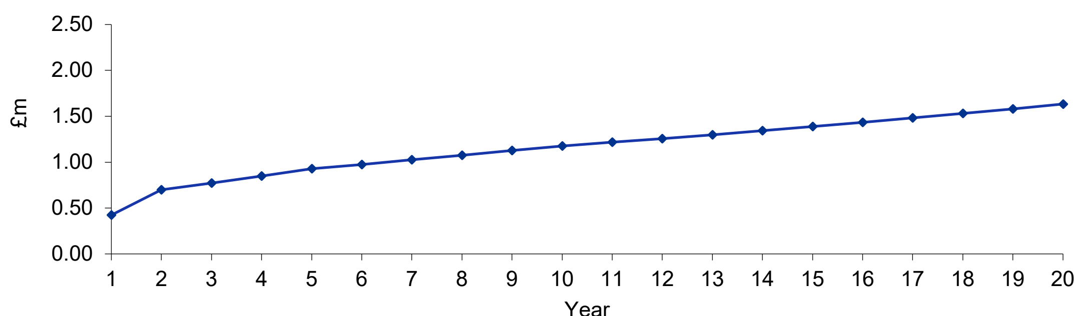


Figure 6 – Base Case Plus tax charge



The Council is considering the potential to reduce this tax obligation by means of the subsidiary using the Gift Aid scheme to donate to a local charity or charities rather than distribute cash as profit. Donations (via Gift Aid) to charities linked to the delivery of the Seafront Strategy should mean in theory that any such donations would be used in ways that would align with the charitable objectives of the charity concerned and thereby align with the Council objectives and benefit local residents and the Beach Hut amenities.

The structure involves making Gift Aid donations from taxable profits, hence reducing the tax liability. For every £1 donation, £0.20 (£0.25 from FY2023) is deducted from the subsidiary's tax liability.

The Council has asked KPMG to present the outcome of a "Gift Aid" scenario which involves donation of profits to a local charity and hence a Gift Aid tax exemption.

In this scenario, it is assumed that a charitable donation of taxable profits is made sized such that the corporate tax charge reduces to zero. Taxable profits are derived from profit before tax figures adjusted for non-deductible interest.

For the Council to benefit from any Gift Aid distributions to a charity it would need to spend its receipts in a way that would otherwise save the Council spend. The Council is separately investigating whether such spend opportunities exist. Any charity would need to be outside of BCP control.

The decision, whether to make charitable donation or not, would ultimately be for the subsidiary Board to make at the relevant time each year. The Directors of the SPV have a duty to the SPV and its shareholders but despite being the shareholder the Council would not ultimately have control over the distribution of the profits.

Figure 7 – Base Case with Gift Aid 20 years (PWLB)

Key	
	Cash flows to Council
	Cash flows to Charity

We note this scenario is presented over a 20-year period.

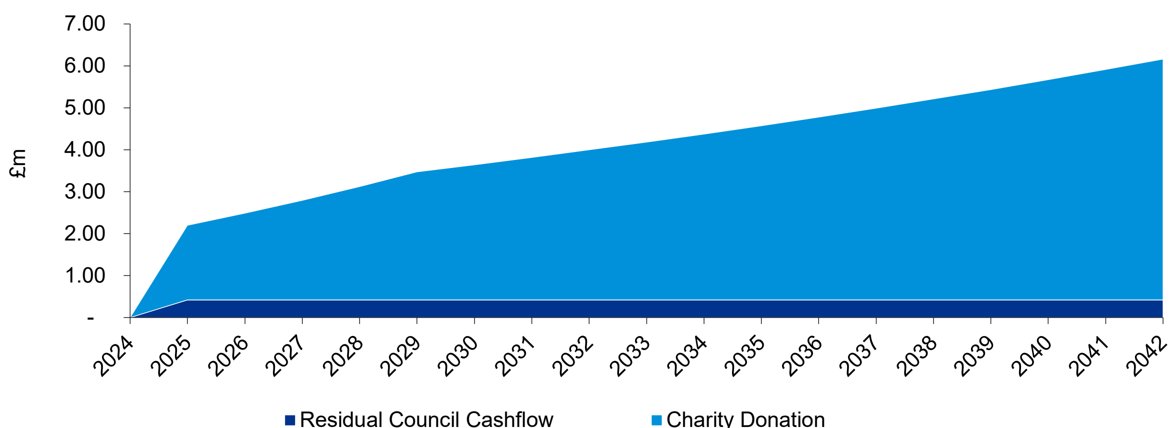
In this scenario, the majority of distributions that would otherwise be due to the Council would need to be donated to charity. Of the total £87.2m NPV of forecast distributions from the subsidiary, £32.8m would be made available to the Council with the remaining £54.4m assumed to be a donation to a local charity.

This scenario shows the level of charitable donations required to fully reduce the corporation tax charge to zero. The subsidiary could target any middle ground by making some gift aid payments but still paying some corporation tax.

Under this scenario the subsidiary would not be in a position to repay third party debt in full over the 20 year period as cash profits would need to be gift aided rather than used to fully repay debt. For the purposes of the NPV analysis, we assume the residual debt balance at the end of year 20 is a net cash outflow for the Council (i.e. the Council would settle the debt at that point).

The profile of gift aid distributions under this scenario is presented graphically below. The Council would need to determine whether suitable opportunities exist for the subsidiary to make donations to this profile such that they would benefit the residents of BCP.

Figure 8 - Distributions



To the extent that the charity or charities are undertaking works or services that would otherwise be paid for directly by the Council, they may have a worse VAT recoverability position than would be the case had the equivalent spend been made by the Council. This would need to be considered based on the specific situation at the time.

5.7 Impact on Council Capital and Revenue Budgets

The tables below indicate the impact on the Council's capital and revenue budgets of the Base Case and Base Case Plus case versus the Do Nothing option.

Both Base Case and Base Case Plus scenarios result in a capital receipt of £50m which could contribute towards BCP's transformation programme and would otherwise not be available to the Council as well as £450k per annum of investment in the Beach Huts to finance investment at no additional cost to the Council.

Table 2: Revenue Impact (Revenue to the Council £m)													
Year		**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Do Nothing	Net Income	0.00	4.32	4.44	4.57	4.69	4.82	4.98	5.15	5.32	5.50	5.68	**49.47**
	Total	**0.00**	**4.32**	**4.44**	**4.57**	**4.69**	**4.82**	**4.98**	**5.15**	**5.32**	**5.50**	**5.68**	**49.47**
Base case	Dividend	0.00	0.00	0.00	0.04	0.04	0.05	0.05	0.05	0.05	0.05	0.05	**0.38**
	Shareholder Loan Interest	0.00	0.80	0.79	0.82	0.82	0.82	0.81	0.80	0.79	0.78	0.77	**8.00**
	Guarantee Fee	0.00	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	**10.40**
	Total	**0.00**	**1.84**	**1.83**	**1.90**	**1.90**	**1.91**	**1.90**	**1.89**	**1.88**	**1.87**	**1.86**	**18.78**
	Net Impact vs Do Nothing	**0.00**	**(2.48)**	**(2.61)**	**(2.67)**	**(2.79)**	**(2.91)**	**(3.08)**	**(3.26)**	**(3.44)**	**(3.63)**	**(3.82)**	**(30.69)**
Base Case Plus	Dividend	0.00	0.05	0.05	0.05	0.05	0.05	0.06	0.06	0.06	0.06	0.06	**0.55**
	Shareholder Loan Interest	0.00	0.85	0.88	0.88	0.87	0.87	0.86	0.85	0.83	0.82	0.80	**8.51**
	Guarantee Fee	0.00	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	**9.50**
	Total	**0.00**	**1.85**	**1.88**	**1.88**	**1.87**	**1.87**	**1.87**	**1.86**	**1.84**	**1.83**	**1.81**	**18.56**
	Net Impact vs Do Nothing	**0.00**	**(2.47)**	**(2.56)**	**(2.69)**	**(2.82)**	**(2.95)**	**(3.11)**	**(3.29)**	**(3.48)**	**(3.67)**	**(3.87)**	**(30.91)**

Table 3: Capital Impact (Capital receipt to the Council £m)													
Year		**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Do Nothing		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Total	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**
Base case	Equity Contribution	(0.01)											**(0.01)**
	Shareholder Loan Drawdown	(17.04)											**(17.04)**
	Sale of Beach Huts	67.05											**67.05**
	Shareholder Loan Principal Repayment	0.00	0.00	0.00	0.01	0.07	0.13	0.16	0.20	0.24	0.28	0.32	**1.40**
	Total	**50.00**	**0.00**	**0.00**	**0.01**	**0.07**	**0.13**	**0.16**	**0.20**	**0.24**	**0.28**	**0.32**	**51.40**
Base Case Plus	Equity Contribution	(0.01)											**(0.01)**
	Shareholder Loan Drawdown	(17.04)											**(17.04)**
	Sale of Beach Huts	67.05											**67.05**
	Shareholder Loan Principal Repayment	0.00	0.00	0.02	0.08	0.12	0.18	0.22	0.27	0.32	0.37	0.42	**2.01**
	Total	**50.00**	**0.00**	**0.02**	**0.08**	**0.12**	**0.18**	**0.22**	**0.27**	**0.32**	**0.37**	**0.42**	**52.01**

5.8 Summary

The Transaction provides potential for considerable revenue generation above the Do Nothing option as a result of the commercialisation agenda. In the Base Case, an additional revenue of £12.5m (HMT Green Book discount rate) and £17.4m (PWLB discount rate) is generated. While in the Base Case Plus, this amount is £20.7m (HMT Green Book) and £27.7m (PWLB).

The outcome of the analysis based on Council assumptions and the HMT Green book methodology demonstrates that there is benefit to the Council of undertaking the Transaction. The Transaction generates an NPV (HMT Green Book) value of £92.4m (25 years) vs the Do-nothing of £74.7m.

This could be further enhanced from the Base Case Plus with an NPV (HMT Green Book) benefit of £25.47m over 22.5 years.

However, if the tax implications of the Transaction are taken into account and the Council’s cost of capital by reference to PWLB rates used as the discount rate the Base Case generates an NPV deficit of £10.3m and the Base Case Plus generates a benefit of £1.2m (PWLB) (22.5 years).

The Council should consider a range of measures in considering value for money, including the principles set out by HM Treasury relating to achieving market value for asset sales.

Section 8 of this report considers how the tax position could be optimised for the Transaction.

6 Governance considerations

The Council currently has several subsidiary companies including Bournemouth Building & Maintenance Limited ("BBML"), BCP Future Places Ltd (BFP") and Seascape Group Limited ("SGL").

The Council intends to implement a governance structure for the Beach Hut subsidiary that is in line with the structure used for its current subsidiary companies.

To aid the effective governance of the subsidiary, BCP will need to consider a range of factors when establishing the subsidiary including:

- **Shareholding**: It is assumed that the subsidiary will be incorporated as a company limited by shares to act as a wholly owned subsidiary of the Council with the Council as the sole shareholder. Therefore, the Council will have 100% of the shares in the company and ultimate control.
- **Board composition:** To ensure effective governance of the subsidiary, a qualified board will be put in place. In line with BCP's other companies, it is assumed that the board will consist of no less than three individuals. A board composition could consist of:
  - A chairman – could be a non-executive - who oversees the whole business
  - A managing director - employed by the subsidiary - who runs the Beach Huts. The managing director reports to the chairman and oversees the board of executive directors.
  - Executive directors of the subsidiary - who sit on the board and manage key areas of the business, such as finance and operations.
  - Non-executive directors - who advise on the strategic direction of the business.
- **Constitution:** The company will be formed using 'Articles of Association'/ 'Shareholders Agreement' and any resolutions and agreements affecting the company's constitution.
- **Articles of Association:** The Articles of Association will be the main integral governing document since it will specify the regulations for operations and define the subsidiary's purpose. The document will also lay out how tasks are to be accomplished within the subsidiary, including the process for appointing directors, frequency of board and shareholder meetings, powers and duties of directors and the handling of financial records.
- **Reserved matters** can be included in the constitution to set out those decisions by the board that will require the Council's approval. Typically, such matters are those that make a fundamental difference to the business. The Council can set out any specifics it wishes. As these reserved matters are set out in the Articles of Association or Shareholder Agreement, they could be inflexible once set. Examples of matters that can be considered include:
  - annual approval of the subsidiary business plan,
  - material variations from the company business plan to a pre-set variation in absolute (£) or relative terms (%),
  - material disposals of assets (with definitions of material and disposal including any pre-set value in absolute (£) or relative terms (%)),
  - capital expenditure other than approved in the annual business plan surpassing a pre-set value in absolute (£) or relative terms (%),
  - material third party contracts surpassing a pre-defined threshold,
  - decisions with material impacts on Key Performance Indicators (KPIs) outside of pre-set parameters,
  - changes to company objectives; and,
  - material changes to pricing strategy etc.
- **Reporting/ communication:** The Council as parent organisation will require regular reporting of matters to the board as a monitoring and oversight process. Typically, it would be expected to

see quarterly update reports for parties such as the Corporate and Community Overview and Scrutiny Committee or Place Overview and Scrutiny Committee on the performance of the subsidiary and its compliance with the established aims. The Council can also set Key Performance Indicators (KPIs) to monitor and track through an appointed committee or the Board actual outcomes against the original objectives. KPIs could be linked to the ongoing objectives of the subsidiary, the underlying operations and new activities as they arise.

- **Business Plan:** Typically a business plan/ budget is prepared annually by companies. The Council should require the company to prepare a prepare a business plan on an annual basis for a 3-5 year period for the approval of BCP.

7 Accounting

Introduction

- Only the Council and specifically its s151 officer can, in consultation with its external auditors as required, determine the accounting treatment appropriate to a specific transaction based on the facts and circumstances of that transaction at the time is it entered into.
- The potential accounting implications of the Transaction (Limited company subsidiary) described in this document for consideration by the Council are set out below. This is the potential accounting treatment by BCP of the proposed transaction in its single entity accounts under ACOP and the Capital Finance Regulations as they are currently understood to apply.

Capital expenditure and borrowing

- The subsidiary (even though a wholly owned subsidiary of the Council) will be a separate entity. Therefore, under the prudential regime – which applies only to the transactions which the Council is required to record in its own single entity accounts – there will be no capital expenditure or borrowing incurred by BCP as a consequence of the transaction. Specifically, it will not need to account for the external borrowing and acquisition of assets undertaken by the subsidiary, and such expenditure by the subsidiary will not score as capital outlay for the Council.
- Therefore, capital expenditure by the subsidiary on acquiring assets, and the external borrowing it undertakes to do so, will not fall to be capital expenditure by the Council.

Minimum Revenue Provision (MRP) / General Fund impacts

- As the Council will not be undertaking capital expenditure or borrowing in its own right, it will not be required to make an annual MRP charge, nor will it incur interest costs on borrowing in its General Fund ("GF").

Capital receipts considerations

- Under the proposed transaction the Council is disposing of certain assets to a wholly owned subsidiary of the Council, the subsidiary. The issue therefore arises whether the transaction gives rise to available Capital Receipts (as defined under by Capital Finance Regulations).
- Three objectives need to be met if the Council is to record capital receipts:
  - The Council must demonstrate that it has actually disposed of the underlying assets such that it is, under proper practices, required to derecognise the assets from its own single entity balance sheet (i.e., achieve a "true sale" to the subsidiary);
  - That were the Council to acquire the assets disposed of itself, that such an acquisition would fall to be capital expenditure; and
  - The consideration on the disposal of the assets must be in the form of cash. Under the Capital Finance Regulations only when cash is received, on the disposal of capital assets, can the Council recognise available Capital Receipts. Where the consideration is received in a form other than cash (say in the form of financial instruments) the Council will need to consider whether it has received Deferred Capital Receipts.
- These three conditions are considered further below in the context of the proposed transaction.

Achieving a "true sale"

- To achieve a "true sale" of the assets to the subsidiary the Council must demonstrate both that (i) it has transferred substantially all the risks and rewards incidental to the ownership of the assets to the subsidiary (i.e. that it is the subsidiary which benefits from the economic flows associated with those assets and can control them); and (ii) that the Council has not reabsorbed those risks and rewards through other means.
- The key risks and reward associated with the assets to be transferred to the subsidiary will be around (i) rental income; (ii) maintenance and life-cycle costs; and (iii) the residual value of the assets.

- Under the proposed transaction it will be the subsidiary, rather than the Council, which will be substantially exposed to the risks and rewards incidental to the ownership of the assets in that it will be the subsidiary (and through it, its external funders) that will take the risk:
  - On variations in both the gross income and the net income generated by the assets after deducting the costs incurred by the subsidiary on maintaining the assets and meeting its obligations to users of the assets; and
  - On the residual / market value of the underlying assets. This reflects that the Council, as a single entity, will not have the right to re-acquire the assets at a nominal or undervalue at a future point. Instead, it is intended that the disposal will not contain any rights for the Council to reacquire the assets from the subsidiary (but should such rights be granted to the Council they will only be exercisable at an independently established market valuation).
- The subsidiary will control the economic benefits generated by the assets as it will have the ability to determine and direct to what use those economic benefits are put. This includes the uses to which any profits generated from the assets are put (including their use to make charitable donations) which will be solely at the discretion of the directors of the subsidiary.
- As the Council will prima facie achieve a "true sale" of the assets, consideration needs to be given to whether (i) the provision of a limited guarantee by the Council to the subsidiary's external debt funders; and / or (ii) the acceptance by the Council of financial assets in (a debt obligation from) the subsidiary in part payment for the assets dilutes this transfer of the risks and rewards of ownership to the subsidiary.

Provision by the Council of guarantee

- The potential provision by the Council of a limited guarantee to the subsidiary is not considered to dilute the extent to which the risks and rewards inherent in the underlying assets are transferred on their disposal to the subsidiary.
- This reflects the fact that the guarantee will be designed to reimburse the subsidiary's external funders where the subsidiary's net income falls below a certain threshold. The threshold at which the Council's guarantee could be triggered has not yet been fixed. However, it has been assumed that the guarantee will apply where the net income of the subsidiary falls to 70% (or below) of the subsidiary's expected net income – namely, it will operate on a "last loss" basis. This means that it is the subsidiary (and its external funders) which bears any losses which might occur from all reasonably expected fluctuations in net income (i.e., the subsidiary and its funders must absorb the first 30% of any reduction in net income below that expected).
- Moreover, (i) the expected net revenues of the subsidiary will be based on a prudent and robust assessment of the expected income and costs associated with the assets (i.e. the net income threshold against which the 70% guarantee trigger will be assessed will not be artificially inflated); and (ii) the Council's guarantee can only be called after all the subsidiary's cash reserves and other income sources are exhausted or otherwise inadequate to meet the debt service requirements of the subsidiary's external funders.
- The "last loss" basis of the potential guarantee mechanism and the high threshold at which it is expected to apply would indicate that the guarantee is only likely to be triggered in remote (or at least highly unlikely) circumstances. Accordingly, it would be reasonable to conclude that the provision of the guarantee would not substantively dilute the transfer to the subsidiary of the risks and rewards of ownership of the underlying assets.

Acceptance by the Council of debt instruments in the subsidiary in part payment

- The Council will receive consideration for the assets as a mix of cash and a debt repayable by the subsidiary to the Council. The majority of the consideration is currently expected to be in the form of cash (rather than debt instruments). The Council's debt will be sub-ordinated to that provided by external investors to the subsidiary.
- The repayment of the debt due from the subsidiary will depend on the subsidiary's overall financial performance, which – at least in the initial stages of the subsidiary's development – will reflect the subsidiary's management of the assets it has acquired from the Council.
- This is not, however, considered to dilute the extent to which a "true sale" of the assets has been achieved. This reflects that:

- The subsidiary will remain in all circumstances liable for the repayment of the Council's loan (and interest on it). As such the risk that the asset performance is not sufficient to repay the loan (or, as is more likely, the subsidiary has to repay it with additional interest over a longer period than originally intended) is a risk retained by the subsidiary, whilst the Council is exposed to a credit risk in respect of the subsidiary as a business on its financial asset, rather than an ownership risk in the underlying assets;
- The Council's loan will not directly entitle it to share in any upside (i.e. rewards) associated with the assets, which will accrue solely to the subsidiary; and
- The Council's loan will be only be a for a minority of the fair value of the assets transferred to the subsidiary with the external debt holders providing the majority of the funding required to acquire the assets.
- Therefore, whilst the acceptance of a financial asset in the form of a debt instrument will expose the Council to credit risk in respect of the subsidiary, the Council will not be re-absorbing the majority of the risks and rewards associated with the underlying assets.

Conclusion

- The proposed structure would achieve a "true sale" of the underlying assets to the subsidiary.

Would the acquisition score as Capital if undertaken by the Council?

- As described by the Council the assets to be disposed of to the subsidiary, would be treated as capital expenditure by the Council if assets of this nature were acquired by the Council.
- This reflects that the fact that the assets would be (i) expected to be treated as a resource from which future economic benefits are expected to flow; and (ii) held by the Council for either the purposes of their service potential or income generating ability for a period of more than 1 year. As such they would be expected to be treated as either Property, Plant & Equipment, or Investment Properties under proper practices, and thereby fall to be capital expenditure for the purposes of the Capital Finance regulations.
- The acquisition of the assets (disposed of to the subsidiary) by the Council would be treated as capital outlay.

Is cash received?

- As currently proposed, the consideration received by the Council will consist of both cash and a deferred capital receipt in the form of the acceptance by the subsidiary of the obligation to repay a loan (and associated interest) to the Council.
- The proposed transaction assumes that the deferred capital receipt, in the form of a loan payable to the Council, will rank lower than the borrowing undertaken externally by the subsidiary to fund its payment of the cash component of the consideration payable to the Council on the transfer of the assets.
- Only that element of the consideration received in cash by the Council will score as Available Capital Receipts. To the extent that the consideration is received in the form of a loan asset, it will be treated as a Deferred Capital Receipt (which will not be an available resource to the Council to fund capital expenditure).
- The Deferred Capital Receipt recognised in respect of the receipt of a loan asset will be reclassified to being Available Capital Receipts only to the extent that the subsidiary repays the principal of that loan.

Treatment of other forms of non-cash consideration

- One approach under consideration is that the Council disposes of the assets in return for cash together with an obligation on the subsidiary to undertake specified services for the Council at no cost to the Council.
- Under this scenario the fair value of the consideration which the Council would need to recognise on the disposal would be the sum of the (i) the cash and any other financial assets received); and (ii) the fair value of the services to be provided by the subsidiary to (or on behalf of) the Council for which the Council will not be required to pay.

- The consideration received in the form of an undertaking by the subsidiary to provide future services at no further cost to the Council would be classified as a Deferred Capital Receipt (as the services will not yet have been provided).
- However, capital resources (such as those generated on the disposal of assets) cannot be used to fund revenue expenditure. Therefore, the Council cannot avoid the cost of services being treated as a charge to the General Fund because they are being provided in return for the transfer of capital assets. Therefore, as the services are provided by the subsidiary, the value of those services:
  - Is charged to the cost of services in the I&E, with a corresponding credit to the Capital Adjustment Account (CAA); and
  - The Council will reclassify a proportion of the Deferred Capital Receipts equal to value of the services received to Available Capital Receipts.
- This approach means that capital resources will not be improperly used to fund service provision and that the level of Available Capital Resources is appropriately stated.

Overall conclusions: Capital Receipts considerations

- The Council will achieve a "true sale" on the disposal of assets to the subsidiary in return for consideration in the form of cash consideration and the acceptance of a loan obligation by the subsidiary to the Council.
- The Council will recognise capital receipts to the extent it has received cash consideration. This reflects that no borrowing remains outstanding in respect of the assets being disposed and accordingly, the Council does not need to consider – on the grounds of prudence – setting aside a proportion of the Available Capital Receipts to the Capital Financing Reserve).
- This reflects that the prudential regime applies only to the Council's single entity (rather than group) accounts and that therefore cash consideration arising on asset disposals, even to a wholly owned subsidiary, will score as capital receipts (as the acquisition by the Council of those assets would score as capital expenditure).
- And s.21(3) of the Local Government Act 2003 requires that, in the event of conflict between statutory provisions and proper practices, that the statutory provisions (namely that capital receipts are recognised in respect of the cash consideration) will prevail.
- The consideration received by the Council in the form of a loan repayable by the subsidiary to the Council will be treated as Deferred Capital Receipts. These will only become Available Capital Receipts as loan principal is repaid by the subsidiary.
- If non-cash consideration is received in the form of an undertaking by the subsidiary to provide services to the Council at no cost to the Council, then (i) the fair value of those services will count as consideration on the disposal of assets and be recognised as Deferred Capital Receipts; and (ii) that consideration will not be available to fund service expenditure. Therefore, the fair value cost of the services will need to be charged to the I&E as they are provided (with a corresponding credit to the CAA).
- In preparing its group accounts, the Council – noting the application of s.21(3) of the LGA 2003 – will not apply group accounting in full as it will not eliminate those transactions between itself and the subsidiary which give rise to Available Capital Receipts and Deferred Capital Receipt balances in its single entity accounts. This is to ensure that the level of reserves shown in the group accounts is not artificially depressed by the elimination on consolidation of the Available and Deferred Capital reserves arising on transactions with the subsidiary.

Summary of accounting considerations arising on the disposal to the subsidiary

The preceding analysis has identified that in the Council's single entity accounts:

- The transfer of the assets to the subsidiary will in substance be a "true sale" of the assets; and that
- The Council will recognise a mix of Available and Deferred Capital receipts depending on the nature of the consideration received.
- As a disposal of the assets that Council will therefore need to derecognise the assets from its balance sheet and recognise a profit / loss on disposal in the I&E Account when the disposal is

complete (i.e., the risks and rewards and control of the assets have been transferred to the subsidiary);

- This will require that the carrying value of the assets (at the time of disposal) is removed from the balance sheet and debited to the I&E Account) and that the fair value of the total consideration received is credited to the I&E with corresponding debits to both cash and financial assets (loans) reflecting the split of the consideration between cash and financial assets;
- However, as the General Fund is not permitted to benefit (or suffer) from capital transactions the net impact of the disposal will need to be neutralised in the General Fund. This will require that – through the Movement in Reserves – the profit / loss on disposal is debited / credited (as appropriate) to the Capital Adjustment Account (CAA) with the cash proceeds being credited to Available Capital Receipts and non-cash consideration being credited to Deferred Capital Receipts.

Proper purpose considerations

- The Council will recognise Available Capital Receipts on the disposal of assets to its wholly owned subsidiary to the extent that the subsidiary pays cash consideration for those assets, which the subsidiary would fund by way of external borrowing.
- This requires the Council to consider whether the transaction is for a proper purpose (i.e. that it is not solely a device to generate available capital receipts funded by way of external debt).
- Whilst this is a matter on which the Council will need to satisfy itself, the current understanding is that the motivation for undertaking the transaction is for commercial and strategic reasons. The generation of available capital receipts is incidental to that core purpose. This reflects that:
  - The primary driver of BCP's proposed structure is the Council's strategic desire, as part of its wider transformation programme, to introduce significantly greater commerciality to its utilisation of assets and thereby increase the level of income and service benefits generated by its extensive asset base;
  - The subsidiary is a mechanism by which to collate those assets with scope for income and service benefit optimisation. BCP expects the subsidiary to grow and complement the Council's wider place-making agenda over time; and to this end
  - The subsidiary is likely to, within a robust overall governance and oversight framework which the Council will design and implement, have meaningful autonomy of action and greater flexibility to take rapid and market focussed decisions. This autonomy will be reflected in the subsidiary's Board of Directors and the management team which will run it on a day-to-day basis; and
  - The use of external funders to support the subsidiary is seen by the Council as not only a mechanism by which to introduce sharpened commercial disciplines but also to insulate the Council's finances and other activities from the subsidiary (as well as reinforce the subsidiary's autonomy) as the substantial majority of all the reasonably foreseeable risks and rewards associated with the assets will be borne by the external funders.
- Whilst this is a matter for the Council to decide upon, the current understanding of BCP's proposed structure would suggest that it is driven by a proper purpose and that the generation of available capital receipts is incidental to that purpose.

Other accounting considerations

The treatment of the Council guarantee

- The guarantee will fall to be a financial guarantee (as defined by IFRS 9) as it is assumed it will require the Council to reimburse the losses which would be incurred if a specified debtor (the subsidiary) fails to make payments due under a debt instrument (the subsidiary's loans from external investors).
- The Council will charge a market-based premium for the provision of the guarantee.
- Under IFRS 9 the Council will be required to:
  - Initially recognise the guarantee at its fair value on the balance sheet (i.e. as a liability). That liability is then unwound (or amortised) to the I&E as services are provided (i.e. it is a credit to the I&E). Where the guarantee is entered into on a commercial basis the fair value will be equal to the premium received; then

- A loss allowance is calculated for the guarantee. The loss allowance is a probability weighted risk-adjusted assessment of the likelihood of the guarantee being called on and the costs which would be expected to fall on the Council if it were (taking into account the potential for the Council to recover monies from others). There are two bases for the calculation of the loss allowance. The first is the life-time loss allowance, namely all the losses which could occur over the whole life of the guarantee; the second is the 12-month loss allowance which is a measure of the proportion of life-time losses which could occur due to default events over the next year; and then
- The guarantee is subsequently carried at the higher of (i) the initially recognised fair value less any amounts amortised to revenue; and (ii) the loss allowance calculated for the guarantee. This means that provided the initial fair value (less amounts amortised to revenue) remains greater than the loss allowance, no further provision is required.

The treatment of the loan between Council and the subsidiary

- A portion of the consideration provided by the subsidiary on the disposal of assets is in the form of the acceptance by the subsidiary of a loan obligation to the Council which will give rise to a financial asset and deferred capital receipt on the Council's balance sheet.
- The Council will need to account for its financial asset (loan to the subsidiary) under IFRS 9, on the amortised cost basis (as it is assumed that the Council's business model for holding the financial asset will be solely for payments of principal and interest).
- This will require the Council to make an appropriate Expected Credit Loss (ECL) provision (a probability weighted risk-adjusted assessment of the likelihood of credit losses arising on the loan) when the loan asset is first recognised. In this context it should be noted that:
  - Any increase in the ECL arising on the principal would not be expected to be a charge to the GF as the loan balance represents a deferred capital receipt (and the original asset disposed of was fully funded through capital resources). Any provision required in respect of unpaid interest would however be a charge to the I&E account; and
  - Interest income on the loan (measured on the effective interest rate method which will typically be the same as the nominal interest rate on the loan and at a commercial rate) will be credited to the I&E when earned. To the extent that the subsidiary has not paid interest due by the year-end, the Council will recognise a short-term financial receivable for the amount due.

8 Tax

Scope of work

The tax scope of work covers:

- ***Phase 1a*** – Outlining the tax implications of transferring the Beach Hut activity into a wholly owned SPV.
- ***Phase 1b*** – Review of the potential tax charge for the SPV, this will include:
  - High level comments on interest deductibility from a transfer pricing and Corporate Interest Restriction perspective, this will include consideration of the guarantee arrangements between BCP and the third-party lender.
  - High level comments on the proposed management charge from BCP to the SPV in respect of ongoing administrative services.
  - An outline of the potential tax issues in transferring additional obligations (and costs) into the SPV. Please note that further work will be needed to establish whether this is feasible from a legal and governance perspective, and therefore the comments are included in this report for discussion purposes only. It is recommended that legal advice is sought on the transfer of additional obligations.
- This analysis does not constitute formal transfer pricing advice or documentation and is for the purpose of the financial analysis exercise only to provide an indication of the tax relief available. The report will make recommendations where further work will be required if the project reaches implementation stage.
- ***Phase 2*** – Review of the tax charge in the financial model to ensure that the charge reflects the findings at Phase 1.

Assumptions

- A local authority is not liable to corporation tax. While it is expected that BCP will meet the definition of a local authority for these purposes as set out in s.1130 CTA 2010 (and reproduced in Appendix [1]), this should be confirmed by BCP.
- It is understood that BCP is not registered as a Royal Charter organisation however this should be confirmed by BCP.
- It is assumed that the accounting for the transaction will show a sale of assets by BCP and the acquisition of fixed assets by the subsidiary – the 'true sale' position referred to above. This is important, as corporation tax uses the accounting treatment as its starting position.

Tax analysis of transaction

Corporation tax

- There should be no corporation tax implications for BCP on the disposal of the Beach Hut assets to the subsidiary, as any gain arising will not be subject to tax as BCP is outside the scope of corporation tax.
- From the subsidiary's perspective, as the transfer takes place within a chargeable gains group (see definition below) it will transfer across on a no gain no loss basis. As such, the tax base cost in the asset for the subsidiary will be the original purchase price paid for the Beach Hut assets by BCP, as adjusted for any enhancement expenditure/disposals during BCP's ownership. In addition, 'indexation allowance' is available as a deduction from chargeable gains to reflect the impact of inflation, however it is only available up to 31 December 2017.
- A company, referred to as the `principal company of the group', and all its 75% subsidiaries form a chargeable gains group, together with any 75% subsidiaries of those subsidiaries. This 75% subsidiary requirement is in terms of beneficial ownership of ordinary share capital.
- In addition, a subsidiary can only be a group member if it is also an `effective 51% subsidiary' of the principal company. This means that the principal company must have a beneficial entitlement (either direct or indirect) to more than 50% of any: i) profits available for distribution to equity

holders of the subsidiary; and ii) assets of the subsidiary available for distribution to its equity holders on a winding-up.

- A company for these purposes includes (but is not limited to) a company within the meaning of the Companies Act 2006 or a company constituted under any other Act or a Royal Charter or letters patent or formed under the law of a foreign country. Note that a company without ordinary share capital may only be a member of a group as its principal company. As such, the Council will form a chargeable gains group with the SPV and the asset will transfer on a no gain no loss basis.
- A chargeable gains groups allows disposal of assets within the group to be transferred at nil gain/nil loss. The gains are therefore only taxed when the transferee leaves the chargeable gains group – known as a “de-grouping charge”.

Stamp duty land tax (‘SDLT’)

- Based on our understanding of the corporate group (i.e., the subsidiary will be associated with the Council in at least a 75% group relationship in terms of ordinary share capital and entitlement of equity holders to assets and profits) BCP and the subsidiary would qualify as being in a SDLT group relief group and therefore SDLT group relief should be available on the transfer subject to meeting the relevant conditions.
- These conditions include that there must be no arrangements in place at the time of the transfers for a change of control or de-grouping of subsidiary, for the consideration for the transfer to be provided or received by someone from outside of the group and that the transaction is carried out for bona fide commercial reasons and not for the avoidance of stamp duty, income tax, corporation tax, capital gains tax or SDLT.
- The SDLT return would have to be submitted to HMRC within 14 days of the transfer and it must declare on the return that the parties meet the conditions of ‘associated body corporates’ and therefore meet the requirements for SDLT group relief. We would recommend that the commercial rationale for transferring the property is documented, so that contemporaneous evidence can be provided in the event of an HMRC enquiry.

VAT

- Whether VAT is applied to the land will primarily depend on whether BCP has opted to tax the land.
- It is understood/anticipated that an option to tax will be in place prior to the land transfer to the SPV, and that it is expected that the transfer will meet the conditions for the Transfer of a Going Concern (‘TOGC’). Where the conditions are met, VAT will not be chargeable on the sale as the transaction will be outside the scope for VAT purposes.

Ongoing tax considerations for the subsidiary

Corporation tax

Tax administration

- On incorporation of the subsidiary, Companies House will notify HMRC of the company’s existence which will trigger the issuance of a notice (CT603) to file an annual corporation tax return (CT600). The corporation tax return is due for submission within 12 months from the end of the period of account. The corporation tax return gives details of the income a company has earned and the gains it has made, together with the calculation of the corporation tax liability. When a company submits its form CT600, it will also submit a set of accounts together with any other detailed analysis and computations necessary to show that the return is complete and correct and provides support for the figures included in the form CT600.
- Corporation tax returns are required to be filed online. A full copy of the company accounts, suitably ‘tagged’ in Inline eXtensible Business Reporting Language (iXBRL), must be filed online with the corporation tax return.
- The Subsidiary will be subject to corporation tax (currently at a rate of 19% but rising to 25% from April 2023) on taxable profits.
- As a general rule, corporation tax payable for an accounting period is due nine months and one day from the end of that period (e.g. 1 October 2023 for a 31 December 2022 year-end).

However, the Corporation Tax (Instalment Payments) Regulations set the due dates for payment of the total liability of companies which are defined as being large or very large and require payment of corporation tax in instalments, which can accelerate the payment dates.

Trading v property rental business

- It is understood that the portfolio of Beach Hut assets comprises of a range of occupation types being: 'Superhuts' which are operated on 25 long leaseholds, annual licences, casual occupancies which are booked for weekly blocks and overnight lodges.
- The Beach Huts themselves are not suitable for overnight use, in fact it is prohibited for the guests to do so, and there are no bathroom facilities available in each of the Beach Huts. In addition, it is understood that the Council currently provides public facilities (including public toilets) to the users of the Beach Huts but also to the general public that may visit the beach front.
- When considering the activity of the subsidiary, it must be established whether the activity is one of a 'trading' nature or whether the activity constitutes a 'property rental business'. The tax adjusted profits of each activity are broadly computed by reference to the same principles for tax purposes, but there are some slight differences when it comes to the use of losses and the availability of certain exemptions when it comes to the Corporate Interest Restriction ('CIR') rules.
- A property rental business is carried on by a person where they own an interest in land, and they enter into transactions that produce rents or other receipts from that land or property. However, where additional ancillary services are provided as part of the operation of the site then the activity is considered to amount to trading. As such, it is considered that the activity of the subsidiary is a trade for tax purposes, on the basis that the rentals are on a short-term basis, the subsidiary will provide ancillary services (which may be procured from the Council) such as the provision of public facilities to the customers, and the occupants have limited rights when it comes to the use of the property. HMRC manual PIM4300 provides specific examples of caravan sites and guest houses being treated as a trade for tax purposes.

Interest deductibility

- As the acquisition of the Beach Huts by the subsidiary will largely be debt funded by loans from BCP and third parties, consideration will need to be given to the tax relief that is available for interest and other financing costs.
- As a basic principle, interest payable by a UK company is normally deductible for corporation tax purposes in line with its recognition in the income statement in the company's GAAP compliant accounts under the "loan relationships" regime.
- However, deductibility of interest can be restricted under various UK corporation tax rules, including, in particular the:
  - Transfer pricing legislation (Part 4 TIOPA 2010);
  - Unallowable purpose rule (sections 441 & 442 CTA 2009);
  - Corporate Interest Restriction ('CIR') (Part 10 TIOPA).
  - Late paid interest rules (section 373 et seq CTA 2009)
- A commentary on the application of these provisions to the proposed funding arrangements for subsidiary is provided below.

Transfer Pricing

- It is understood that the third-party senior loans to the subsidiary will be guaranteed by BCP and that a guarantee fee will be charged to the subsidiary:
- Under the UK transfer pricing rules, tax deductions should be available for interest incurred on debt provided it is obtained on arm's length terms. If a related party transaction is not on arm's length terms, tax adjustments are required to disallow elements of the transaction which are not arm's length.
- The shareholder loan from BCP to the subsidiary and (by virtue of the guarantee arrangement in place) the senior loan to the subsidiary will be caught by the transfer pricing legislation and therefore will require documentation to be in place to demonstrate that:
  - both the amount of debt funding and the interest rates on the debt can be supported as arm's length; and

- that this debt funding would have been taken on at arm's length. The documentation should assist the position in the event of any challenge.

- The proposed gearing of the subsidiary of 100% is considered unsupportable from a transfer pricing perspective. The position of total gearing at 85% of the Beach Hut business valuation at the terms as currently modelled may be supportable as being aligned with the arm's length principle subject to certain financial ratios for transfer pricing purposes being met.
- The deemed non-arm's length element of shareholder debt (of 15%) should be excluded from any ratio calculations and any interest arising on the non-arm's length element will not be deductible for corporation tax purposes.
- The guarantee fee to be paid to BCP by the subsidiary in respect of the third-party senior loan is also subject to the UK transfer pricing rules. The indicative guarantee fee appears reasonable but should also be considered in detail as part of a transfer pricing study.
- This analysis does not constitute formal transfer pricing advice or documentation and is for the purpose of the financial analysis exercise only to provide an indication of the tax relief available. It is recommended that further work is undertaken to document the filing position to be taken in the subsidiary's tax computations and note that it would be necessary to reflect on the TP position on a period by period basis depending on the performance of the business.

Unallowable purpose

- The unallowable purposes rules can apply where the purposes for which a company is party to a loan includes an "unallowable purpose", which is broadly a purpose that is not amongst the company's business or other commercial purposes.
- If the rule applies, any debits attributable to the unallowable purpose (on a just and reasonable apportionment) are disallowed for corporation tax purposes.
- The question whether a company is party to a loan relationship for an "unallowable purpose" is a question of fact, which will need to be determined based on the precise circumstances of each case and therefore should be considered further once the exact funding arrangements are known as this will depend on the commercial nature of the funding arrangements between the subsidiary and the council.

Corporate Interest Restriction ('CIR')

- The CIR regime was introduced in April 2017 and can apply to further restrict tax relief that is available for interest costs – the CIR rules apply after transfer pricing and the unallowable purpose rules.
- Broadly, the CIR is applied at the level of the "worldwide group" for its "period of account" and then allocated to individual UK tax-paying companies within the group.
- A group will only suffer a disallowance to the extent that its "aggregate net tax-interest expense" ("ANTIE") (i.e. broadly, net tax deductible interest-like expenses across the group) exceeds its "interest capacity" for the period.
- Subject to carry forward rules, the "interest capacity" is calculated as the lower of:
  - 30% of the group's "aggregate tax-EBITDA", broadly, the group's taxable earnings before relief for tax-interest expenses, capital allowances, intangibles amortisation and certain other specific tax reliefs; and
  - The group's "adjusted net group-interest expense" ("ANGIE"), broadly, the net finance cost recognised in P&L in the group's financial statements in respect of finance transactions, subject to certain adjustments,
  - but subject to a minimum "interest capacity" of £2m p/a.
- However, it is also possible for a group to make a "group ratio election", under which the "interest capacity" for the period is calculated as the lower of:
  - The group's "qualifying net group-interest expense" ("QNGIE"), broadly, the group's ANGIE, but excluding certain types of expenses (including related party finance costs); and
  - The "group ratio percentage" of the group's aggregate tax-EBITDA, which is defined as QNGIE divided by "group EBITDA" (broadly, based on the group's PBT in its financial statements, subject to certain adjustments).

- It is the current intention for BCP to provide a guarantee to the third-party lender, in order to increase the subsidiary's borrowing capacity. Where an entity borrows from a third party, and that loan is subject to a guarantee from a related party, the third-party loan is treated as though it is a related party loan for the purpose of calculating QNGIE. As such. If the only interest costs in the subsidiary are the amounts payable to BCP on the sub-ordinated debt, and the interest payable on the senior debt (which is guaranteed by BCP) it is unlikely that the group ratio method will improve the interest capacity of subsidiary.
- Based on the numbers currently being modelled, it is expected that the subsidiary will suffer a tax restriction on interest costs based upon the fixed ratio method (being 30% of tax-EBITDA). Tax relief for interest will be limited to the £2m de-minimis, and any amounts disallowed in the subsidiary will be carried forward and should be available to "reactivate" in later periods where there is increased interest capacity as the senior debt is repaid and the interest costs reduce. In theory, it should be possible to take tax relief for the amounts of interest disallowed under the CIR rules over the 20-year life of the project.
- The CIR position should be remodelled once the exact funding arrangements are known. In addition, please note that the Corporate Interest Restriction would need to be considered on an annual basis outside of this exercise.

Late paid interest rules

- Where a close company, being one under the control of five or fewer persons, accrues for interest payable on a loan to one of those persons, corporation tax relief may be deferred, unless it is paid within 12 months of the company's year end.
- These rules will apply to any interest payable by SPV to BCP due to the fact that BCP is exempt from corporation tax and thus does not 'bring into account' the income for tax purposes. In addition, these rules use a definition of 'company' which does not include a local authority.

Management services provided by BCP to the subsidiary

- It is understood that the BCP will provide some ongoing administrative services to the subsidiary (for example, accounting support, IT, marketing, maintenance, legal services etc) and that a charge will be made to the subsidiary from BCP for these services. We understand that BCP has entered into a Service Level Agreement with other existing subsidiaries for similar services. Currently no charge has been reflected in the financial analysis.
- Any such charge will be subject to the transfer pricing provisions and will need to be supportable as being on an arm's length basis in order for tax relief to be claimed in the subsidiary.

Tax reliefs and allowances

Group relief

- Group relief allows losses to be surrendered from loss-making companies to profitable companies in the same 75% group. This applies to current year losses but has been extended to carried forward losses from 1 April 2017.
- For group relief to apply, one company must be a 75% subsidiary of the other, or they must both be 75% of a third company.
- A company is a 75% subsidiary of another company for corporation tax purposes when all three of the following conditions are met:
  - The parent company has at least 75% ownership of the ordinary share capital of the company; and
  - The parent is beneficially entitled to at least 75% or 90% of any profits available for distribution to equity holders of the subsidiary, and
  - Those shares entitle the holder to at least 75% of the company's assets that are available or distribution to the equity holders on a winding up.
- As per the group structure provided (included in Appendix 3), it is understood that the subsidiaries included in the appendix are all wholly owned by the Council.
- Looking at the subsidiary accounts on Companies House (without sight of the tax computations for these entities) it is noted that there are potentially losses in Seascape Group Limited and Seascape Home Property Limited that could be surrendered to the subsidiary to reduce the

taxable profits, however they are relatively small amounts in the context of the expected profits of the subsidiary.

- The Finance (No. 2) Act 2017 introduced reformed corporate loss rules into UK legislation. The new rules broadly achieve two main aims:
  - They introduce a restriction on the use of carried forward losses against profits arising from 1 April 2017, which essentially means a company's "relevant profits" can only be reduced by 50% by brought forward losses. Each company or group is entitled to a deductions allowance of £5 million annually apportioned for periods of less than a year. A group for tax purposes is broadly the current definition of a group relief group but with a broader definition to include non-corporate or non-share entities.
  - They give greater flexibility in the use of losses that arise after 1 April 2017.
- The loss relaxation measure applies for carried-forward losses arising on or after 1 April 2017. This applies to: trade losses, non-trading loan relationship deficits ("NTLRDs"), non-trading losses on intangible fixed assets ("NTLIFAs"), and management expenses.
- Losses arising from 1 April 2017 can be set against total profits of the company or can be offset against the profits of other group companies arising in the same period or future periods.

Capital allowances

- The subsidiary could potentially claim capital allowances on the Beach Hut assets and on other qualifying plant and machinery. A brief overview of capital allowances is set out below.
- Capital allowance claims (including amended claims and withdrawal of claims) must be made in a company's return, or in an amended return, for the accounting period for which the claim is made. The company may claim less than the full amount available, however the full amount claimed must be specified.
- When a company incurs expenditure of a capital nature, such costs are not deductible from trading profits because the expenditure will have an 'enduring benefit' for the trade.
- Instead, where a company employs capital assets for use in the business (eg machinery and motor vehicles), it receives a measure of relief in the form of 'capital allowances'. Capital allowances are also available for buildings (and structures) used by a business, where construction begins on or after 29 October 2018.
- Capital allowances cannot be claimed on land. Therefore as the majority of the market value of the Beach Huts is tied up in the land value, it is expected that the quantum of capital allowances relief will be limited.
- Capital allowances are not available in respect of residential property. While ordinarily the Beach Huts are not expected to be viewed as residential property, to the extent that they do, then capital allowances may alternatively be allowed by reason of them amounting to 'furnished holiday lettings'. This legislation has detailed requirements that need to be met concerning the time during a year for which they are available for use, are actually in use, and are not used excessively by a single customer. Guidance on this specific matter can be provided as required.
- In order for the subsidiary to claim any capital allowances on the fixtures in the Beach Huts, the Council will have to ensure the pooling requirement is met.
- The pooling requirement is that the seller has previously either:
  - claimed a First Year Allowance or the Annual Investment Allowance on the fixtures; or
  - allocated the cost of the fixtures to a capital allowance pool (even if no written down allowance has been claimed on them, it is sufficient that HMRC have been formally notified of them within a tax return).
- Capital allowances are not available to any future purchaser on any part of the seller's qualifying expenditure in respect of fixtures that have not been pooled.

Qualifying charitable donations

- Where the subsidiary makes a taxable profit, this tax liability may be mitigated by use of making a charitable donation to a registered charity.
- CTA10/S189 allows the deduction of qualifying charitable donations from a company's total profits computing CT chargeable for the accounting period in which they are paid.

- The maximum payment in respect of QCDs that could be made to mitigate the tax liability is the taxable profits in the year, any unutilised QCDs will not carry forward as a tax asset of the entity making the donation.
- BCP has stated that under Charity Law, the Council cannot discharge a statutory function by making a donation to a charity.
- The charity would need to review its own position in relation to the VAT recovery on costs that it incurs, in the context of the nature of supplies that it provides.

Additional assets/activity to be transferred into the subsidiary

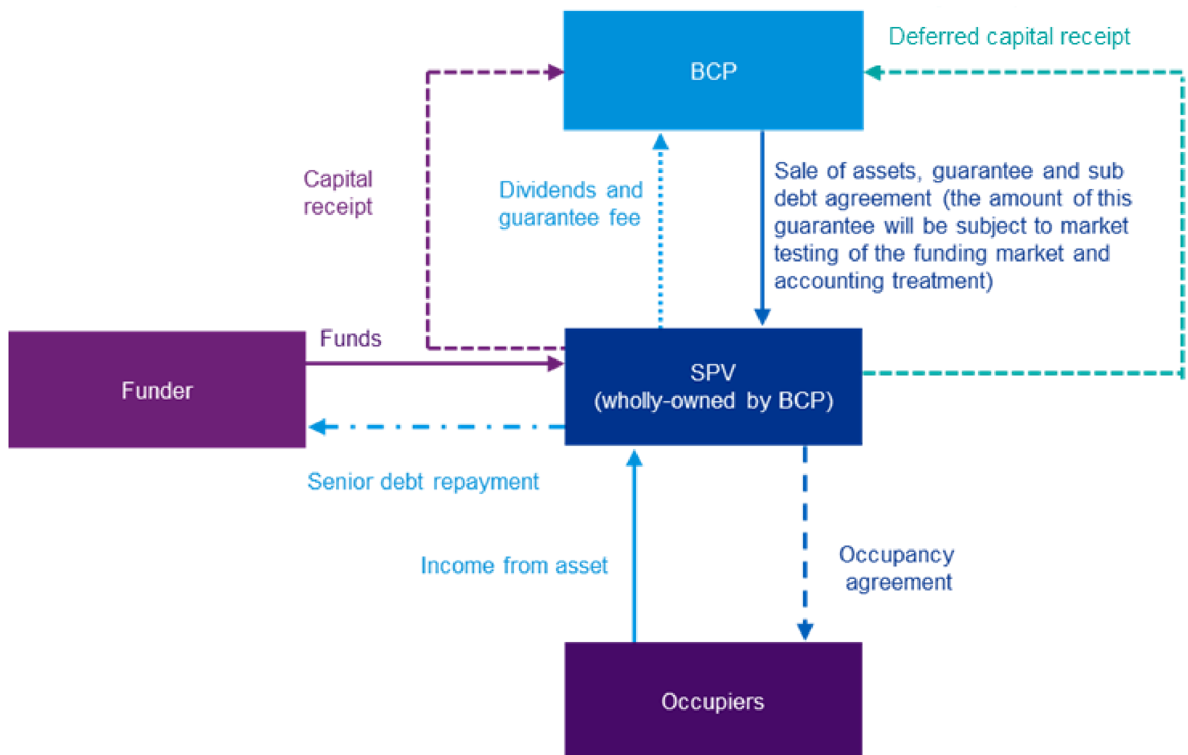
- Turning to the tax implications of the subsidiary undertaking additional ancillary services in relation to maintaining the beach front area. It is understood that certain services are currently undertaken by the Council which in part, benefit the users of the Beach Huts, but are more generally available to the public.
- Allowing the Beach Hut subsidiary to perform additional ancillary services is primarily a commercial decision, and BCP should seek legal advice to understand the extent to which this is legally possible and also consider the accounting implications of such a transfer.
- In order to comment on the tax implications more fully, the subsidiary would need to establish the ongoing arrangements with the Council, the impact of transferring an obligation to the subsidiary alongside the Beach Huts (and the impact on the valuation of those assets) and whether this would create income in the subsidiary to the extent that the subsidiary is providing a service to the Council.
- From a purely corporate tax perspective, the subsidiary and the Council should be alert to the following tax risks:
  - If the costs are not incurred for the purpose of the subsidiary's trade or are incurred on an uncommercial basis, they are likely to be disallowed for tax purposes as they are not incurred "wholly and exclusively" the purpose of subsidiary's trade.
  - Alternatively, if the Council transfers some of its services to the subsidiary while retaining the obligation to deliver those services to the public, then HMRC would expect the subsidiary to charge the Council for the delivery of those services on an arm's length basis. This would likely result in additional taxable profits in the subsidiary.
  - To the extent that the obligation to deliver ancillary services is transferred alongside the Beach Hut assets, one would expect this to reduce the aggregate value of the assets being transferred. A third party valuation might be thought appropriate to confirm this matter. This may have an implication for the transfer pricing analysis on interest deductibility costs, as the overall project gearing, specifically the Loan to Value ratio will be increased. In addition, where the subsidiary is incurring additional cost this will impact the subsidiary's ability to service the interest which may further impact the transfer pricing analysis.
  - Depending on the accounting analysis of the potential transfer, there is a risk that the obligation to deliver services to the council is recognised as a liability on the balance sheet of the subsidiary which would be unwound over the term of the arrangements. To the extent that this is effectively accrued income for the subsidiary, this would result in additional taxable profits in the subsidiary.

VAT

The provision of holiday accommodation is a standard rated activity and therefore the subsidiary will need to account for VAT on charges to its customers. As a result, the subsidiary will be able to recover VAT on costs incurred in relation to the provision of those services.

- To the extent that additional activities are transferred to the SPV that do not relate to the provision of holiday accommodation, the VAT incurred on such costs would likely be irrecoverable as they are not related to the trade. Further analysis would be needed once the exact fact pattern is known.

Appendix 1 Structure



Appendix 2 Key assumptions

(Updated June 2022)

This appendix states the key assumptions which were provided by or agreed with the Council following further work undertaken by the Council after the previous KPMG report. The figures have been extrapolated over a likely debt term to get an indication on how much capital the subsidiary could raise.

- **Purchase price of assets:** BCP has provided the book value of the assets. It is noted that to achieve the desired accounting treatment and meet the Council's best value requirements, the assets will need to be transferred at fair value. In the absence of a formal valuation of the assets, a capitalisation method agreed by the Council has been used to estimate the value of the assets. This will need to be replaced by a formal valuation if the Project is progressed. To provide a high-level estimate of the fair value a net initial yield of 8% was applied to the 2021 annual income of £5.4m. This results in a proxy for fair value of £67m which is used in this report. The net initial yield of 8% reflects the non-prime purpose-built student accommodation in regional locations according to CBRE in Residential Investments Q3' 2021. This yield has been used since there are limited large scale transactions similar to the Beach Hut asset class. Additionally, the assets have similarities to student accommodation, such as a stable income stream, low operating cost base and a waiting list in most cases.
- **Asset base:** BCP has worked with its legal team and estimates that not all of the Beach Huts will be transferred to the subsidiary due to leasing arrangements. The current estimate stands at 3,461 huts (out of 3,749).
- **Inflation:** The Office for Budget Responsibility ("OBR") RPI forecast was considered. The OBR provides forecasts for inflation. In the forecast as of 9th May 2022, which covers the period until Q1 2027, RPI has a maximum rate of 5.12% and then stabilises in the latter years to around 2.74%. A compound average rate was calculated using the OBR forecasts for RPI. This results in a rate of approximately 3.33%.
- **Revenue forecast (Do Nothing scenario):** BCP has provided a revenue forecast for 5 years which it is understood assumes an increase in the number of assets. For the analysis, BCP has confirmed that the budgeted revenue estimate for year 2022/23 should be increased by an inflation rate of 3.33% for each year over the appraisal period.
- **Revenue forecast (Base Case):** BCP has provided a revenue forecast for 5 years should the Transaction proceed. This considers an increase in the income derived from the assets taking into account price and policy harmonisation across the geographical areas BCP controls. In the first 5 years, the Council has requested that a 5-year weighted average price increase of 6.2% is applied year on year with harmonisation of prices completed in year 2027/28. For year 2028/29 onwards BCP requested that the revenue be increased by an inflation rate of 3.33% for each year over the remaining period.
- **Operating and maintenance cost (Do Nothing scenario):** BCP has provided an expenditure forecast for 5 years. For the analysis, BCP has advised to increase the budgeted direct costs and indirect costs estimate for year 2022/23 by 5.63% and 5.40% respectively for each of the first 5 years, then by inflation of 3.33% pa. over the remainder of the period.
- **Operating and maintenance cost (Base Case):** BCP has provided an expenditure forecast for 5 years which it is understood assumes an increase in assets. For the analysis, BCP requested that the budgeted direct costs and indirect costs estimate for year 2022/23 be increased by 3.45% and 2.12% for each of the first 5 years, then by inflation of 3.33% pa. over the remainder of the period. These costs include an investment into Beach Hut assets which pushes the total costs in the base year (2022/23) to £1.62m from £1.01m (Do nothing).

- **Subsidiary /Company costs:** BCP has provided a budget estimate for annual company costs. The year 2022/23 figure has been taken and increased by BCP's projected cost growth rate of 5.6% for the first 5 years. BCP has also instructed that after the first 5 years, an inflation rate of 3.33% is used for the remainder of the period.
- **Tax:** For corporation tax, a tax rate of 20% (25% as of year 2023/24 onwards) was applied simply to any annual surplus. Senior debt interest is deemed to be deductible but interest on subordinated debt payable to the Council is not totally deductible due to transfer pricing rules (see Tax section). In addition, as a company liable to corporation tax, the corporation interest rate restriction rules may apply, total interest in a given year may be deductible to the extent of the lower of £2m and deductible interest after transfer pricing rules are considered. Please see tax section for detailed rulings.
- **Lease:** It is assumed that the leasehold is of at least 99 years (and more likely 125 years+) and therefore represents a true disposal of land interest.
- **Discount rate:** A discount rate of PWLB gilts + 80bps has been used, which is between 2.50% and 3.00%, instead of the HMT Green Book rate of 6.09% (nominal). The PWLB rate reflects BCP's cost of capital, and this rate is adjusted daily. The HMT Green Book rate is based on the economic concept of a Social Time Preference Rate. Given this analysis is a financial one and not an economic analysis, KPMG has agreed with BCP that the PWLB is a better measure for this purpose. The HMT Green Book rate has not changed in several years despite a reducing interest rate environment. Note that using the HMT Green Book rate, the NPC analysis for the proposals would be more favourable.

Input assumptions				
	Previous Report	**Do Nothing**	**Subsidiary (Base Case)**	**Base Case Plus**
Revenue	£5.83m	£5.22m	£5.22m	£5.22m
Operating Costs (Direct / Indirect)	£0.72m	£1.01m	£1.62m	£1.62m
Company Costs	£0.1m	-	£0.09m	£0.09m
Inflation rates	2.90%	3.33%	3.33%	3.33%
Growth rates first 5 years				
Revenue		3.33%	5.88%	12.60% (2 years) / 5.22% (3 years)
Operating Costs (Direct / Indirect)		5.63% / 5.4%	3.45% / 2.12%	5.67% / 2.12%
Company Costs		-	5.60%	5.60%

Appendix 3 Debt assumptions

Debt assumptions		
	Definition	**BCP guarantee**
Tenor	Number of years to pay the senior debt back	25 years (Base Case) / 22.5 years (Base Case Plus)
Repayment profile	The profile under which debt is repaid and whether it is repaid in full over the tenor of the debt.	Repaid in full over the debt term with a sculpted amortisation profile to hit the Debt Service Cover Ratio.
Transaction cost	Transaction costs are cost related with executing the financing transaction. This includes legal fees, financial advice, etc. These costs will be reimbursed by the funder at financial close.	800k
Inflation hedging	Private placements can be structured as fixed rate, index linked or combination of both.	Fixed
Debt Service Cover Ratio	This is the ratio of a Project's CFADS to its debt service obligations.	1.3x
Debt Service Reserve Account ('DSRA')	DSRA provides for some cash (enough to meet the next debt service payment, generally 6-12 months) to be set aside to provide liquidity and secured in favour of lenders	6 months
Guarantee fee	A guarantee fee is the amount charged by BCP for providing a guarantee to the subsidiary. It is assumed that this is the difference in margin between the guarantee and no guarantee debt option equivalent. In this case 1.25%.	1.95%

- **Subordinated debt (deferred capital receipt):** Sub-ordinated debt is debt that ranks after senior debt for interest and repayment. For the proposed structure, the subsidiary will have to purchase the assets from BCP at a purchase price which represents fair value. As such, a sub-debt from BCP to the subsidiary will be required to make up for the difference between purchase price and the amount of senior funding. In the analysis, the sub-debt is priced at a coupon of 2.58%. This is derived to ensure the subsidiary is able to service the debt without roll up of interest costs through the appraisal period. This is indicative only and not material to the overall analysis at this stage. In the scenario run, the subsidiary is able to repay all interest of the sub-ordinated debt as it falls due.
- **Dividend:** Based on the DSCR levels for the proposed transaction, taking into account the other assumptions, there will be a surplus after servicing the senior debt. This amount will be returned to BCP as a combination of the sub-debt repayment, sub-debt interest, guarantee fee and dividend.

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