

Introduction

13.001 During the past year, the following matters have arisen in connection with operation of local authority trading enterprises (LATEs):

- a change in the statutory definition of a LATE;
- restrictions on councils lending to LATEs; and
- sale of LATEs immediately after the end of a financial year and the effect on accountability.

13.002 This article provides information that will be useful to both local authorities and LATEs.

Change in the Definition of a LATE

13.003 When the Local Government Act 1974 was amended in 1989 to permit the establishment of LATEs, it was intended that council-controlled businesses should face the same commercial pressures as any other business, including the requirement to pay tax. However, it became evident that, because of the broad legal meaning of “charity”, most activities carried out by LATEs could be structured to obtain tax-exempt status.

13.004 To prevent this, an amendment to the law was included as section 3 of the Taxation (Remedial Provisions) Act 1998. However, because of the broad definition of a LATE, it became apparent that a number of non-business charities would lose their tax-exempt status. This was an unintended effect. Therefore, it was necessary to review the definition of a LATE, so that only appropriate entities would be categorised as LATEs.

13.005 The definition of a LATE was changed with effect from 1 April 1999 by the Local Government Amendment Act 1999. A LATE can still be in the form of either a *company* or an *organisation*. A *company* must be one in which equity securities carrying 50% or more of the voting rights are held or controlled (directly or indirectly) by one or more local authorities. An *organisation* must operate a trading undertaking with the intention or purpose of making a profit, and must be subject

to significant control (directly or indirectly) by one of more local authorities.

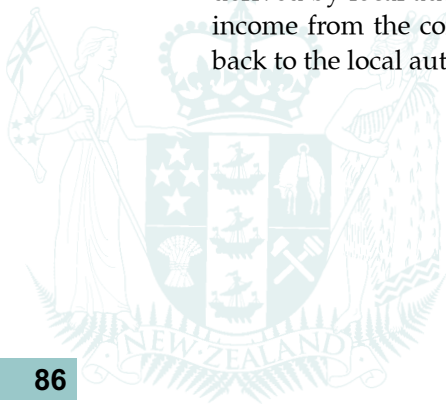
13.006 The new definition redefines “significant control”. There are two aspects to the new definition:

- Where there is control of 50 percent or more of the votes at any meeting of the members or controlling body of an organisation. Previously, only 30 percent was required.
- Alternatively, if there is a right to appoint half or more of the trustees, directors, or managers (however described) of the organisation – whether or not jointly with other local authorities or persons. Previously, the definition referred to the right to appoint trustees, directors or managers without stipulating how many.

13.007 The impact of this change is that council-controlled non-profit trading organisations no longer meet the definition of a LATE. Also, profit-oriented trading undertakings – other than companies where councils have between 30 and 49% of the voting rights and do not have the power to appoint half or more of the trustees, directors, managers or similar – now fall outside the definition.

13.008 Subsidiaries of port companies are now expressly excluded from the definition.

13.009 The changed definition of a LATE is appropriate for accountability purposes and is considered as being generally appropriate for tax purposes. However, in some situations organisations that are not LATEs may have control of LATEs. In these cases, the controlling organisation is treated as a LATE for tax purposes. This is provided by the Income Tax Amendment Act 1999. The intention is to ensure that all income derived by local authorities from LATEs is taxed; otherwise income from the controlling organisation could be directed back to the local authority without being taxed.



Restrictions on Council Lending to LATEs

13.010 Section 594ZPA of the Local Government Act 1974 restricts lending to LATEs by local authorities. The section says that no local authority shall lend money to a LATE, or provide any other financial accommodation to a LATE, on terms and conditions that are more favourable to the LATE than those that would apply if the local authority were (without charging any rate or rate revenue as a security) borrowing the money or obtaining financial accommodation.

13.011 We sought legal advice to determine the practical effects of this provision. On the basis of this advice, we take section 594ZPA to mean that:

- Local authorities are not able to provide financial accommodation to LATEs other than on commercial terms.
- The restrictions do not generally apply to loans that were already in existence when section 594ZPA was enacted. However, when these loans come up for renewal or reach a point in their term when the interest rate can be reassessed, the restriction applies.
- Interest-free loans repayable on demand, or for which interest is payable only on demand, are probably now in breach of this restriction.

13.012 We urge all local authorities and LATEs to reassess any lending arrangements in the light of section 594ZPA.

Sale of a LATE Immediately After the End of a Financial Year, and the Effect on Accountability

13.013 An issue arose during the year regarding the accountability for and reporting of LATEs that are sold by councils immediately after balance date. The questions arose as to a council's accountability for the LATE as at balance date, and the reporting requirements of the LATE itself.

- 13.014** Councils are required to produce consolidated financial statements for themselves and their LATEs for each financial year. Despite the fact that the LATE in the case under review was sold on the day immediately following balance date, it was still held by the council during the financial year. On this basis, the council concerned was still required to account for the LATE as part of its consolidated financial statements for the financial year.
- 13.015** Section 594z of the Local Government Act requires the directors of each LATE, within three months of the end of each financial year, to deliver to the shareholders and make available to the public an annual report (including audited financial statements) for that financial year.
- 13.016** There is a question as to whether this section applies when a LATE has been sold within three months after balance date. On the one hand, it may be appropriate for the reporting requirements in section 594z to be met, given that the public and (former) shareholders have an interest in the performance of the LATE for the financial year. On the other hand, it is arguable that, when a council sells a LATE it forgoes its entitlement to have certain information reported to it, and any reporting to the public should be done at council level through the council's annual report.
- 13.017** There is also a question as to who should sign the financial statements of the sold LATE for the subsequent financial year. Section 594z requires the "directors of each LATE" to deliver an annual report to the shareholders within three months of balance date. This requirement does not make sense for a company that is no longer a LATE and will presumably have different directors.
- 13.018** There appears to be a gap in the Local Government Act as to the accountability and reporting requirements when a local authority sells a LATE immediately after balance date. Consideration needs to be given to remedying this gap.