

Report to:	Council Public Excluded
Date:	26 July 2023
Subject:	KET Options Report
Prepared by:	P Kearney – Senior Manager Corporate Services
Input sought from:	PwC
Authorised by:	W Doughty - Chief Executive Officer

1. PURPOSE

The purpose of this report is to provide an update on KET regarding structure, tax considerations and options should a decision be made to transfer shares in IWK from KET to KDC. Transferring shares from IWK to KDC and winding up KET is deemed optimal due to:

- a) Scale – Majority of IWK work (~70-80%) is done for Council and therefore negligible benefit in having an additional layer between Council and IWK
- b) Simplicity – KET structure only includes IWK therefore removing KET as a layer ensures a streamlined relationship
- c) Governance – The KET board is made up of KDC Councillors therefore KET is an extra step in decision making
- d) Costs – Winding up KET will reduce the administration and overhead burden on resources e.g. Audit costs for KET & consolidation, staff time in preparing financials and reports
- e) Opportunity – Disestablishing KET allows the ability to investigate optimum options for a future CCO structure considering KDC strategies, need for flexibility and upcoming legislative and regulatory changes
- f) Partnership – Dissolving KET removes an arm’s length relationship with IWK.

2. RECOMMENDATION

It is recommended that the Council:

- a) Receives the report
- b) Approves winding up of KET, transfer of IWK shares to KDC and the associated steps to achieve this including determining prior 4 year tax exposure and amendment of IWK constitution
- c) Indicate support for investigating options for future proof CCO structures
- d) Authorise the Chief Executive Officer to determine the release of this public excluded report.

3. SUMMARY

3.1 KET Current Structure

KET is a registered charitable trust set up by KDC in 2000. Its charitable objectives relate to the collection and disposal of waste in an ecologically sound manner, sustainable waste management, promotion of recycling and raising public awareness of sustainable resource management. The trustees of KET are appointed by KDC with trustees having broad powers to spend funds and apply property toward furthering the charitable objectives. On a wind up, any surplus property and money is to be applied towards charitable purposes of a like nature within the Kaikoura District.

KET holds 100% of shares in Innovative Waste Kaikoura (IWK) which is a charitable company that operates the Kaikoura resource recovery centre and landfill and also holds a multi-year contract with KDC to provide 3 Waters Maintenance in the district. IWK’s charitable purpose is the promotion, development and implementation of environmentally sound waste management processes and practises. Under IWK’s constitution, its shareholders (currently KET) must be charities and shares can only be transferred to other approved charities. In addition, dividends can only be paid to charities and on liquidation and remaining property must be gifted or transferred to the charitable shareholder/s or charities with a similar purpose in New Zealand. KET also has the power to appoint directors for IWK.

3.1.1 Current Structure Tax Issues

Generally registered charities are exempt from income tax under either section CW 41 or section CW 42 of the Income Tax Act 2007. However, if a registered charity is also a council controlled organisation (CCO) it is not exempt from income tax. Section CW 41 (4) provides that the non-business income charitable exemption does not apply to an amount of income derived by:

a) a council-controlled organisation, other than a council-controlled organisation operating a hospital as a charitable activity.

There is a similar exclusion in section CW 42(2) for business income derived by a charity where the income is derived by a council-controlled organisation.

PwC have confirmed their view that both KET and IWK are CCO's and given the exclusions in the income Tax Act, neither are therefore exempt from income tax and should be accounting for income tax.

While IWK has been filing income tax returns and paying as necessary, KET has not. As a result of this non-payment, an immediate action of preparing income tax returns for the last 4 years should be undertaken and a voluntary disclosure statement made to IRD. Prior 2 year analysis indicates that there has been negligible income in KET and assuming a similar situation for the 2 years previous (i.e. 4 years total) there should not be material tax liabilities.

3.2 Transfer of KET Shares

For KET to transfer the IWK shares to KDC it is necessary to consider whether this is permissible under the constitution of IWK and the KET trust deed.

Clause 4.2 of the IWK constitution provides that any shareholder wishing to transfer any share/s in the company may only transfer such shares to another person who has charitable status approved by Inland Revenue. As a result of this clause, KET is prohibited from transferring the IWK shares to KDC as it is not a charity. KDC will need to have this clause amended for the transfer to be able to take place. Section 32 of the Companies Act 1993 provides that the shareholders of a company may, by special resolution, alter the constitution of a company.

If the constitution were changed by special resolution so that the shares could be held by KDC this would not necessarily result in IWK ceasing to be eligible to be a charity. A key requirement for charitable status is that no person can profit from the charity. KDC would not be able to profit from a shareholding in IWK as clause 14.2 of the constitution provides that IWK must not pay any dividend to any shareholder which is not a charitable organisation approved by Inland Revenue.

A second consideration is does KET's trust deed allow it to transfer the shares to KDC. KET's trust deed grants the trustees broad powers but the trustees are required to act in line with the charitable purposes of the trust. The objectives of KET include the collection and disposal of waste in an ecologically sound manner, sewerage treatment programmes, and protecting natural resources through sustainable waste management. IWK fulfils some of these objectives for KET through its operation of a resource recovery centre and landfill and its contract in relation to 3-waters maintenance. It would be considered reasonable that the transfer of the IWK shares to KDC would enable more efficient management of IWK in terms of scale, risk management and enhanced service delivery. With this context, such a transfer should support and advance KET's charitable objectives.

The alternative option to a straight transfer from the KET to KDC, and also the preferred approach, would be to wind up KET and distribute the shares on dissolution. Clause 14.2 provides that in the event of a voluntary winding up, all monies and properties remaining shall be applied towards such charitable purpose or purposes in the Kaikoura District of a like nature to the charitable purposes of KET. The transfer of IWK shares to KDC on a dissolution of KET should be an application of that asset towards KET's charitable purposes, given KDC is best placed to oversee and deliver the waste management systems.

3.3 Tax Issues

Assuming the constitution of IWK is updated to allow a transfer of the shares to KDC there should be no income tax consequences for KET. This is on the basis that KET holds the IWK shares on capital account, and it will be acting within its charitable purposes in transferring the shares to KDC.

Given there is a prohibition under the constitution of IWK for any dividends to be paid to a non-charity, and there is no entitlement to receive residual value on a liquidation of IWK, KDC arguably will not receive anything of value on receipt of the shares i.e. there may be no value received to tax.

If however it transpires that there is value in the shares (IWK has net assets of ~\$970,000) the following provisions are relevant:

- i) Section CB1 Amounts from Business – Shares not received as part of any business activity of KDC therefore no income should arise under CB1
- ii) Section CV 13 Amounts derived from Trusts - This section provides that an amount is income if it is beneficiary income under section HC 5 or HC 17, or a settlement on trust of property described in section HC 7(3) or a taxable distribution from a foreign trust (section HC 18). The receipt of the shares will not be within section CV 13.
 - a. First, it will not be beneficiary income because KDC is not a beneficiary of KET. KET is a charitable trust, it does not have beneficiaries, rather it acts to further its charitable purposes in this instance by transferring the shares to KDC.
 - b. Second, provided the documentation is carefully drafted, the receipt of the shares will not be a settlement on trust of the property. The intention is not to distribute the shares on trust to KDC but rather to transfer the shares to support efficiencies and thereby further KET's objectives around waste management.
 - c. Lastly, the transfer of the shares is not a distribution from a foreign trust.
- iii) Section BF 1(b). This section requires a person to pay income tax on taxable distributions from non-complying trusts. KET is a non-complying trust due to it not having filed tax returns. However, the receipt of the shares by KDC will not be a taxable distribution. Section HC 15 provides that a distribution is a taxable distribution to the extent it is not a distribution of beneficiary income or corpus. A distribution is defined for the purposes of the trust rules as being when a trustee transfers value to a person because the person is a beneficiary of the trust. As KDC is not a beneficiary of KET (as noted it has no beneficiaries), the transfer of the shares will not be a distribution.
- iv) Finally, no income tax issues are anticipated for IWK if its shares are transferred. If IWK had been a tax-exempt charity, there would have been concern to ensure that it did not lose its charitable status. However, CCO IWK is already a taxpayer.

PwC have considered the specific anti-avoidance provisions in part G of the Act but have not identified any concerns.

3.4 Next Steps

- a) Determine tax exposure for past 4 years for KET and file voluntary disclosure
- b) Amend constitution for IWK to allow transfer of shares from KET to KDC
 - a. KET Board to confirm constitution amendment and notice to dissolve
- c) Transfer shares and dissolve KET
- d) Explore future proof CCO options

4. FINANCIAL IMPLICATIONS AND RISKS

- a) Tax liability - The likelihood of material tax implications is deemed nil to low however this will only be confirmed once four years of prior year returns are analysed
- b) External Consultant Support – Costs will be kept to a minimum by doing as much in house as possible however noting the finance team capacity with Representation Review, Annual Report, LTP, Rating Review all running concurrently, some external support will be required
- c) Late Payment Penalties – Voluntary disclosure should minimise IRD imposition of late payment penalties

5. COMMUNITY OUTCOMES SUPPORTED

The work is in support of all community outcomes.



Community

We communicate, engage and inform our community



Development

We promote and support the development of our economy



Services

Our services and infrastructure are cost effective, efficient and fit-for-purpose



Environment

We value and protect our environment



Future

We work with our community and our partners to create a better place for future generations

6. SIGNIFICANCE OF DECISION

This decision is not considered significant in terms of Council's Significance and Engagement Policy.

7. RELEVANT LEGISLATION

The Local Government Act 2002 states that a local authority should ensure prudent stewardship and the efficient and effective use of its resources in the interests of its district or region.

8. COMMUNITY VIEWS

No community views were sought in relation to this report