

## **Facts and background**

### **Definition of music services**

Local authority "music services" are the services provided by local authorities that aim to facilitate and offer musical opportunities to young people, both in schools and through wider music education programmes. They are funded by central government (currently by the Department for Education (DfE)). Many music services departments also receive funding and in-kind support from their local authorities.

In recent months, many local authorities have been cutting their music service's budgets, in anticipation of the government's cuts in this area and as a result of their own reduced budgets. Therefore, the music services departments of local authorities have been looking at ways to deliver their services more cost-effectively, generating greater income, and with more independence and flexibility.

### **The Government's National Plan for Music Education**

The long-awaited government report on the national plan for music education (plan) was published on 25 November 2011 by the DfE, confirming the Government's plans for funding music education from 2012 to 2015 (see [DfE and Department for Culture, Media and Sport: The Importance of Music: A National Plan for Music Education \(November 2011\)](#)). The plan confirmed government funding is secured from 2012 to 2015, but will be reduced over the three years from £77 million, to £65 million, to £60 million.

### **The formation of music education hubs**

The plan responds to Darren Henley's report on music education (for the DfE and Department for Culture, Media and Sport) (see [DfE and the Department for Culture, Media and Sport: Music Education in England \(February 2011\)](#)). The Henley report made a series of recommendations to the government about music education and how this should sit within the National Curriculum.

A major recommendation of the Henley report (which the plan confirms the government will implement), is the formation of "music education hubs". These hubs are intended to lead the delivery of music services in local authority areas and, in some cases, it is expected will join together two or more local authority areas under one hub.

### **The lead partners and distribution of funding by Arts Council England**

The hubs will be led by a "lead partner", which is likely to be either:

- The local authority.
- An independent organisation that leads on delivering music services in that area.

- The lead partner will work to deliver music education in its area in partnership with other organisations such as:
- Arts Council England (ACE) funded organisations.
- Local choirs and musical societies.
- Regional and national charities and businesses.

The hubs will also be required to tailor music education in their areas to specific local needs.

The government funding will largely be distributed by ACE through an open application process to the music education hubs. ACE has released its music education hubs prospectus (see [DfE and ACE: Music education hubs: Prospectus for applicants](#)). The prospectus outlines the application process for lead partners, along with details of the funding process and reporting requirements. Interested organisations had until 17 February 2012 to submit a bid on behalf of the proposed hub.

### **Transfer of music services to independent entities**

The lead partner of the hub does not have to be a separate legal entity from the local authority. However, given the pressure on their own budgets, some local authorities have made the decision or are considering transferring out their music services to an independent entity or entities. The new entity or entities will take forward the provision of music services in the local authority area and will be likely to be the "lead partner" for that area's music education hub.

This checklist assumes the local authority is considering transferring its internal music services department to a new entity, which will lead one of the new music education hubs.

### **Preliminary questions about externalisation**

Before making decisions on externalisation:

- Establish whether the local authority has the power to transfer the music services to an external entity. For more information, see Practice notes:
  - [The Well-being power under the Local Government Act 2000](#); and
  - [Local government: powers to participate in external organisations](#).
- Consider the local authority's appetite for transferring out the music services to an independent entity.
- Consider whether private or third sector involvement in the ownership or governance of the hub is necessary or desirable. If so, what incentives do these parties require to participate in the hub, if any?

- Identify the items that comprise the undertaking that is going to be transferred, including:
  - contracts;
  - liabilities;
  - property;
  - other assets (including musical instruments);
  - intellectual property; and
  - staff (including employees and contractors).

For more information, see Practice notes, Due diligence in outsourcing and Due diligence: joint ventures.

- Identify the working practices and other commercial relationships that support the music services' delivery, including the relationship with schools, students and parents.
- Identify the key stakeholders in the new entity's establishment (including the schools, local partners, music organisations and service providers). This involves:
  - consulting the key stakeholders early and regularly during the process (see Practice notes, Duty to consult: when does it arise and what does it entail? and Public sector equality duties) and
  - considering engaging the local partners, service providers and the elected members of the local authority, if possible.
- Consider whether the new entity could share resources or premises with the local authority and how any resource sharing or collaboration could be managed. Alternatively, consider the practical implications of transferring over the main resources and premises (see Shared services and partnership working toolkit).
- Conduct a preliminary analysis of whether an independent entity is a viable means of delivering the music services.
- Consider whether the existing staff have the necessary skills to operate the new hub and, if not, how that additional expertise could be provided to the hub.

## **Business case and cash forecast for the establishment of the entity**

### **Business plan**

Use the preliminary analysis to develop a business plan, which shows the:

- Transitional costs.

- Income.
- Funding.
- Overheads.

For more information on key questions to address when appraising the business plan for a new entity spinning out from the public sector, see [Practice note, Mutualising public services: box, Assessing the business case for mutualisation.](#)

## **Funding**

Consider the funding the new entity may be eligible for, including:

- ACE grants through the funding of music education hubs.
- Local authority funding (including funding for transitional and future costs) (see Standard document, Grant agreement).
- Other sources, such as:
  - trusts and foundations;
  - not for profits; and
  - social investors.
- Donations from members of the public.
- Fundraising events.

## **Income streams**

Considerations about income streams involve calculating the:

- Income from provision of services to schools.
- Additional income from parents for musical activities.

This also involves considering:

- What are the registration, music club, orchestra and choir fees, if any?
- The likely income from concerts and events.
- Are there other potential sources of funding, such as the:
  - provision of commercial services;

- income from other educational services;
- loan of musical instruments; and
- letting of premises for events and functions?

If a charity is established, some trading activities may need to be carried out through a trading arm.

### **Explore alternative sources of funding**

When exploring alternative sources of funding, consider:

- Whether the entity will have any assets over which it can secure borrowings (see [Quick guide, Methods of raising debt finance](#)).
- Whether the entity will be able to leverage sponsorship or other support from local businesses.
- If the new entity will be seeking investment from community members, financial services regulations may be engaged and specialist advice will be required.

### **Tax considerations**

Tax considerations include:

- If a charity, to what extent the new entity will be able to raise further funds through gift aid or donations from individuals (see [Practice note, What is a charity?](#)).
- Will the entity need to charge value added tax (VAT) for services it provides? To what extent will the services benefit from the VAT education training exemption?
- To what extent will the new entity be liable to pay corporation tax? If a charity, what percentage of the income will qualify for the corporation tax exemption?
- If a charity, what other charitable tax breaks could the new entity benefit from?

### **Relationship with local authority**

#### **Funding**

Considerations about funding include:

- To what extent will the local authority continue to fund the new entity? Will it offer other in-kind support (such as access to premises or resources)?
- Will the local authority transfer to the new entity:
  - funds currently held; and

- any funding received to deliver music services after the transfer date?

### **Services contracts**

Considerations about service contracts include:

- Will the local authority award contracts to the new entity? For example, for delivery of services:
  - to schools directly; or
  - through schools to pupils and parents.
- What are the procurement implications of contracting with the local authority (see Practice note, Part B, below threshold and other procurements outside the regulations)?

### **Ongoing relationship**

Considerations about ongoing relationships include:

- What role will the local authority play going forward (including to schools and students engaged in the music programmes)?
- Will the local authority continue to support the new entity? For example, will the authority make certain support services available to the hub (such as human resources (HR), finance and legal services)? If so, at what rates? Will any subsidy be available?
- What will the public perception of the local authority's role be? Will the local authority's branding be used for the new entity?

### **Governance**

Considerations about governance include:

- What role will the local authority play in the new entity's governance? For example, if the entity is a company, will the local authority have a stake in the company or a role on the board?
- Will the employees have any role in the governance of the new entity? What about any private or third sector involvement?

### **Legal structures**

Will the legal form of the vehicle be:

- A company limited by shares (see Company Formation and Constitution topic).
- A company limited by guarantee (see Practice note, Companies limited by guarantee).

- An industrial and provident society.
- A community interest company (CIC), which can be structured as a company limited by shares or by guarantee. For more information, see Practice note, Community interest companies: CICs.
- A charitable company limited by guarantee that registers with the Charity Commission (see Charitable status).

Before making decisions about the legal structure, consider:

- The extent to which the legal vehicle is important, if the new entity is expected to be the lead partner of a music educational hub. Is it necessary from a funding or partnership perspective to be a charity?
- The extent to which the potential risks to individual directors can be managed by establishing an incorporated vehicle (see Practice note, Directors' general duties under the Companies Act 2006).
- How the "social mission" of the new entity will be protected by the constitution. For example, could the new entity's:
  - objects (that is, its purposes) be limited; or
  - assets be protected by an asset lock to prevent assets from being sold undervalue and ensure assets are used for the benefit of the community?

Remember the constitution must also be sufficiently flexible to permit the entity to take advantage of any business opportunities that may arise.

- How the new entity will access finance and the implications on the legal structure.
- Can tax liabilities be avoided or reduced by adopting charitable status (see Practice note, What is a charity?) Tax breaks for charities include:
  - exemption from income tax, capital gains tax and corporation tax on profits (although profits may only be used to further the charity's charitable objects);
  - exemption from paying stamp duty land tax on properties purchased;
  - 80% rate relief (for properties that are completely or mainly used for charitable purposes); and
  - eligibility for gift aid on donations from UK taxpayers.
- Will any directors of the new entity receive a salary? If the new entity is a charity, payments for services as a trustee are usually prohibited (although exceptions can apply).

- The formalities that are required for establishing the relevant structure, including registration requirements and how long this is likely to take.

For more information, see [Practice note, Social enterprises: legal structures](#)).

## **Charitable status**

### **Hallmarks of charitable status**

Before making the decision to seek charitable status, consider:

- Will the activities of your entity qualify for charitable status? A charity is any organisation that:
  - is established for the public benefit; and
  - has objects that are exclusively charitable in law.
- You will need to choose suitable charitable objects for your charity and consider the wording for these carefully. It is likely that the new entity will have a charitable object based on furthering education. There are likely to be a range of other charitable objects that the organisation may further. Consider what these should be and the appropriate wording for the objects. Charitable objects should be drafted with enough flexibility to not limit the charity's activity in the future, while giving members of the public an indication of what the charity does.
- Charities also need to show that they satisfy the "public benefit test". This involves considering:
  - the extent to which the entity satisfies the public benefit test; and
  - if the charity will create too much private benefit.
- Charities are normally governed by a group of voluntary trustees (who are also the company law directors, if a charitable company). Is there a group of individuals who would be willing to act as trustees? Do they have the necessary experience and skills?

### **Advantages and disadvantages of charitable status**

Consider the advantages and disadvantages of charitable status.

#### **Advantages**

The advantages of charitable status include:

- Benefits from charitable tax reliefs.
- Charitable status may make it easier to apply for funding (although many other legal structures may also be eligible for funding). Research whether charitable status will open avenues of funding for your organisation.

- Public recognition or reputational benefits of charitable status.

## **Disadvantages**

The disadvantages of charitable status include:

- There are restrictions on trustee benefits for trustees of charities. Will this make it difficult to attract the right trustee board?
- Charities cannot generate profits (over an accepted de minimis level) from non-charitable trading, so it may be necessary to establish a trading subsidiary (see [Trading subsidiaries](#)). As a charitable company, the new entity will be subject to the regulation of two bodies:
  - the Charity Commission; and
  - Companies House.

For more information, see [Practice note, Charity Commission inquiries and regulatory compliance casework: overview](#).

## **Applications to the Charity Commission**

If you decide to set up the new entity as a charity, you will need to submit an application to the Charity Commission, enclosing the required evidence and information. The Charity Commission will examine the charity's objects and proposed activities. It may scrutinise any private benefit created by the charity and the charity's independence from the local authority. Consider how long the application is likely to take.

## **Independence from local authority**

If the new entity has local authority involvement, it will need to demonstrate to the Charity Commission that the charity has sufficient independence from the local authority. How will the new entity do this? What conflicts of interest procedures will you put in place to manage trustee conflicts of interest?

For more information, see:

- [Governance](#).
- [Practice note, What is a charity?](#)
- [Practice note, Partnership working between the public sector and the third sector](#).
- [Practice note, Mutualising public services](#).
- [Practice note, Local government: appointment of members and officers to external organisations](#).

## **Trading subsidiaries**

Before establishing a trading subsidiary, consider:

- The activities the new entity will carry out. It is likely that some of the activities will not be classed as charitable trading (and, therefore, any profits will be subject to corporation tax).
- Charities can carry out a de minimis level of non-charitable trading that is based on a percentage of their annual total gross income, subject to an absolute maximum of £50,000. The income up to the de minimis limit is not subject to corporation tax.
- Any trading generating taxable income above the de minimis level will need to be carried out through a trading subsidiary.
- Are there other reasons why some activity should be carried out through a separate trading subsidiary? This involves considering risk and reputation.
- Trading subsidiaries are usually wholly or mainly owned by the charity. Consider how the trading subsidiary will be governed.
- How to structure the payments from trading subsidiary to the charity to create the most tax-efficient model.

## **Governance**

Before making decisions about governance, consider:

- Who will sit on the board of the new entity? It is advisable to have a range of skills and experience on the governing body. How will the new entity recruit these directors? Consider board members with skills and experience in:
  - music education and music services;
  - local authority services;
  - school education;
  - law;
  - finance; and
  - business.

If the entity is a charity, trustees will usually provide their trustee services on an unpaid basis.

- If the new entity is a company, it will have company members as well as directors. How will the membership be structured? Will the members be the same people as the directors?
- How much involvement does the local authority want or need? This involves considering:
  - whether the local authority will have a presence on the new entity's board. How will any local authority nominated board members be appointed;
  - whether the local authority will be a company member of the new entity. A local authority may hold membership in its own right or elect a nominated representative to become a company member;
  - what voting rights will the local authority (or its nominee(s)) have at the membership or board level? Consider the implications of the Local Government and Housing Act 1989, if the local authority has voting rights; and
  - if the new entity is a charity, the Charity Commission's guidance on the independence of charities (see Charity Commission: RR7: The Independence of Charities from the State (February 2001)).

For more information, see Practice note, Local government: appointment of members and officers to external organisations.

- How will decisions be taken? What will the board or member decision-making process be? How often will meetings be held?
- How will the key stakeholders or investors be integrated into the legal structure (if at all)?
- How will employees be integrated into the legal structure (if at all)?
- Is there a way of involving supporters in the legal structure?
- If the new entity will have a trading subsidiary, consider how it will be governed.

## **Establishing and running the separate entity**

Before establishing and running a separate entity:

- Allow time in the planning of the transfer for registration with Companies House and an application to the Charity Commission (if a charity) or CIC Regulator (if a CIC) to be prepared and processed.
- Ensure establishment costs are accounted for, including:
  - company registration fees;

- acquiring premises and equipment;
- establishing office management, HR, information technology and other systems; and
- expert financial, legal and other consultancy advice.
- Decide who will manage the company registers and who will be the:
  - bankers;
  - auditors;
  - accountants;
  - insurers; and
  - legal advisers.
- Ensure the new entity has the insurance policies that are required by law, as well as any other policies it needs.
- Ensure the necessary HR, pay as you earn systems and other staff management systems are in place (see Standard document, Staff handbook).
- Consider the systems that are needed to ensure the new entity satisfies any other regulation it is subject to, for example, concerning:
  - data protection;
  - safeguarding children and vulnerable adults; and
  - Companies House and the Charity Commission.

For more information, see:

- Practice note, Safeguarding Vulnerable Groups Act 2006;
- Practice note, Data sharing and data security; and
- Company Formation and Constitution topic.

## **The transfer**

### **Due diligence**

Due diligence involves:

- Undertaking a comprehensive due diligence exercise of the contracts, liabilities, property, other assets and staff that were identified during the preliminary stages of the project as being relevant to the new entity.
- Critically reviewing the:
  - title documents to any properties;
  - employee service agreements;
  - any key service delivery support contracts; and
  - all other relevant documents.
- How the new entity will negotiate with the local authority during the transfer process.

For more information, see Practice note, Due diligence and post-completion integration: acquisitions and Checklist, Due diligence: asset purchases.

### **Treatment of premises, assets and liabilities**

Considerations about the treatment of premises, assets and liabilities include:

- How the entity will hold any property. Will the local authority continue to hold the freehold or leasehold and lease, licence or sub-let the property to the new entity?
- What will happen to any existing contracts with suppliers? For example:
  - will the contracts terminate;
  - can the contracts be assigned; and
  - can the contracts be novated?
- To what extent will the new entity have access to or rights over confidential information, know-how and other intellectual property rights belonging to the local authority after the transfer? This will involve considering:
  - the intellectual property rights that will be needed for the new entity to operate (including branding and teaching materials) (see Practice note, Intellectual property: overview); and
  - whether these rights will be transferred to the new entity or the new entity will licence these rights from the local authority.
- Tangible property (instruments and equipment). Where can this be stored? How will this practically be transferred to the new entity?
- The funds held by the local authority for music services. Will these be transferred? What about future funds that are paid to the local authority for music services?

- Ongoing liabilities.

## Staff

In determining the new entity's staffing, consider:

- How many staff will transfer and conduct thorough due diligence of the terms of their employment. TUPE considerations include:
  - TUPE will protect the terms and conditions on which the transferring staff are employed and the new entity will be legally required to honour them (see Transfer of undertakings toolkit); and
  - beware that, where staff have transferred out of public employment, the new entity may be expected to treat them as though TUPE applies, even where technically it does not.
- The extent of the new entity's exposure to TUPE and pensions liabilities, whether imposed through legislation or any contract with the public body. What support will the local authority provide the new entity in meeting these obligations, for example, will it guarantee the new entity's pension liabilities?

For more information, see:

- Standard document, Legal due diligence request: asset purchases (employment);
- Standard document, TUPE: employee information spreadsheet on an outsourcing or re-tendering;
- Practice note, Managing pensions risk in local authority outsourcing transactions; and
- Practice note, GAD passports and broad comparability: overview.
- Will the transferring staff support the project?
- Whether there are any consultants that support the delivery of the service(s) by the local authority that are not subject to TUPE, who could be engaged by the new entity after the transfer. Could staff from the local authority be seconded to the new entity and vice versa, to facilitate resource sharing after the transfer (see Standard document, Secondment agreement)?

For more information, see Practice notes:

- TUPE: overview;
- Employee due diligence issues on transactions.
- Public sector pension schemes: outsourcing.

## **Implications of the transfer**

Considerations about the transfer include the risk:

- That the public procurement rules may apply, if the local authority intends to award a contract to the new entity. For more information on public procurement, see [Quick guide, Public procurement in the UK](#).
- Of breaching the rules against state aid, if the local authority will be offering assistance to the new entity with establishment costs or working capital, or even access to premises, services or guarantees at nil cost or at preferential rates. For more information on state aid, see [Checklist, State aid](#). Consider any tax and accounting implications.

## **Transfer deed**

Before executing a transfer deed, consider:

- How the contract will allocate risk between the local authority and the new entity.
- Including a schedule listing the assets, including any intellectual property rights, property, contracts and staff that comprise the undertaking.
- Including an exit management plan to ensure consistent standards of service delivery if the contract is terminated.
- The term of any service delivery contracts to give the entity sufficient stability to encourage investment.

The transfer deed should:

- Define as precisely as possible the service(s) the new entity will deliver.
- Ensure the new entity is protected by warranties from the local authority. Consider the warranties the local authority requires and the risks to the new entity.
- Include provisions for assigning and subcontracting, if appropriate.
- Ensure the contract includes procedures for the event of contractual breach.