WATSON FARLEY
&
WILLIAMS

BRIEFING

UK INSOLVENCY PRIORITIES TO CHANGE THROUGH THE PARTIAL RETURN OF HMRC'S PREFERRED STATUS.

NOVEMBER 2018

- HMRC TO HAVE PRIORITY STATUS IN INSOLVENCY FOR CERTAIN TAXES FROM 2020
- PARTIAL REVERSAL OF THE ABOLITION OF CROWN PREFERENCE IN 2003
- CHANGE HAS SIGNIFICANT IMPLICATIONS FOR SECURED AND UNSECURED CREDITORS

"…HM TREASURY ANNOUNCED THAT FROM APRIL 2020 HMRC WILL HAVE GREATER PRIORITY TO RECOVER TAXES PAID BY EMPLOYEES AND CUSTOMERS WHEN A COMPANY GOES INTO INSOLVENCY."

As part of the UK Budget on 29 October 2018, HM Treasury announced that as of April 2020 HMRC will have greater priority to recover taxes paid by employees and customers when a company goes into insolvency.[1] In a short policy paper entitled "Protecting your taxes in insolvency"[2] the government explained that it will change the rules so that more of the taxes paid by employees and customers but held, in its words, in trust[3] by a business, go to fund public services rather than being distributed to other creditors such as financial institutions.

At present, there is no detail as to how this change will be implemented, other than that HMRC would again become a preferential creditor[4] in an insolvency for certain tax liabilities (including Value Added Tax ("VAT"), Pay-As-You-Earn Income Tax ("PAYE"), employee National Insurance contributions ("NICs") and Construction Industry Scheme ("CIS") deductions). However, other taxes payable by a company on its own behalf (e.g. Corporation Tax and employer NICs) would not have priority status.

[1] https://www.gov.uk/government/publications/protecting-your-taxes-in-insolvency-budget-2018-brief

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752136/Insolvency_web.pdf

[3] VAT, PAYE, employees' NICs and CIS deductions are not, in the strict legal sense, held "in trust" by a business. If they were, they would automatically be protected on an insolvency, as they would not form part of the insolvent company's assets. Rather, they are "collected" by businesses through, in the case of VAT, increasing the price of supplies made by the business and, in the case of PAYE, employees' NICs and CIS deductions, withholding on account of the payments made by the business.

[4] The HM Treasury policy paper refers to HMRC becoming a "secondary preferential creditor". Secondary preferential debts are a relatively new concept that were first introduced in 2014 to address the requirements of EU legislation around depositor protection. Therefore, HMRC will rank behind ordinary preferential debts, such as employee claims.

"THE ABOLITION OF CROWN PREFERENCE WAS DESCRIBED BY THE GOVERNMENT AT THE TIME AS AN "INTEGRAL PART" OF THAT PACKAGE OF REFORMS [AND] SAT ALONGSIDE THE INTRODUCTION OF THE PRESCRIBED PART…"

This change is something of a surprise, particularly given that Crown preference was abolished in 2003 by the Enterprise Act 2002. That reform was part of a wider package of changes to the UK insolvency regime and the result of careful consideration of the lessons learned from the previous experience of company insolvencies, particularly through the recession of the early 1990s. The abolition of Crown preference was described by the government at the time as an "integral part" of that package of reforms.[5] That characterisation was well founded, given that the abolition of Crown preference sat alongside the introduction of the prescribed part that is set aside from floating charge recoveries to be paid to unsecured creditors. Together these reforms were intended to achieve some return to unsecured creditors, whereas previously an insolvent company's assets often went to repay secured and preferential creditors (including the Crown for tax debts) with very little or nothing left for unsecured creditors.

Therefore, whilst this change is not a complete reversal of the policy decision made in 2002, it does represent a significant change of heart (albeit by a different government and in a different national climate). The policy has already attracted some criticism from R3 (The Association of Business Recovery Professionals, the leading organisation for insolvency, restructuring and turnaround specialists in the UK), which has said that it is potentially a "retrograde and damaging step".[6]

We can see why the proposal may be attractive in the current national climate: the policy seems to be that, where tax has been collected from taxpayers (e.g. employees, customers and suppliers) by a business on behalf of HMRC, the collections should be passed from the business to HMRC and not used, say, to prop up the working capital requirements of a struggling business. After all, why should the public coffers be used to help a business trade out of a precarious economic position? That, looked at in isolation, makes perfect sense.

But, some taxes have long been collected by business on behalf of HMRC and that feature of the tax system would presumably have been taken into account in abolishing the Crown preference – so, it would be helpful to understand, given the policy trade-offs that were delicately balanced to arrive at that outcome in 2002, why it is now appropriate to row back from that position, particularly as it was noted at the time that there had been a trend in other jurisdictions towards restricting or abolishing Crown or State preference. This trend was viewed as more equitable, as the benefit went to unsecured creditors (an outcome that was in part ensured through the prescribed part in the case of the reformed UK insolvency regime).

Further, there are other commercial contexts where monies are collected by one party for onward payment to another party, in some cases under a specified legal obligation and in others as part of a chain of contractual payments where commercially the expectation is that payment to one party will lead to a payment down the chain.[7] The receiving party's treatment as an unsecured creditor in the insolvency of the collecting party is often thought to lead to unfairness, but that has not led to any preferential treatment under the UK insolvency regime.[8]

[5] See the government White Paper "Insolvency – A Second Chance" (Cm 5234, July 2001)

[6] https://www.r3.org.uk/index.cfm?page=1114&element=32639&refpage=1008

[7] For example, by property managing agents on behalf of landlords or by contractors on behalf of sub-contractors.

[8] In a similar vein, concerns have been raised in relation to consumer prepayments on retailer insolvency, which has been studied by the Law Commission and has led to some limited proposals for reform: see https://www.lawcom.gov.uk/project/consumer-prepayments-on-retailer-insolvency/

"…IT IS CLEAR THAT THERE MAY BE AN IMPACT ON SECURED CREDITORS IN RELATION TO THE AMOUNT REALISED FROM FLOATING CHARGE SECURITY…"

Separately, it is worth noting that it is not entirely clear from the materials released so far whether the new preference would apply only in a scenario where the business actually "collects" the cash tax concerned (or, in HM Treasury's terms, holds the tax in trust). PAYE and employees' NICs liabilities can arise where cash payments have not been made to employees; and, in such cases, depending on the circumstances, a business can be taxed a further amount if it then fails to recover the tax from the employee (and so in effect bears the employee's tax as a benefit-in-kind). A business may also fail to pass a VAT charge onto a customer, such as where it does not believe the supply to be taxable and that treatment is subsequently successfully challenged by HMRC. Details like these will need to be addressed in the coming months.

Conclusion

The development of this policy will need to be watched closely to see how it is implemented and whether any modifications are subsequently proposed to offset the effect on unsecured creditors. We understand that, quite sensibly, the government intends to consult on the proposal later in the year.[9] That will hopefully give business and insolvency and restructuring advisers the opportunity to raise some of the points mentioned above. However, it is clear that there may be an impact on secured creditors in relation to the amount realised from floating charge security, which is likely to be relevant for book debts and cash held in bank accounts. That may in turn increase the risk for lenders and raise the cost of financing. For unsecured creditors, it will be important to take any available steps to improve their position on an insolvency, for example ensuring that any retention of title arrangements are robust and enforceable.

[9] R3 has reported that there will be a technical consultation on the proposal that will be published later this year: see https://www.r3.org.uk/index.cfm?page=1949&element=32644&refpage=1865

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.

STEPHEN PARKER
Partner, Restructuring & Insolvency
London

+44 20 7814 8000
+44 20 7863 8908
sparker@wfw.com

TOM JARVIS
Partner, Tax
London

+44 20 7814 8000
+44 20 7863 8917
tjarvis@wfw.com