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Finance Act 2020: Two Important Reforms for the UK Restructuring / Insolvency Market

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The Finance Act 2020 received Royal Assent on 22 July, meaning that:

HMRC will rank as a preferential creditor

in respect of certain taxes, in insolvency proceedings commencing from 1 December 2020 – strengthening HMRC's position at the expense of other creditors

Directors risk potential personal liability for taxes

in certain "tax abuse" cases involving insolvency or potential insolvency

HMRC as Preferential Creditor

Essence of reform

HMRC will become a secondary preferential creditor for debts in respect of VAT and other "relevant deductions", from 1 December 2020.[1] Prior to this change, HMRC ranked as an unsecured creditor for all of its debts — but will in future be paid ahead of floating charge holders and unsecured creditors, for relevant taxes.

Details

On the face of the Finance Act, historic tax debts will be included, without time limit or cap. However, the Finance Act permits the Treasury to enact secondary legislation to specify a reference period, such that only amounts referable to that period will rank as a secondary preferential debt.[2]

Secondary legislation[3] specifies what qualifies as a "relevant deduction". This includes PAYE income tax, employee national insurance contributions, student loan repayments and construction industry scheme deductions.

Other considerations:

- Penalties and interest will not form part of HMRC's preferential claim.
- The measure will have no effect on insolvency proceedings commencing before 1 December 2020.
- HMRC's preferential status will apply over all floating charges, whether created before or after December 2020.
- The new creditor hierarchy is summarised in Annex A.

1. Section 98, Finance Act 2020.
2. Section 99, Finance Act 2020.
3. The Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020 will come into force on 1 December 2020, along with the relevant provisions of the Finance Act.

HMRC as Preferential Creditor (cont.)

Impact

The controversial reintroduction of HMRC's priority status (last seen in 2003) is expected to reduce returns for floating charge and unsecured creditors.

It appears this change applies to any relevant tax which, pursuant to Covid-19 relaxation measures[1], has been deferred / not paid and remains unpaid at 1 December 2020. The potentially higher amounts of unpaid taxes in the current market further increases the risk for other creditors — especially as many companies have taken on additional debt to trade through this dislocated market.

In turn, this may reduce appetite for lending and increase funding costs for UK companies, and lead to greater recourse to fixed charge and asset-based lending.

There is also concern that the proposed reform will give HMRC too much influence in insolvency processes. For example, the use of a company voluntary arrangement to compromise HMRC will become substantially more difficult, given constraints on compromising preferential debts within a CVA unless the preferential creditor consents.[2] The government has attempted to address these concerns, but it is clear HMRC's interests may not be aligned with those of other creditors and it may now hold a de facto veto in certain scenarios.

HMRC will still share in the prescribed part (set aside from floating charge realisations for unsecured creditors) in respect of their non-preferential claims (e.g., for corporation tax) — effectively giving HMRC a second bite at the cherry.

1. UK VAT-registered businesses were able to opt to defer VAT payments between 20 March and 30 June 2020 owing to the Covid-19 crisis; such payments should be paid in full on or before 31 March 2021. HMRC's "Time to Pay" service is available in respect of other outstanding tax liabilities, for businesses in temporary financial distress.
2. Section 4(4) Insolvency Act 1986.

Risk of Directors' Liability in "Tax Abuse" Cases

Essence of reform

Directors may be held personally liable for a company's tax liabilities where HMRC considers that avoidance or evasion has taken place, or where they have evidence of "phoenixism".[1] The measure aims to ensure that genuine insolvencies are not caught, with the added safeguard of an appeal right.

Details

Individuals may be held jointly and severally liable for amounts due to HMRC, in certain cases of:

- tax avoidance or tax-evasive conduct, where the company engaging in the conduct in question is subject to an insolvency procedure (or there is a serious possibility of it becoming so);
- repeated insolvency and non-payment; and
- cases involving a penalty for facilitating tax avoidance or evasion, where the company is subject to an insolvency procedure (or there is a serious possibility of it becoming so).[2]

Further details are provided in Annex B.

Historic tax liabilities[3] and penalties[4] fall outside the scope of the legislation.

The government is clear that the majority of insolvencies arise as a consequence of genuine financial difficulties, and that this reform is targeted at the minority that seek to misuse insolvency to avoid meeting their tax liabilities. Nonetheless, these measures will increase the pressure on those running distressed companies, and tax diligence expectations, at what is already a difficult time for all involved.

1. "Phoenixism" is the practice of running up liabilities in a limited liability entity, then avoiding paying them by making the company insolvent — and setting up a new company carrying on broadly the same business (often to repeat the practice).
2. Section 100 and Schedule 13, Finance Act 2020.
3. Specifically, the Finance Act excludes (a) any tax liability that relates to a period ending prior to its enactment, and (b) any tax liability (other than one that relates to a period) arising from an event or default occurring before that day: section 100(2).
4. Specifically, the Finance Act excludes any penalty in respect of which the determination to impose the penalty, or the commencement of relevant tribunal proceedings, occurs prior to its enactment: section 100(4).

Annex A: New Creditor Hierarchy (Simplified)

- Proceeds of fixed charge assets to fixed charge-holders
- Prescribed fees / expenses of the official receiver
- **New:** where winding-up proceedings are begun within 12 weeks following the end of any (new, stand-alone) moratorium — unpaid moratorium debts, and unpaid priority pre-moratorium debts[1] – pursuant to the Corporate Insolvency and Governance Act, effective June 2020 – see our analysis here, especially page 16
- Expenses of the insolvency procedure, to the relevant counterparty
- Preferential debts:
  - contributions to occupational pension schemes
  - employee remuneration and accrued holiday entitlements (capped)
  - debts owed to the Financial Services Compensation Scheme
  - deposits covered by the Financial Services Compensation Scheme
  - other eligible deposits (in excess of deposits covered under the Financial Services Compensation Scheme)
  - **Forthcoming: for insolvency proceedings opened on or after 1 December 2020 — certain HMRC debts: amounts owed to HMRC in respect of VAT and other relevant deductions**
- **Recently increased:** "Prescribed part", set aside for unsecured creditors from realisations from floating charge assets (up to a maximum of £600,000 or — where relevant floating charge was created on or after 6 April 2020 — £800,000)[2]
- Proceeds of floating charge assets (less preferential debts and the "prescribed part") to floating charge-holders
- Unsecured creditors
- Statutory interest
- Subordinated creditors
- any surplus to shareholders

1. This effectively excludes any pre-moratorium financial debt accelerated during the moratorium.
2. Under The Insolvency Act 1986 (Prescribed Part) (Amendment) Order 2020. The increased amount also applies where the relevant floating charge was created before 6 April 2020 if a later floating charge (over any of the company's assets) ranks equally or in priority.

Annex B: Conditions for the Issue of a Joint Liability Notice

This Annex details:

- the three categories of circumstances in which HMRC may issue a joint liability notice to an individual in respect of certain taxes or penalties, under the Finance Act 2020;
- what conditions must be satisfied; and
- the amounts for which the individual may be held liable.

In each case, the individual recipient has a right of review and a right of appeal.

Tax avoidance and tax evasion cases

An authorised HMRC officer may issue a joint liability notice to an individual where it appears to the officer that each of the following conditions is met:

- The company has engaged in tax avoidance or tax-evasive conduct;
- The company is subject to an insolvency procedure[1], or there is a serious possibility that it will become so;
- The person:
  - was responsible for the company's conduct, or knowingly[2] benefited[3] from it, when the individual was a director or shadow director of the company, or a participator in the company; or
  - took part in, enabled or facilitated the company's conduct, when the individual was a director or shadow director of the company, or took part in management of the company;
- There is (or is likely to be) a tax liability referable to the avoidance or evasive conduct; and
- There is a serious possibility that some or all of that tax liability will not be paid.

The **effect of the notice** is to render the individual jointly and severally liable with the company (and any other individual given such a notice) for the relevant tax liability.

1. This includes schemes of arrangement, liquidation (including members' voluntary liquidations in certain circumstances), administration, company voluntary arrangements, receivership, administrative receivership and companies struck off the register, as well as foreign insolvency procedures / schemes which "correspond" to their UK counterparts. This could raise some interesting cases for courts to consider whether foreign proceedings "correspond" to UK equivalents. **Notably, it does not currently include the new restructuring plan procedure.**
2. The legislation treats the individual as knowing anything that the individual could reasonably be expected to know.
3. The legislation extends the meaning here to cover benefits received by the individual's connected persons.

Annex B: Conditions for the Issue of a Joint Liability Notice (cont.)

Repeated insolvency and non-payment cases

An authorised HMRC officer may issue a joint liability notice to an individual where it appears to the officer that each of the following conditions is met:

- In the five years prior to the notice, the person was a director, shadow director or participator of at least two companies which became subject to an insolvency procedure[1] within that period and owed amounts to HMRC or, e.g., had failed to submit a relevant return;
- Another, new, company carries on a business that is the same as, or similar to, that of at least two of the insolvent companies;
- The person has been connected to the new company (i.e., is a director or shadow director of the company, or a participator in the company, or takes part in management of the company) within the five years prior to the notice; and
- At least one of the old companies that became insolvent has an unpaid tax liability, and the total unpaid tax liability of the old companies is more than £10,000 and represents >50% of the total amount of those companies' liabilities to their unsecured creditors.

The notice cannot be issued more than two years after HMRC first became aware of the relevant facts.

The **effect of the notice** is to render the individual jointly and severally liable with:

- the new company (and any other individual given such a notice) for:
  - any tax liability of the new company on the day of the notice; and
  - any such liability which arises in the following five years, provided the notice remains in effect; and
- the old company (and any other individual given such a notice), if it has a tax liability on the day of the notice.

Forthcoming guidance is expected to provide that this power will not be used in respect of "turnaround specialists" whose connection with the companies is part of a genuine attempt to save the company. However, this continues the current (unfortunate) trend in drafting tax legislation widely such that it captures both "in scope" and "out of scope" behaviours and then relying on guidance or similar to provide "reassurance" that out of scope cases will not be pursued.

1. See footnote 1 on previous page.

Annex B: Conditions for the Issue of a Joint Liability Notice (cont.)

Cases involving penalty for facilitating avoidance or evasion

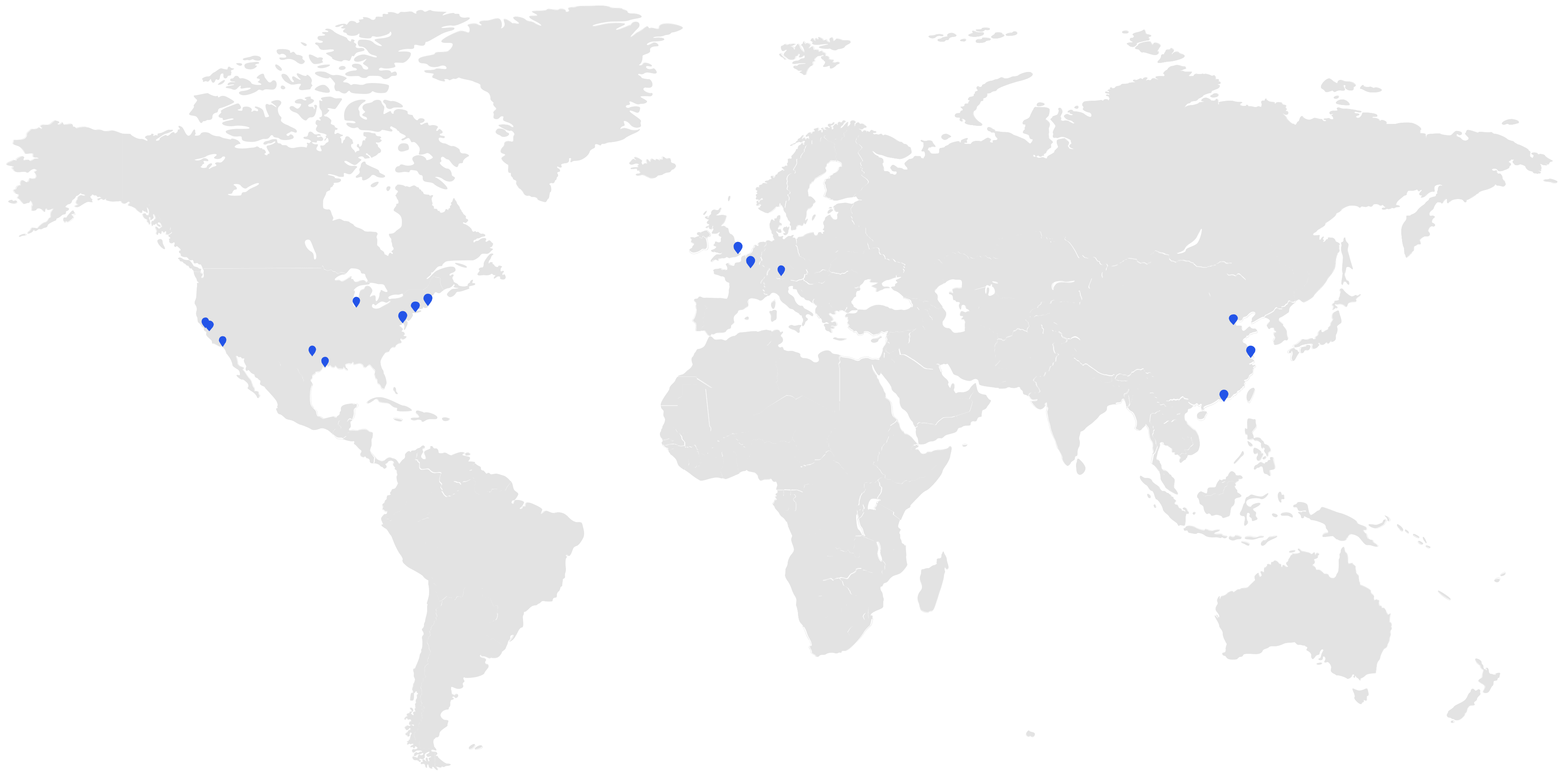
An authorised HMRC officer may issue a joint liability notice to an individual where it appears to the officer that each of the following conditions is met:

- HMRC has imposed a penalty under certain specified tax provisions, such as penalties for promoters of tax avoidance schemes or enablers of offshore tax evasion (or proceedings have been commenced before the First-tier Tribunal for the imposition of such a penalty);
- The company is subject to an insolvency procedure[1], or there is a serious possibility that it will become so;
- The individual was a director or shadow director of the company, or a participator in the company, at the time of the act/omission in respect of which the penalty was imposed (or proceedings for the penalty were commenced); and
- There is a serious possibility some or all of the penalty will not be paid.

The effect of the notice is to render the individual jointly and severally liable with the company (and any other individual given such a notice) for the amount of the penalty.

1. See footnote 1 here.

International Reach



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