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Return of UK Tax Authority as Preferential Creditor in UK Insolvency Proceedings Takes Effect 1 December 2020

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At a Glance

The UK tax authority, Her Majesty's Revenue & Customs ("HMRC"), ranks as a preferential creditor in respect of certain taxes in UK insolvency proceedings commencing from 1 December 2020 — strengthening HMRC's position at the expense of other creditors.

HMRC as Preferential Creditor

Essence of reform

HMRC will be a secondary preferential creditor for debts in respect of VAT and other "relevant deductions", for insolvency proceedings commencing on or after 1 December 2020.[1] Prior to this change, HMRC ranked as an unsecured creditor — but will now be paid ahead of floating charge holders and unsecured creditors, for relevant taxes.

Details

On the face of the Finance Act 2020, 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 which commenced 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 the Annex.

Impact

- The partial reintroduction of HMRC's priority status (last seen in 2003) is controversial and 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[4], 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.[5] 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.

Annex: 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[6] — 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)
    - New: 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)[7]
- 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

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1. Section 98, Finance Act 2020.↩

2. Section 99, Finance Act 2020.↩

3. The Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020 enter into force on 1 December 2020, along with the relevant provisions of the Finance Act.↩

4. 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 can be paid in full by the end of March 2021 or in interest-free instalments up to the end of March 2022. HMRC's "Time to Pay" service is available in respect of other outstanding tax liabilities, for businesses in temporary financial distress.↩

5. Section 4(4) Insolvency Act 1986.↩

6. This effectively excludes any pre-moratorium financial debt accelerated during the moratorium.↩

7. 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.↩

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Suggested Reading

- 06 November 2020 Kirkland Alert European COVID-19 Government and Central Bank Measures Supporting Business
- 08 October 2020 Kirkland Alert UK Reforms to Heighten Scrutiny of Pre-Pack Administration Sales to Connected Parties
- 25 September 2020 Kirkland Alert Major Positive Changes in the German Restructuring and Insolvency Landscape — Preventive Restructuring Process &