Priority in insolvency – heavy lies the Crown (preference)?

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Delivering on the announcement in the Autumn Budget, HMRC issued its consultation "Protecting your taxes in insolvency" on 26 February 2019. The consultation proposes legislation that will give HMRC the elevated status to secondary preferential creditor in a company's insolvency. If this is implemented, HMRC will have priority to recover certain taxes from insolvent businesses ahead of other creditors from 6 April 2020.

Is this the return of the Crown preference abolished in 2003? This article considers this question and the scope and rationale of the proposals, focusing on the impact on secured creditors in an insolvency.

Scope: What will rank as a secondary preferential debt?

Asset realisations in a UK insolvency are paid out in the following descending order:

- fixed charge secured creditors;
- the appointed insolvency practitioners' fees and expenses;
- preferential unsecured creditors (in two classes);
- prescribed part creditors;
- floating charge secured creditors;
- non-preferential unsecured creditors.

Currently, HMRC ranks as a non-preferential unsecured creditor. Broadly, each class of creditor must be paid in full before the next class can receive a distribution, so promoting HMRC to preferential status is a significant move. But what taxes are caught?

HMRC's preferential status would only apply to taxes collected and held by businesses (but not yet paid to HMRC at the time of its insolvency) on behalf of other taxpayers. This includes tax revenues for VAT, PAYE (including student loan repayments) and employee NICs plus any interest or late payment penalties due on these taxes. Importantly, it does not catch taxes owed by the business itself, such as corporation tax and employer NICs.

Reasoning behind the proposals and the wider impact

What is the rationale for this proposed change in legislation? The consultation argues that where a business enters insolvency: "Taxes paid by employees and customers do not always go to funding public services … Instead, they often go towards paying off debts owed to other creditors." In the government's opinion, these tax revenues "paid in good faith" should not go to the general pool of creditors but should be used for their intended purpose, to fund public services.

The consultation singles out financial institutions as the creditors most likely to be affected by the new legislation. It provides some (unsupported) comments on the likely economic impact with a bold statement that "government does not expect it to have a material impact on lending". However, it anticipates a significant projected benefit to the Exchequer, peaking in 2022/23 at £185 million, compared with present recoveries from insolvency. It naturally follows that, for the Exchequer to gain such a significant advantage, someone else has to lose.

If the proposals are implemented, a financial institution ranking below HMRC's preferred status will need to carefully consider its borrower's business and how it accounts for tax revenues from employees and customers. It will be important to exclude these segregated funds from any pre-lending assessment of the assets available to repay borrowing secured by a floating charge. This may in turn impact on the cost of borrowing. Businesses will also need to isolate tax revenues in their accounts, creating extra administrative work and potential costs. The consultation has also caused concerns within the insolvency profession, not least regarding the additional costs and burden on insolvency office holders when processing HMRC claims.

Next steps and the consultation

The current consultation ends on 27 May 2019 with a view to including provisions in the draft Finance Bill 2020.

Conclusion

The proposed legislation is not a full return to the Crown's preferential status before 2003. It is, however, a similar beast and has the potential to worry not only creditors generally but businesses too. It will undoubtedly affect financial institutions that lend on a floating charge basis and will have implications for business when lenders secured by floating charges re-evaluate their risk profiles.

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