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UK Budget 2020

Will the effect of the proposals in the Budget be to support businesses in a difficult trading period?

March 2020

What is the likely effect of the reintroduction of Crown Preference with effect from December 1, 2020 and increase in the Prescribed Part from April 6, 2020?

Whilst the press focus on the Budget on March 11, 2020 has been on the measures introduced to support those affected by COVID-19 and the cut in interest rates, the availability of finance for businesses in the UK will be impacted adversely by the March 11 announcement of the reintroduction of crown preference from December 1, 2020.

- This means that HMRC will become a preferential creditor in insolvency for uncapped amounts of VAT and taxes collected and held by businesses on behalf of other taxpayers, i.e. PAYE, employee NICs and CIS deductions. Currently the only preferential claims are certain capped employee claims for notice pay and holiday pay. Preferential creditors' claims are paid from floating charge realisations, before payments to lenders who hold a floating charge over the assets of the business, and before payments of dividends to unsecured creditors. They therefore dilute realisations to other floating charge creditors.
- The practical effect of this change will be that lenders will reduce the amounts that they lend to businesses, to take account of the dilution in the realisations that they would receive in insolvency as a result of the prior ranking of the uncapped HMRC claims.
- As a result, the availability of funds which lenders are prepared to advance to businesses will be reduced at precisely the time that businesses need access to additional funds. This change will have particular impact on asset-based lenders who rely as security on floating charge assets, and are often lenders approached by borrowers who need additional funding in difficult trading conditions.
- In businesses where the tax position of the borrower is unclear and where there could be significant arrears, lenders may take the view that the tax position is so uncertain that they are unwilling to lend any amount as the risks of limited recoveries are too great.

Let's look at the background to this change and the likely effects for lenders and borrowers in more detail.

Background

In February 2019, HMRC published a consultation paper, "Protecting your taxes in insolvency," which proposed the reintroduction of crown preference, which was abolished by the Enterprise Act 2002 ("the Act"). The Act introduced the concept of a qualifying floating charge and a streamlined appointment process for administration, whilst abolishing administrative receivership in relation to charges post-dating the Act coming into force in 2003. The Act also introduced the concept of the 'Prescribed Part,' which ring-fences a proportion of the funds generated by the floating charge for unsecured creditors, including HMRC, up to a maximum amount of £600,000. This was thought at the time to introduce a mechanism which would result in the benefit of the abolition of the preferential status of HMRC going to unsecured creditors as a whole, which was thought by the Government at the time to be 'more equitable.'

Prior to 2003, certain taxes due to HMRC had been classified as 'preferential claims' in an insolvency process. This meant that they were paid from floating charge realisations, after payment of the costs and expenses of the insolvency process, along with the other classed of preferential claims which are certain categories of claims by employees. The types of claims by HMRC which were preferential were capped and were PAYE deducted in the 12 months preceding the insolvency proceedings, and VAT payable in the 6 months preceding the insolvency proceedings.

The abolition of crown preference was considered to be a move taken to reduce the impact for lenders of the abolition of Administrative Receivership. Administrative Receivership was a process that gave lenders with security over substantially all of the assets of a company control over the realisation of assets by appointment of their choice of receiver. The administrative receiver would take over the running of a business in administrative receivership, in a similar way to an administrator, but only for the period it took to realise assets with a value sufficient to discharge the appointing creditor's debt, usually via a sale of the business as a going concern, following which companies frequently ended up in liquidation with very limited if any assets and little prospects of dividends for unsecured creditors. The process attracted a lot of adverse criticism from unsecured creditors and others for not promoting business rescue. The Government concluded that there would be a fairer process and better realisations for all creditors in administration, where the office holder was appointed to achieve a better result for all creditors, and could therefore take a different realisation strategy from an Administrative Receiver. In addition, the introduction of the Prescribed Part by the Act provided a better outcome for unsecured creditors.

The current categories of preferential debt in England and Wales are set out in Section 386 and Schedule 6 Insolvency Act 1986 and are certain employee claims for accrued wages up to a cap and holiday pay.

HMRC then gave up its preferential status for PAYE and VAT and became an unsecured creditor for all of the debt it claimed from the commencement of the Act.

Announcement in autumn 2018 of proposal to reintroduce crown preference

Given the reasons for the abolition of crown preference, it was therefore a surprise that the Government announced in the Autumn Budget 2018 that it proposed to reintroduce crown preference for HMRC for certain tax claims, with no previous consultation with those involved in the industry. The intention expressed by the government was expressed in the Budget Brief to be as follows:

"Taxes paid by employees and customers do not always go to funding public services if the business temporarily holding them goes into insolvency before passing them on to HMRC. Instead, they often go towards paying off the company's debts to other creditors.

From 6 April 2020, the government will change the rules so that when a business enters insolvency, more of the taxes paid in good faith by its employees and customers but held in trust by the business go to fund public services as intended, rather than being distributed to other creditors such as financial institutions."

There had been no consultation with industry bodies such as R3 or the British Bankers' Association prior to this announcement. The news was met with much consternation and opposition from those involved in restructuring and insolvency, and in particular the lenders who considered that this would lead to considerable uncertainty in terms of realisations for creditors, who would, in most cases, have no idea as to the tax arrears of any borrower on a day to day basis. The measures would lead to dilution of realisations for lenders with floating charges and for unsecured creditors other than HMRC. This was a particular concern to asset-based lenders who rely heavily on floating charge realisations.

The policy is to shift the burden of bad debt from the Crown to other creditors. It is estimated by HM Treasury and HMRC that the proposed measure will yield £185m per annum. The additional tax collected will not only be collected at the expense of other creditors but, to the extent that those other creditors are UK taxpayers, it will diminish HMRC receipts from those taxpayers. HMRC has confirmed that its estimate of £185m per annum is an estimate of the yield net of reduced tax receipts from other sources but has declined to explain its calculation.

Draft legislation published to implement the changes

In July 2019, draft legislation was published by the Government to be included in the next Finance Bill to deliver on the Budget 2018 commitment. This was despite the widespread opposition to the proposals which had been communicated to the Government by industry bodies in the interim period. The draft legislation was published with a note commenting that the legislation would ensure that from April 2020:

"When a business becomes insolvent, more of the taxes paid in good faith by its employees and customers will go to fund public services as intended, rather than being distributed to other creditors such as financial institutions."

The consultation period continued to run until September 2019 and the relevant trade bodies continued to voice their opposition to the proposals and to point out that they would not assist the rescue culture, and that the availability of borrowing, and therefore the chances of successful restructurings, would reduce as a result.

The draft legislation provided for preferential treatment of a larger amount of tax from April 6, 2020 than that provided for in the Insolvency Act 1986. It amends section 386 Insolvency Act 1986, in a new section 15D(1) to be added to Schedule 6 Insolvency Act 1986, to add a new category of secondary preferential debt namely:

Any amount owed at the date of the commencement of the insolvency process by the debtor:

- In respect of value added tax
- A relevant deduction

A deduction is 'relevant' as set out in a new section 15D(2) to be added to Schedule 6 Insolvency Act 1986 where:

a) The debtor is required, by virtue of an enactment, to make the deduction from a payment made to another person and to pay an amount to [HMRC] on account of the deduction.

b) The payment to [HMRC] is credited against any liabilities of the other person.

c) The deduction is of a kind specified in regulations made by [HMRC] by statutory instrument.

This therefore covers taxes paid by employees or customers through a deduction by the business, for example from wages or prices charged such as PAYE (including student loan repayments), Employee NICs and Construction Industry Scheme deductions.

HMRC will remain an unsecured creditor for taxes levied directly on businesses such as Corporation Tax and Employer NICs.

Announcement in the Budget on March 11, 2020 that the draft legislation will come into force on December 1, 2020

The Chancellor announced in the Budget on March 11, 2020 that the draft legislation will be part of the Finance Bill 2020 to be laid before Parliament in the next few weeks and will come into force on December 1, 2020, not the April 6 commencement date referred to in the draft legislation circulated in July 2019.

Increase in the amount of the Prescribed Part from April 6, 2020

The new legislation does not involve the abolition of the Prescribed Part. Indeed recent legislation has seen the amount of the Prescribed Part increase from £600,000 to £800,000 with effect from April 6, 2020 by the Insolvency Act 1986 (Prescribed Part) (Amendment) Order 2020 made on March 2, 2020. The Order will not apply to floating charges created before April 6, 2020.

Lenders will therefore now face a double blow in relation to realisations from the floating charge as a result, now that the Prescribed Part will increase and the crown preference will be reintroduced from December 1, 2020.

Key points in relation to the changes for lenders and for borrowers

- The legislation will apply to insolvencies commenced after December 1, 2020 irrespective of the date that the tax debts were incurred or the date of the qualifying floating charge.
- Existing tax debts of the relevant type will be preferential if the insolvency is commenced after December 1, 2020.
- Company voluntary arrangements (CVA's) are less likely to be viable and to succeed with increased categories and amounts due to preferential creditors who will need to be paid along with secured creditors as part of the CVA.
- Realisations for floating charge holders and unsecured creditors will reduce as a result of the dilution.
- Lenders are likely to seek to take fixed charges wherever possible and review the control that a borrower has over assets to enable valid and enforceable fixed charges to be taken over assets such as bank accounts wherever possible, which will reduce the ability of the borrower to access these funds and reduce the available working capital as a result.
- Lenders are likely to reduce the total funds that they are prepared to lend to a borrower as a result, and from our conversations with lender clients, this is already having an effect on lending and on the availability of funds to borrowers, particularly in the asset based lending market. Invoice discounting is likely to become even more popular as a result, where the lender takes an assignment of the invoice and does not rely on realisations from the floating charge.
- Lenders will want to review the tax position of a borrower prior to the advance of funds and on an ongoing basis to keep the likely dilution of realisations on insolvency under regular review. They will want to understand the usual quantum of payments by the business to HMRC for VAT and PAYE and any other deductions and how this amount varies from month to month.
- Lenders are likely to insist that Directors/borrowers make representations as to the tax position of the borrower on completion of the advance, give repeating representations during the lifetime of the loan, and allow access to the relevant company records to support the representations to allow the lenders to regularly review and check the tax exposure of the borrower and the likely quantum of the HMRC preferential claim.
- In larger operations, lenders may insist on group structures which minimise the dilution from crown preference, by including companies which hold floating charge assets such as stock, but do not collect VAT or employ employees, as obligors under loan facilities.
- Lenders may insist that a borrower holds tax reserves to deal with liabilities to HMRC which would otherwise dilute realisations. Again this will tie up cash which would otherwise be available as working capital for the business.
- Lenders are likely to have to spend more time actively managing the loan, checking on the tax position of the borrower, and acting to review arrangements or enforce in the event that the tax liabilities were increasing such that realisations would reduce significantly on insolvency.

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