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ARTICLE

The Return of Preference?

Marcus Rea, Partner, Deloitte LLP, London, UK

Synopsis

The recent UK Budget included a handful of measures that should be of particular interest to the restructuring and insolvency community. There has been a gradual re-emergence of an effective preferential status for tax over the last few years. These measures appear to continue that trend.

The 2018 Budget

On Monday 29 October the UK government delivered its most recent Budget. In addition to the normal announcements around tax rates, allowances and the like, three measures will be of particular interest to the restructuring and insolvency community.

Tax abuse & insolvency

A discussion document was issued by HMRC with this snappy title back in April 2018. Following the receipt of various responses, in the Budget the government reconfirmed that it had decided to press ahead with proposals designed to tackle its concerns around tax evasion and abuse in the context of insolvency.

New provisions were announced which could make relevant individuals (directors, shadow directors and other, as yet not quite defined, relevant parties) jointly and severally liable (with the company) for unpaid taxes in certain prescribed situations. These circumstances can broadly be described as either where companies have employed certain tax 'schemes' or where 'phoenixism' is apparent. The legislation will be introduced in 2019 and is intended to apply from Royal Assent to that Finance Act.

For these purposes, we understand that a tax 'scheme' will be deemed to have been employed where a company has entered into tax-avoidance arrangements or has engaged in tax evasion. The former is broadly intended to map to planning that would have been notifiable under various existing disclosure requirements or where the general anti-abuse rule applies. Tax evasive conduct plainly involves doing something that is fundamentally illegal, but would essentially encompass deliberately falsifying or withholding information or ultimately failing to submit a tax return. Any relevant individual responsible for this behaviour, who assisted or facilitated it, or who benefited from it is potentially at risk of receiving a notice under the new rules.

'Pheonixism' refers to the repeated non-payment of tax through the practice of performing some form of business activity and thereby creating a tax liability in a company only to avoid payment through an insolvency process and then setting up a new company to carry out the same business again. It is reasonable to assume that if a relevant person is connected to multiple companies that have avoided tax in this way in a defined period of time, they too will fall within the ambit of the legislation.

Draft legislation has yet to be published and therefore it is unclear to what extent HMRC will address any of the concerns raised through the consultation process. What is clear is that, despite various concerns having been raised around effectively conferring a preference for Crown debts and despite there being a number of existing provisions that tackle this sort of behaviour (albeit dispersed through the tax code), the government has decided that these new provisions are required.

Notwithstanding the government's assurances that the measures will be targeted at deliberate, egregious behaviours and its acceptance that most insolvencies are entirely genuine, there is significant risk of collateral damage to the UK's reputation as a place to fund and rescue domestic and multi-national businesses if this legislation is ever used indiscriminately. In the Enterprise Act 2002, the government recognised that the previously preferential status of tax in insolvency had been acting as a deterrent to genuine rescues. A deliberate policy choice was made to support business rescue, by amending the order in which funds must be applied to each type of claim. That decision, together with a robust and clear legislative framework, has contributed to the creation of a supportive and fair insolvency and restructuring regime, recognised by the World Bank as one of the best in the world. In that context, it will be unfortunate if the proposed legislation undermines this view.

People will be particularly concerned to ensure that appropriate safeguards are included to mitigate the inherent subjectivity of any draft legislation. We understand that it is intended that HMRC will issue guidance to clarify the circumstances when these

measures would be used. However, it will be critical for the primary legislation itself to include very clear definitions, to be focussed and easy to understand.

In addition there are some particular areas that require careful thought. For instance, directors of groups of companies, where a commonality will be normal, may be concerned that they could fall with the scope of the legislation should multiple companies in those groups experience insolvency and this is caught within the definition of 'phoenxism'. And it will be important to consider the position of turnaround directors, whose very jobs may inevitably involve numerous insolvencies, and those investment houses that specialise in dealing with underperforming and distressed businesses (and whose partners and staff often become directors of companies or who might be considered shadow directors of those entities regardless).

Protecting your taxes

Unexpectedly, the Budget also heralded new provisions under this banner, which, once enacted, will elevate the payment priority for many pre-insolvency tax liabilities.

Companies routinely withhold or collect certain taxes from their employees and customers, such as PAYE, employees' NIC, VAT and in some cases also amounts under the Construction Industry Scheme. In an insolvency event this withheld cash has historically been part of those funds available to floating charge and unsecured creditors (of which HMRC would be one). From 2020, HMRC will claim those taxes collected pre-insolvency as a priority payment at the time of the insolvency event ahead of other unsecured or floating charge creditors. The government has argued that these monies were never really a company's but were rather held on trust.

Creditors with fixed charges over assets will be unaffected to the extent their claims can be settled in full by proceeds from realising those secured assets. However, it is clearly not uncommon for there to be a shortfall and for even these creditors to have an amount that ranks as unsecured after the fixed charge has been released. Therefore the change in priority is likely to affect all creditors, particularly where significant amounts of pre-insolvency VAT or employee PAYE liabilities (likely to be the two most relevant taxes) have accrued.

HM Treasury is expecting significant additional income from this measure (c. GBP 185m by 2021-22 and higher in subsequent years) but, again, have yet to release draft legislation. The government has, however, stated its intention to continue to offer Time to Pay arrangements to help viable businesses with tax debts to avoid entering insolvency in the first place.

Corporate capital loss restrictions

Finally in this triumvirate of new measures, the Budget declared an intent to extend the relatively new corporate income loss restriction rules to capital losses too. A consultation was announced with a closing date of 25 January 2019 to get feedback for this proposal with the intention that draft legislation will follow later in the year (albeit anti-forestalling provisions will be introduced effective from Budget day to prevent avoidance behaviour).

From April 2020, only 50% of net capital gains made in any particular period will be capable of being sheltered with brought forward capital losses (mirroring the rules that now apply to corporate income losses).

The consultation proposes that the existing GBP 5m de minimis profit hurdle that must be met before the income loss rules apply is to remain and be shared – effectively a group will be able to make up to GBP 5m profits (whether income or capital in nature) before the two sets of rules apply – with the tax payer given the flexibility to decide (to the extent that the general tax code gives them the choice) whether to employ income losses or capital losses at their discretion. The GBP 5m is a group threshold and unsurprisingly the definition of group is deliberately quite broad. The intention appears to be to use the group designation found in the corporate income loss restriction rules (broadly tying into the definition for the purposes of corporate income tax group relief), which is logical from the perspective of a shared allowance but results in the oddity of a test that does not marry with what constitutes a group for the purposes of the capital gains legislation itself.

Concerns were expressed on the introduction of the original corporate income loss restriction rules around whether they were appropriate in rescue and insolvency scenarios. A corporate rescue exemption, similar to that found in the corporate debt legislation for releases, was suggested by respondents to the original consultation but declined. Some concessions were made in terms of giving a relaxation of the rules for one-off reversals of onerous lease provisions in the context of Company Voluntary Arrangements and the inclusion of a terminal period relief from the rules.

Those concerns remain with the proposed capital loss restriction rules. It is not unusual for a stressed or distressed business to sell capital assets to raise cash in order to help it survive. Meanwhile, administrators or liquidators will naturally look to realise valuable capital assets after their appointment. Large one-off disposals of capital assets are therefore entirely normal in this environment and capital gains are far from unusual. From 2020 there will be a far greater possibility that HM Treasury will take a portion of any proceeds and this will need to be factored into cashflow forecasts. It is to be hoped that the government will be willing to introduce at least some measure of relief for corporate

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rescue and insolvency in the proposed capital loss legislation, but we shall need to wait and see.

A change of emphasis

The last few years has seen a gradual erosion of the position that tax liabilities will stand with other unsecured creditors in insolvency. These three measures continue that trend towards restoring a preferential status and make it ever more important that the restructuring and insolvency community take tax advice when determining a course of action.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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