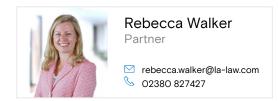




Preferring the Crown – HMRC to Benefit from Preferential Status

AUTHOR / KEY CONTACT



Presently H.M. Revenue & Customs (HMRC) are an ordinary unsecured creditor in respect of sums owing to it by a UK corporate entity when it goes into a formal insolvency procedure. HMRC receives a dividend (on a pence in the pound basis) in the same way as other unsecured creditors of the insolvent entity such as customers, suppliers or landlords (who do not usually hold any security over the entity's assets as a Bank or other secured lender would). In an insolvency situation, all unsecured creditors are put on an equal footing so that the funds available to them are distributed in proportion to the amount of their claim.

HMRC previously held preferential status in respect of their claims until this was abolished in 2003.

Crown Preference - from 1 December 2020

The introduction of the <u>Finance Act 2020</u> brings with it a return of 'Crown Preference' on insolvency appointments (such as administration or liquidation) that take place from <u>1 December 2020</u>. This means that HMRC will be a preferential creditor in relation to certain sums that it is owed when the corporate taxpayer enters a formal insolvency procedure.

The impact of this change shall be as follows:

- HMRC will rank ahead of floating charge holders in respect of certain of its claims without any time or value cap;
- HMRC will have new 'secondary' preferential status for sums owing by the entity in respect of certain taxes collected or deducted including VAT, PAYE, Employee NIC and Construction Industry Scheme (CIS) payments;
- The other preferential debts of the entity (as is currently applicable) will continue to be paid before the 'secondary preferential debts' now in favour of HMRC. These prior ranking claims include those made by employees for unpaid wages and holiday pay and pension contributions;

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Preferential status will continue not to apply to Corporation Tax and Employer NIC

New Order of Priority

Therefore, in respect of corporate entities going into an insolvency process (such as administration or liquidation) after 1 December 2020, the basic order of the distribution of funds by the insolvency practitioner shall become as follows:

- Amounts due to lenders under fixed charge
- Costs and expenses of insolvency process
- Preferential claims by employees for wages, holiday pay and pension contributions (currently also preferential)
- (New) Secondary preferential status for claims by HMRC including for VAT, PAYE, Employee NIC and CIS
- Amounts due to secured lenders under their floating charge security (subject first to a 'prescribed part'
 being deducted which is either the first £600K or £800K of the floating charge pot to be set aside by
 the insolvency practitioner for unsecured creditors the upper limit applicable if the lender's floating
 charge security post-dates 6 April 2020)
- Amounts due unsecured creditors (including HMRC's claims for Corporation Tax and Employer NIC)
- Surplus available to shareholders (if any).

Impact on Banks and Secured Lenders

Banks and other secured lenders will want to maximise the prospect of sums being paid to them under security other than 'floating charge' security as the return will be diluted in favour of HMRC. If the corporate entity does not own any property or fixed equipment, the Bank will be reliant on security taken over the entity's 'floating charge' assets, being assets of a quantity and value that changes periodically (e.g. stock, debtor and moveable plant and equipment). Floating charge security is normally created under a debenture granted by the corporate borrower to the Bank. Banks and secured lenders will therefore be very keen to monitor what their corporate customers owe HMRC in respect of PAYE, Employee NIC and VAT and this may determine whether new loan advances are made or extensions are given on existing facilities.

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With HMRC deferrals and Time to Pay Arrangements being commonplace at this time, this will swell the recovery in favour of HMRC at the expense of the Bank and other secured and unsecured creditors. Banks may insist that new advances are supported by fixed charges over assets or even guarantees (including cross-company or personal guarantees from directors backed up by a mortgage over their homes). Lenders may also look to alternative funding options such as invoice financing where they will be more confident that they are protected in the event of the borrower's insolvency. We predict that Banks, lenders and other credit providers will be extremely keen to review the tax position of a borrower prior to the advance of funds and on an ongoing basis.

Impact on other Creditors

Furthermore, other unsecured creditors of insolvent corporate entities (such as landlords, suppliers and customers) will need to recognise that the available pot to be distributed to them will be reduced by virtue of HMRC being given preferential status.

It important that creditors exercise good credit control measures and apply sensible credit limits to mitigate against the risk of a large debt owing without any prospect of recovery if the other party enters a formal insolvency procedure. A careful balance needs to be struck in seeking to be supportive to other businesses that they trade with in these difficult economic times, whilst at the same time protecting against the risk of another party's insolvency, which can have a detrimental knock-on effect on others in the supply chain.

What can be done now?

At present there are a number of protections and support packages in favour of UK businesses to avoid them being forced into formal insolvency as a result of circumstances arising from the pandemic. However, some of those businesses may not ultimately be able to recover and could enter into an insolvency procedure in the future. Those dealing with vulnerable businesses should take stock of the current change with the reintroduction of Crown Preference and consider the impact on any return to them in that situation. Now is the time to look at alternative ways of managing the risk of an unpaid debt and put in place sufficient protections to enable the relationship to weather the storm.

The <u>Restructuring and Insolvency</u> team at Lester Aldridge frequently advise businesses in financial difficulty as well as those affected by the insolvency of another such as suppliers, customers, Banks and landlords. They also advise insolvency practitioners in connection with their appointments and are well-placed to advise on the implications of this latest changes in any given context.

If you have any questions in relation to the content of this article or wish to discuss a matter relevant to you, please get in touch with our Restructuring & Insolvency solicitors by calling <u>0344 967 0793</u> or email <u>online.enquiries@LA-law.com</u>.

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