Section 98: HMRC debts: priority on insolvency; Section 99: HMRC debts: regulations; Section 100 and Schedule 13: joint and several liability of company directors etc

Overview

The Finance Act 2020 (FA 2020) introduces significant reforms to the UK's insolvency regime, through the reintroduction of Crown preference for certain tax debts, alongside the introduction of joint and several liability for company directors and certain other individuals in cases of corporate insolvency.

Changes to Crown preference

Background

Crown preference was originally a feature of the UK insolvency landscape, but was abolished under the Enterprise Act 2002,[1] which introduced certain reforms intended to promote a "rescue culture".[2]

This abolition responded to sentiments expressed at the time that the Inland Revenue and HM Customs and Excise (as they then were), protected by Crown preference in respect of relevant tax debts, were inflexible in supporting corporate restructurings and too quick to move to a winding up petition. It was also felt that the Government, rather than smaller creditors who could themselves be forced into insolvency, would be better able to deal with any lost tax revenues that might arise were Crown preference removed.

However, in Autumn Budget 2018,[3] the Government announced a change in approach, with the proposed re-introduction of Crown preference for certain tax debts. The measures, consulted upon in 2019, were ultimately enacted in sections 98 and 99 FA 2020, with secondary regulations under section 99 FA 2020 subsequently being made. The reforms, originally proposed to take effect from 6 April 2020, will now come into effect on 1 December 2020.[4]

Operation of the new legislation

Section 98 FA 2020 makes changes to relevant UK insolvency legislation (section 386 and Schedule 6 to the Insolvency Act 1986, together with equivalent legislation in Scotland[5] and Northern Ireland[6]), by making HMRC a "secondary preferential creditor" for certain tax debts. The effect of giving HMRC such status is that they will rank ahead of floating charge holders and non-preferential unsecured creditors in an insolvency, reducing potential recoveries for those

[1] Enterprise Act 2002 s.251.
[2] See, for example, Department of Trade and Industry, *Insolvency – A Second Chance* (The Stationery Office, 30 July 2001), Cm.5234, para.2.1.
[3] HM Treasury, *Budget 2018* (October 2018), HC 1629.
[4] FA 2020 s.98(7).
[5] The Bankruptcy (Scotland) Act 2016 s.129(2) and Sch.3, Pt 1.
[6] The Insolvency (Northern Ireland) Order 1989 (SI 1989/2405 (N.I. 19)) Art.346 and Sch.4.

creditors. Holders of fixed charges and higher ranking preferential creditors will still be entitled to recover ahead of HMRC.

HMRC will not become a secondary preferential creditor in respect of all tax debts. Instead, the principle behind the reforms is that HMRC will only have this beneficial status in respect of tax debts which have in effect been collected by the insolvent business on HMRC's behalf from customers, suppliers and employees of the business. This would extend to tax liabilities such as value added tax (VAT), income tax deducted under PAYE, employee National Insurance contributions (employee NICs) and amounts deducted under the construction industry scheme (CIS). For other tax debts, such as income tax, capital gains tax, corporation tax and employer National Insurance contributions (employer NICs), HMRC will remain a non-preferential creditor.

The primary legislation as enacted in section 98 FA 2020 only makes specific reference to VAT.[7] For other taxes, HMRC must be able to prove that the relevant tax debt is an amount owed in respect of a "relevant deduction".[8]

For these purposes, a relevant deduction will arise where the debtor is required to make the deduction from a payment made to another person, and to pay an amount to HMRC on account of the deduction, the payment made is credited against any liabilities of the other person and the deduction is of a kind specified in regulations under section 99(3) FA 2020.[9]

Under section 99 FA 2020, in addition to being able to specify relevant deductions,[10] regulations may also limit the amounts in respect of which HMRC are secondary preferential creditor to certain periods.[11] In this regard, it is interesting to note that under the pre-Enterprise Act 2002 regime, Crown preference only attached to tax debts that, broadly, arose within the 12 months prior to the insolvency. However, under the new regime, there is no time limit set out in the primary legislation, and so on the face of it, any relevant tax debts which are outstanding on 1 December 2020 will be within the scope of the new Crown preference should a relevant insolvency occur.

Secondary regulations under section 99 FA 2020

Secondary regulations have been made: the Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020, that come into force on 1 December 2020. These specify the following amounts as being "relevant deductions":

- deductions from contract payments within the scope of the CIS;
- deductions of employee NICs;
- deductions of income tax under PAYE; and
- deductions in respect of student loan repayments.[12]

Notwithstanding the ability to limit the periods for which secondary preferential creditor status applies, the draft regulations as published do not specify any such period.

[7] See, for example, Insolvency Act 1986 Sch.6 para.15D(1)(a).
[8] See, for example, Insolvency Act 1986 Sch.6 para.15D(1)(b).
[9] See, for example, Insolvency Act 1986 Sch.6 para.15D(3).
[10] Under the power in FA 2020 s.99(3).
[11] Under the power in FA 2020 s.99(1).
[12] The Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020 (SI 2020/983), para.2(2).

Criticism of the reforms

A number of criticisms have been levelled at the changes, both from a macro perspective and also regarding the detail of the legislation. These include:

- that the evidence that HMRC have put forward to justify the changes does not measure the potential impact appropriately—whilst the Autumn Budget 2018 Red Book estimated that returning HMRC's Crown preference for relevant tax debts would raise up to £195 million per annum in the periods under consideration,[13] UK Finance has estimated the indirect impact on the ability of financing (in particular floating charge financing) to be well over £1 billion per annum[14];
- that the change goes against international norms, leaving the UK an outlier compared to peer jurisdictions;
- that pushing the cost of insolvencies onto unsecured private creditors, including small suppliers, risks a domino effect;
- that the application of Crown preference to all VAT liabilities does not fit with the broad scheme of the legislation, in particular that VAT arising under the "reverse charge" mechanism should not be viewed as a tax liability collected by the insolvent business on behalf of another person;
- that the application of the new regime to existing security arrangements, in particular floating charges, means lenders may be impacted by a change of law that they could not have anticipated when advancing the original financing;
- that the regime does not adequately cater for securitisations and other structured finance arrangements, which should have been excluded from the scope of the reforms given the need for a certain tax position for companies involved in such arrangements.

Practical impact on financing arrangements

So what effect will the reforms have on financing arrangements? The writer anticipates a number of developments, including:

- that lenders may seek to take fixed security rather than floating charges—however, where the security taken does not limit the borrower's ability to deal with the charged assets effectively, there is a risk that it may in any event be re-characterised as a floating charge. Particular issues arise when seeking to take fixed security over assets such as trading stock, book debts and general business bank accounts;
- that lenders who provide floating charge or rescue financing may be less willing to provide such financing, or may only be prepared to provide a lower amount of financing at a higher cost to reflect their increased risk, in the new environment;

[13] See HM Treasury, *Budget 2018* (October 2018), HC 1629, 38, line 69.
[14] R3 Association of Business Recovery Professionals, *Finance Bill: Concern around insolvency proposal impact* (7 May 2020), available at: *https://www.r3.org.uk/press-policy-and-research/r3-blog/more/29398/store/491539/page/1/finance-bill-concern-around-insolvency-proposal-impact/* [Accessed 23 October 2020].

- that lenders may require additional comfort regarding borrowers' tax positions, through obtaining additional representations and undertakings to mitigate the amount of relevant tax debts incurred by a business;
- that for businesses which have taken advantage of certain COVID-19 related business support measures, for example the ability to defer VAT liabilities until 31 March 2021 or the extended "time to pay" scheme, certain of those liabilities will fall within the scope of the new Crown preference, increasing the risk to floating charge holders and unsecured creditors;
- that for certain stretched businesses, lenders may seek to commence insolvency proceedings prior to 1 December 2020, so that the new Crown preference does not apply.

In addition, concerns have been expressed that the reforms shift the balance of power in insolvencies too far in favour of HMRC. For example, in a company voluntary arrangement, there are limits on compromising preferential debts unless the preferential creditor consents.[15] Furthermore, HMRC will still share in the "prescribed part" (that is, the part of the company's assets set aside from floating charge realisations and made available for unsecured creditors) in respect of their non-preferential tax debts such as corporation tax, giving them a second bite of the cherry to recover unpaid tax.

Directors' joint and several liability

Overview

Section 100 FA 2020[16] also represents a significant development, permitting HMRC to hold directors personally liable in cases where HMRC are of the view that avoidance or evasion has arisen, or where "phoenixism" can be established.

The implications of this proposal, which breaches the principle of limited liability upon which the UK's company law framework is based, are significant. Accordingly, the legislation in section 100 and Schedule 13 FA 2020 include certain protections to ensure that "innocent" directors whose companies find themselves in genuine financial difficulties are not brought within the scope of the new rules. Whether such protections are adequate, however, remains a matter of debate.

It is also noteworthy that unlike the measures in sections 98 and 99 FA 2020, tax liabilities which relate to a period ending before Royal Assent to FA 2020,[17] or which arise from an event or default occurring before that day, together with relevant penalties, are not subject to potential joint and several liability.[18] Perhaps it was felt that to introduce such retrospective joint and several liability would be a bridge too far?

[15] Insolvency Act 1986 s.4(4).
[16] With the substantive legislation set out in FA 2020 Sch.13. The numbering of the schedule may be ironic, given the unlucky consequences for those who find themselves in its scope
[17] Royal Assent (*Hansard*) 22 July 2020.
[18] FA 2020 s.100(2).

Scope of new joint and several liability regime

Under the new regime, an authorised HMRC officer[19] can issue a joint liability notice in specified circumstances. These include, to summarise in broad terms:

- where a company has entered into tax-avoidance arrangements[20] or tax-evasive conduct[21]; the company is subject to an insolvency procedure, or there is a serious possibility of the company becoming subject to an insolvency procedure; the individual was responsible for or received a benefit from the arrangements when the individual was a director, shadow director or participator or took part in, assisted with or facilitated the arrangements or conduct when a director, shadow director or concerned in management of the company; a tax liability arises or is likely to arise from the relevant arrangements or conduct and there is a serious possibility that some or all of that tax liability will not be paid[22];
- where "phoenixism" occurs, such that there are at least two companies with which the individual had a relevant connection in the five years prior to the giving of the notice, which were subject to an insolvency procedure and which did not meet certain tax obligations; there is a new company which is or has carried on the same or a similar trade; the individual has had a relevant connection with that company in the relevant five year period and when the notice was given and the relevant tax liabilities of the old companies are more than £10,000 and more than 50 per cent of the total amount of those companies' liabilities to their unsecured creditors[23];
- where a penalty arising under certain avoidance or evasion related provisions has been imposed on a company, or proceedings have been commenced before the First-tier Tribunal (FTT) for a penalty to be imposed on that company; that the company is subject to, or there is a serious possibility of the company being subject to, an insolvency procedure; the individual was a director, shadow director or participator in it at the time of the act or omission giving rise to the penalty or proceedings and there is a serious possibility that some or all of the penalty will not be paid. Relevant penalties include penalties for breach of the disclosure of tax avoidance schemes (DOTAS) rules, under the promoters of tax avoidance schemes (POTAS) rules, or for enablers of offshore tax evasion or non-compliance or of defeated tax avoidance.[24]

Effect of notice

The effect of the notice differs depending on which of the three specified circumstances applies, but broadly renders the individual jointly and severally liable for the relevant tax liability of or penalty imposed upon the company[25]. However, in the case of phoenixism, in addition to the

[19] To be determined by the Commissioners, FA 2020 Sch.13, para.19.
[20] FA 2020 Sch.13, para.6.
[21] FA 2020 Sch.13, para.7.
[22] FA 2020 Sch.13, para.2.
[23] FA 2020 Sch.13, para.3.
[24] FA 2020 Sch.13, para.5.
[25] FA 2020 Sch.13, paras 2(12), 3(7) and (8) and 5(11).

current tax liabilities of the new and old companies, joint and several liability will also apply for future tax liabilities of the new company which arise in the following five years, provided that the notice remains in effect.[26]

It is possible for joint liability notices to be issued to more than one individual if they meet the relevant conditions, in which case all those individuals, together with the original taxpayer company, will be jointly and severally liable for the tax or penalty concerned.

Affected persons

Whilst much of the discussion regarding these measures has concerned the position of company directors, as noted above, the persons to whom a joint liability notice may be issued include shadow directors, those concerned in management and also "participators".[27] This latter term is given the meaning it has in the close company legislation, and therefore could extend to shareholders and loan creditors (including lenders) to the company concerned.

Credit is available for certain penalties to which individuals may be subject under existing penalty legislation.[28]

Relevant insolvency procedures

The legislation covers a broad range of insolvency procedures,[29] including schemes of arrangement, liquidation, administration, company voluntary arrangements, receivership, administrative receivership and corporate strike off processes, together with corresponding foreign procedures and schemes. The recently introduced restructuring plan procedure[30] is not, however, currently addressed.

Application to LLPs and their members

Although the legislation is framed by reference to companies, the provisions also apply to limited liability partnerships (LLPs).[31] For these purposes, references to directors, shadow directors or participators are to be read as references to members or shadow members of the LLP.[32]

Appeal rights

Given the severe consequences that can arise from the issue of a joint liability notice, the individual concerned has the right to request a review of the decision to give the notice.[33] In

[26] FA 2020 Sch.13, para.3(7)(b).
[27] Corporation Tax Act 2010 s.454.
[28] FA 2020 Sch.13, para.9, although note that this only applies in respect of liabilities arising under FA 2020 Sch.13, paras 2 or 3.
[29] FA 2020 Sch.13, para.8.
[30] Corporate Insolvency and Governance Act 2020 s.7 and Sch.9.
[31] FA 2020 Sch.13, para.1(3).
[32] FA 2020 Sch.13, para.18.
[33] FA 2020 Sch.13, paras 11 and 12—the scope of any review is limited to the decision to give the notice, rather than any underlying tax liability or penalty in respect of which joint and several liability may be imposed, and the nature and extent of the review are only "to be such as appear appropriate to HMRC in the circumstances", thus providing questionable protection to individuals.

addition, the individual may appeal the giving of a notice to the FTT.[34] There are strict time limits to request a review or make an appeal.[35]

In addition to appealing the issue of a joint liability notice, an individual that is the subject of such a notice is also entitled[36] to join any ongoing appeal by the company in respect of the underlying tax liability where the company is subject to a relevant insolvency procedure, including the entitlement to take over conduct of the appeal where the company does not appeal, or is not willing to continue the appeal, again, with strict time limits for the taking of such actions. Similar rights apply in respect of a joint liability notice issued in respect of a penalty.[37]

Concerns

Whilst HMRC's underlying purpose in introducing joint and several liability can be understood, the form of the final legislation has given rise to several concerns. As with much recent legislation, the conditions for the regime to apply are broadly drawn.

Whilst it is hoped that HMRC guidance will be issued which will limit the application of the regime to the most egregious circumstances, a concern must exist that once on the statute book, there is the potential for the rules to be applied more widely.

Some of the aspects that it is hoped will be clarified in guidance include:

- the position of business turnaround professionals, who, on the face of the legislation, might inadvertently be caught given a "track record" of involvement with insolvent companies;
- the absence of definitions of certain key terms in the legislation, such as "potential insolvency" and when a "serious possibility" of an insolvency procedure exists, or of "relevant tax liabilities" or "penalties not being paid";
- how issues around constructive knowledge and the quantification of any "benefits" that individuals may derive from tax-avoidance arrangements or tax-evasive conduct will be addressed in practice; and
- how HMRC will apply the new regime in practice, given the already extensive powers that they have to pursue and secure payment of tax debts.

Conclusion

Sections 98 to 100 FA 2020 introduce significant changes to the UK insolvency regime alongside risks for directors and other persons involved in connection with insolvent or potentially insolvent companies. Given the general economic climate at the current time, and the expected increase

[34] FA 2020 Sch.13, paras 13 and 14, again with limited grounds for the individual to seek to set aside the notice, and without the opportunity for a substantive hearing as part of such an appeal as to the existence or amount of the underlying tax liability.

[35] Generally 30 days from the giving of a joint liability notice, subject to the ability to seek an extension, and with the ability to seek a review and then appeal to the Tribunal.

[36] FA 2020 Sch.13, para.15.

[37] FA 2020 Sch.13, para.16.

in corporate and other insolvencies, it seems clear that these sections will become the subject of much focus from HMRC, taxpayers and tax professionals in coming months and years.

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Corporate insolvency; Directors' liabilities; Joint and several liability; Preferences; Priorities; Unpaid tax

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