

Protecting your taxes in insolvency – Consultation: Response

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General Comments

While we can understand the reasons for the partial restoration of the Crown preference in insolvency, we consider the process by which this was announced, without discussion or notice, to have been unfortunate. If there had been prior consultation, this would have allowed a number of issues which we refer to below to be addressed and potentially resolved. As things stand, there is now only a short time period before implementation takes place within which difficulties can be appropriately dealt with.

It appears that the principal focus of the proposed reform is corporate insolvency and there is a particular intention to give priority to the Crown over floating charge-holders. We wonder whether sufficient attention has been given to the implications of the change as regards non-corporate insolvencies where floating charges cannot be granted, this would include for sole traders and partnerships. There is seemingly an intention to apply the change to all business insolvencies; however, this should be considered carefully.

The focus on corporate insolvency is reflected, for example, by the discussion of the existing ranking rules in section 2 of the Consultation Document, which refers to the Insolvency Act 1986 and the 2016 Rules. This legislation does not, however, contain the Scots law insolvency regimes for individuals (including sole traders), partnerships and trust estates (for which, see the Bankruptcy (Scotland) Act 2016). New corporate insolvency rules from 2018 have also recently come into force in Scotland.

Furthermore, there are a number of other issues relating specifically to Scots law that have not been taken account of. We would be happy to discuss these in more detail if necessary.

We have addressed each of the Consultation questions in turn below. Further details on some of the points can be found in our online article from December 2018: “Back to the Future? The Partial Reinstatement of the Crown Preference in Insolvency” (available at <https://www.abdn.ac.uk/law/blog/back-to-the-future-the-partial-reinstatement-of-the-crown-preference-in-insolvency/>).

Question 1: The government is committed to increasing the priority of certain tax debts in insolvency. Should they be ranked as a secondary preferential creditor, an ordinary preferential creditor, or protected in some other way in the event of an insolvency?

We accept that there is a reasonable argument in favour of HMRC having high priority status for those taxes paid by employees or customers to a party that has subsequently become insolvent. These are taxes that are effectively being collected for HMRC and therefore can justifiably be treated in a different way from other types of taxes.

As a secondary preferential creditor, HMRC will only receive payment after first-ranking preferential creditors have been paid. The justification for prioritising these other creditors over HMRC is unclear and should be further explained. Presumably it reflects a reluctance to

disturb the existing order of priority except from floating charge-holders downwards in corporate insolvency cases (however, other secondary preferential creditors will also proportionally lose out). If the recovery of payable taxes due to HMRC is to be such a priority, then why is HMRC not to be (at least) a first-ranking preferential creditor?

If it is accepted that the insolvent party is holding the monies on behalf of HMRC, there could even be an argument that under the current law the property is held in trust for HMRC. This would mean that the tax sums are excluded from the insolvent estate and are available to HMRC as beneficiary (unless perhaps they have been made subject to fixed security rights e.g. a fixed charge over a bank account containing the sums). The HM Treasury document issued along with the budget (Budget 2018 – Protecting your taxes in insolvency) in fact refers to sums paid being “held in trust by the business”. It does, however, separately state that HMRC will become a secondary preferential creditor “for taxes held on behalf of employees and customers”. It would appear more accurate to state that if a trust is created, it is for the benefit of HMRC rather than for those who are contributing the property. A constructive trust may arise on the basis that the business concerned can be considered an agent acting on behalf of HMRC for the collection of the taxes. A fiduciary relationship, such as this, can seemingly give rise to a constructive trust in both English law and Scots law (for the latter see e.g. *Ted Jacob Engineering Group Inc v RMJM* [2014] CSIH 18).

Even if the trust argument could not be made successfully under the current law (and this may be particularly true in Scotland), an alternative approach would be to provide, in legislation, that the tax sums due to HMRC and being held by a business are held in trust for HMRC. This would enable the property to be separated from the insolvent estate and would effectively give HMRC a super-priority (albeit potentially subject to any fixed security over the “trust” property).

In terms of what is actually proposed, HMRC will be subject to any fixed security creditors, expenses of the insolvency process (e.g. sequestration, liquidation, administration or receivership) and ordinary preferential creditors. As such, HM Treasury calculates that the average debt recovered by HMRC from 2020 will only be 14% and the estimated annual yield from the change will be £185 million (Budget 2018 – Protecting your taxes in insolvency). (But we note the differing amounts specified in the Exchequer Impact Assessment in section 4 of the Consultation Document.) Yet this amount could be significantly greater by using a trust mechanism. The non-utilisation of trust here presumably, again, reflects a reluctance to disturb the priorities of creditors at the higher end of the ranking ladder.

It would be possible to run a trust argument even after the (re-)introduction of the Crown’s preferential status; however, the fact that legislation would be treating the Crown’s claim as connected with property in the estate would likely be used to defeat that argument. For if the property was trust property, it would not be part of the estate, and it would not therefore be necessary for the Crown to have preferential status for the debt due.

The method that the government seems to have chosen would mean that HMRC is able to receive a preferential payment, even if the relevant tax sums held have been intermingled with other assets and are no longer separately identifiable or have been dissipated. If a trust route was instead chosen, attention would need to be paid to how the intermingling or dissipation of the relevant property should be dealt with.

It is stated in para 3.10 of the Consultation Document that there is to be no time limit requirement for taxes due to HMRC to have preferential status. However, it should be recalled that prior to the Enterprise Act 2002 reforms, the Crown preference had time limits attached. We wonder if there is desirability in having some form of time limit. (Even for a trust mechanism approach a specific time limit for claims could be introduced.) For example, if an insolvent

party received relevant tax payments a number of years previously and had not passed these on to HMRC, should these constitute preferential debts? Perhaps consideration should be given to what would best encourage HMRC to recover sums promptly.

We note from para 3.11 of the Consultation Document that any penalties or interest arising from the relevant taxes will also form part of HMRC's claim. We can see the justification for interest forming part of the claim, as monies are being held for HMRC by the insolvent party and HMRC has been deprived of the use of these if they have not been paid over to HMRC promptly. However, penalties are not simply being held on HMRC's behalf and instead are more akin to unpaid taxes due by the insolvent party to HMRC.

Question 2: Would any of the taxes included in this measure pose any particular challenges to insolvency office holders when they process HMRC claims?

We are not aware of any particular difficulties on this point. We are not clear if the list of taxes in para 1.8 of the Consultation Document is definitive as far as affected taxes are concerned. We do not consider any of these taxes to be a particular problem as far as processing HMRC claims is concerned. However, we are not practitioners and so are not best placed to comment on this.

Question 3: Do you foresee additional administrative burdens falling upon individuals, businesses or insolvency practitioners as a result of this measure? If any, how might they be lessened?

We do not foresee additional administrative burdens arising as a result of the measure. However, if a legislative trust mechanism was instead to be introduced, there would have to be specific consideration of how issues like tracing would impact upon administrative work.

Question 4: Do you consider the objectives of any type of formal insolvency procedure will be adversely affected by this measure? If so please evidence or explain why. Please suggest how we could mitigate against this.

We presume that this question relates directly to a possible impact on the "rescue culture" in UK corporate insolvency law. We are aware that some commentators have suggested that there would be a significant negative impact in this regard but we are not entirely clear why this would be so. Floating charge-holders may be relative losers as a result of the measure and lenders seeking such a charge may limit their lending accordingly but this is unlikely to affect insolvency processes generally. There is a possibility that such creditors would seek to appoint an administrator at an earlier stage than currently but this could in fact enable a business to be saved by earlier intervention and in fact encourage the rescue culture.

There may be a view that HMRC would be keener to seek liquidation in order to receive its partially reinstated preference. However, the opposite may be more likely: HMRC could be less inclined to press for liquidation as it would know it could ultimately fall back upon its preference.

Question 5: Are there any transitional issues that we need to take into consideration in implementing this measure?

We are unaware of any specific transitional issues that may require special consideration.

Question 6: In your view, are there any other considerations, or other potential impacts that HMRC should take into account in implementing this measure?

We consider that there are a number of other unanswered questions and problematic issues as far as the proposal is concerned. Firstly, as referred to above, in relation to which businesses will the preference apply? Presumably it is to extend to all parties that hold the relevant tax payments for HMRC, which would include sole traders and partnerships, as well as the likes of companies and LLPs.

If the intention is to include sole traders and partnerships, then for Scotland it will be necessary to amend the Bankruptcy Act 2016 to enable the Crown preference to exist in the context of sequestration (as this is the relevant insolvency process for such parties). It is unclear whether there would be any enthusiasm in Scotland to make this change, but the law relating to preferential debts regarding any type of debtor is a reserved matter and is therefore within the competence of the UK Parliament rather than the Scottish Parliament (Scotland Act 1998, Sch 5, Head C2). It is therefore not obvious on what basis a legislative consent motion may be required for Scotland (see para 3.4 of the Consultation Document).

One of the justifications for removing the Crown preference previously (at least for corporate insolvencies) was that it was being replaced by the prescribed part for unsecured creditors (which would then include the Crown) and this would have priority over a floating charge holder. It is specified in the Consultation Document at para 2.1 that the prescribed part is to be increased from a maximum of £600,000 to a maximum of £800,000. This is a reasonable step as the maximum amount has not been increased since the prescribed part was introduced. It is not clear, however, whether the impact of this linkage has been taken into account in making the (apparently) separate policy decisions relating to the partial reintroduction of Crown preference and the increase in the maximum value of the prescribed part.

It is true that the planned increase in the prescribed part combined with the returning Crown preference further relegates the priority status of floating charges. This can be considered especially problematic for raising finance in Scotland due to the difficulties in obtaining fixed security over many types of property (in comparison to England). The matter has been considered in detail in a recent article: R Caldwell, "Enterprise Goes into Reverse for Floating Charge-holders" 2019 *Juridical Review* 103. The situation provides further support for enacting the Scottish Law Commission's recent proposals to introduce a new non-possessory security (the statutory pledge) (Scottish Law Commission, *Moveable Transactions Report* (Scot Law Com No 249) (2017)).

It may also seem, at first glance, that unsecured creditors will almost invariably suffer too. Yet, the extent to which parties will be winners or losers under the proposed new ranking regime is not as straightforward as it may appear. In a corporate insolvency, the prescribed part only operates as a proportional claim on the "net property" of the company concerned, which is the property which would otherwise be available for the satisfaction of floating charge holders (Insolvency Act 1986, s 176A). Consequently, the net property of the company will be correspondingly reduced by the new Crown preference, and so the prescribed part will also be lower than it would be otherwise. On the other hand, the partial promotion of HMRC to preferential status will reduce the unsecured claims of HMRC in relation to the prescribed part.

Our blog article (<https://www.abdn.ac.uk/law/blog/back-to-the-future-the-partial-reinstatement-of-the-crown-preference-in-insolvency/>) provides an example showing certain differences between recoveries under the current regime and the new regime, which may assist. It is clear from this example that floating charge-holders will suffer the principal losses due to the changes in the law. HMRC is, unsurprisingly, the principal beneficiary but the (other) unsecured creditors also receive a benefit, at least in the scenario outlined, by virtue of both the increased prescribed part and the partial elevation of HMRC to preferential creditor status.

One final point, is that there may be issues affecting the amount of the claim where the tax is due to be paid to the company before it enters an insolvency process but is only actually paid to the company after the commencement of an insolvency process. I.e. will such sums be included within HMRC's preferential claim?

Question 7: Do you have any comments on the assessment of equality or other impacts?

No, except to the extent that any comments above are connected to relevant impact assessments.

It is, however, difficult for us to comment as the information relating to the assessments in the Consultation Document is highly limited.