ICAEW
REPRESENTATION 53/19

HMRC CONSULTATION ON PREFERENCE FOR CERTAIN TAXES

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ICAEW welcomes the opportunity to comment on the consultation *Protecting your taxes on insolvency* published by HMRC on 26 February 2019 a copy of which is available from this link.

This proposal is at odds with government efforts to foster an enterprise culture in recent years. It can be expected to deter lending and have other adverse consequences that have not been sufficiently considered in the proposal.

The reasons given for the proposal are unconvincing. For instance, the impact assessment dismisses the interests of small suppliers and other unsecured creditors simply because they recover such a small percentage of debts. On that basis the proposal should never have been made as the amounts at stake for HMRC are a minute proportion of total taxes raised.

We believe that the proposal should be withdrawn and reintroduced only if a thorough consultation exercise justifies it.

Instead, we believe that HMRC should demonstrate its determination to be a world class professional organisation by exercising the extensive powers it already has more effectively (in particular, to prevent abuse).

This response is made by the Business Law Department of ICAEW and reflects views expressed by a wide range of ICAEW's experts, including its Insolvency Committee and members of its Tax Faculty.

ICAEW is the largest single insolvency regulator in the UK. We license approximately 800 of some 1,550 UK insolvency practitioners as a recognised professional body.

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KEY POINTS

The UK's enterprise culture

1. The proposal focuses on the amount of extra tax HMRC might recover, but does not consider the impact it might have on the reputation of the UK as a good place to do business. If business is deterred as a result of HMRC's proposal, the taxes that would otherwise have been generated will be lost so that proposal may harm the interests of taxpayers rather than benefitting them. A measure to increase government revenues in the short term may result in long term harm to the economy.
2. The UK's insolvency regime is generally seen as an effective and fair one which encourages investment, as evidenced by World Bank ratings on ease of doing business.
3. The Enterprise Act 2002 radically reformed UK insolvency law to promote an enterprise culture in which businesses in financial difficulty might be helped to recover and access to finance would be maintained. HMRC preference was dropped as an integral part of those reforms, alongside the introduction of the "prescribed part" which gave unsecured creditors, including HMRC, priority over floating charge holders in respect of part of the assets.

   ….”as an important and integral part of this package of measures, we will proceed with the abolition of Crown preference in all insolvencies. Preferential claims in insolvency originated in the late 19th century, but in recent years the trend in other jurisdictions has been towards restricting or abolishing Crown or State preference as, for instance, in Germany and Australia. We believe that this is more equitable. Where there is no floating charge-holder, the benefit of abolition will be available for the unsecured creditors. Where there is a floating charge-holder (in relation to a floating charge created after the coming into force of the legislation), we would ensure that the benefit of the abolition of preferential status goes to unsecured creditors. We will achieve this through a mechanism that ringfences a proportion of the funds generated by the floating charge.”[1]
4. Since then, government has made, or proposed, changes to enhance the enterprise culture, for instance, in relation to continuity of certain supplies on insolvency, reporting by large companies on payment practices, increasing the amount of the prescribed part and introducing a moratorium to help business rescue. Measures such as these may help keep the UK insolvency regime internationally competitive at a time when there are signs that it is slipping down the rankings.
5. As recently as April 2018, HMRC, in its discussion document on tax abuse and insolvency, described the purpose of the insolvency regime as follows:

   “The insolvency regime exists to support restructuring and rescue for businesses in financial distress. Where this is not possible, it provides an orderly and fair winding-up of the business' affairs and distribution of available assets to creditors.”
6. Further, government recognised the risks of introducing preference for particular creditors (in this case, consumers making cash deposits) in its response of December 2018 to a Law Commission report on consumers and insolvency:

   “The government recognises the concerns when individual consumers may lose money in an insolvency situation. However, in its view this recommendation could increase the cost of capital, harm enterprise and lead to calls for preferential status for other groups of creditors which would adversely affect the amount available to other unsecured creditors, which would lead to far greater losses to the wider economy….. The government has decided not to pursue this measure.”

[1] White Paper DTI – Productivity and Enterprise. Insolvency - Second Chance (2001)

7. If government now has data suggesting that the Enterprise Act and its recent reforms were misguided, we call on it to make the information publicly available. If it does not, then it is difficult to see why it is now seeking to reverse an integral part of those reforms. The impact assessment is not persuasive in this context for reasons we note later.
8. We believe that the current regime is designed to produce a fair result for creditors, including the taxpayer, whilst also facilitating business rescue. The proposal would significantly upset this balance, with a number of potentially adverse consequences that we outline later in our response. First, however, we comment on HMRC's characterisation of the taxes in question as being of a particular nature that merit special treatment.

Characterisation of the taxes in question

9. It would be natural for taxpayers generally to think that HMRC should have preference (whether over these particular taxes or more generally) as it suits their immediate and obvious interests. However, relatively few individuals have personal experience of proving as creditors of insolvent businesses or awareness of the insolvency regime and its place in the UK's enterprise culture. Government should, therefore, take care to present the facts and different perspectives in an objective and thorough way to enable the public to have a balanced view. We believe that the consultation falls short in that respect.
10. It suggests that employees "pay" the PAYE to the employer, but the amounts are, in fact, deducted by the employer and the employee has no say in the matter. Neither do employees have an obvious interest in ensuring that the employer pays the amounts deducted to HMRC (as HMRC does not seek payment from employees if the employer fails to meet its obligations).
11. The consultation infers that an amount equal to the amounts deducted should be held on some kind of trust by the employer between one date (eg, the date the employer is legally liable to pay relevant amounts to HMRC) and another (eg, date paid, or insolvency). In practice, we do not believe that employers do operate trust arrangements of this kind, or that employees would necessarily expect them to do so. Rather, the amounts are used in the business as working capital until paid. Similarly, in cases where employees are paid gross, they do not ordinarily hold amounts on trust to meet their tax liabilities (and HMRC is therefore exposed to their insolvency). If government believes otherwise it will need to explain more fully how the trust is meant to operate and provide an analysis of the cost implications if businesses are required to change current practices.
12. While VAT may be "paid" by customers of the insolvent business, similar considerations regarding any trust relationship also apply in that context. If the preference will apply to VAT owed by customers to the insolvent business (but unpaid before insolvency), it would not have be "paid" in the ordinary sense of the word.
13. The proposal also covers student loan deductions, but not other deductions employers may be required to make (eg, for pensions). It does, however, provide that penalties and interest on the relevant payments will be given priority, but it is difficult to see how these could be characterised as amounts "paid" by employees or customers or otherwise regarded as being subject to some kind of trust obligation. Neither are they "taxes".
14. Others are exposed to insolvency risks similar to those of HMRC. For instance, consumers who make cash pre-payments to businesses are exposed until such time as they receive the goods or services in question and might consider that the monies should be held on some kind of trust or that they should be accorded preference. As noted above, government decided not to extend preference in that case. We believe it should apply the same reasoning here to the same end (ie, that it should not pursue this proposal further).
15. The proposal is designed to increase returns to taxpayers generally, but it will inevitably be unfair for the specific taxpayers who are unsecured creditors of the business who will lose out; it is unclear why the former group of taxpayers should receive preferential treatment to the latter, particularly as the proposals do not distinguish between unsecured creditors who are compliant in their tax affairs from those who are not.

16. The prescribed part was introduced in part to protect the interests of HMRC and if the proposal is taken forward, HMRC will benefit both from the prescribed part (in respect of non-preferred debts) and preference (for the preferred debts). In some cases, HMRC will, in effect, be in much the same position as it was under the pre-Enterprise Act preference regime, even though HMRC has sought to characterise its preference as applying only over selected taxes.
17. Regardless of characterisation of the taxes, we suggest that government should be asking itself whether the proposal is in the public interest. As a broad generalisation, the general body of taxpayers, which the Treasury represents, is better able to stand a loss than any specific individual or business. In our view, the current regime represents a reasonable compromise where tax debts rank equally with other unsecured creditors with a defined amount having priority through the prescribed part. A case could, however, be made for moving the tax debts down the queue rather than up.

Making HMRC more effective in insolvency processes

18. The consultation portrays the taxpayer as a helpless victim in the insolvency process, but this is very far from being the case. HMRC has various powers or rights that put it in a privileged position compared to ordinary unsecured creditors. It has access to information that other creditors do not have and is typically the largest unsecured creditor in an insolvency. Before government seeks to give HMRC further preferential treatment, it should consider whether taxpayer exposure to insolvent businesses might be reduced through better use of existing powers.
19. HMRC is generally able to assess the amounts owed to it (in a way that might not have been possible in the past) and is in a unique position to assess potential credit risks of tax paying businesses, for instance through RTI on PAYE and through VAT returns.
20. It also has powers that are not available to other unsecured creditors including to:
    - require a business to provide security for both PAYE and VAT
    - decline to register a business for VAT in appropriate cases
    - deduct amounts from bank accounts
    - send in bailiffs or enforcement officers without a court order to seize assets
    - enforce against directors for unpaid National Insurance Contributions
    - exercise Crown set-off
    - require a third party to provide security (for VAT debts)
    - enforce obligations against third parties in cases of Missing Trader Intra-Community (MTIC) fraud
    - make demands on debtors based its own assessments.

    Government has also said that it intends legislating to make directors jointly and severally liable for losses resulting from abuse of the insolvency regime (phoenixism).
21. In many cases, HMRC is the largest single unsecured creditor. This gives it considerable power, in practice, over insolvency processes.
22. In combination, these powers put HMRC in a strong position to choose whether to minimise its exposure to any business or to extend credit in the expectation of future return, indeed it is often the instigator of insolvency proceedings.
23. In looking after its own interests, HMRC's involvement in the insolvency process (with the resources available to it) may benefit other unsecured creditors. For instance, it can participate in company voluntary arrangements designed to help a business survive or by taking more assertive steps to prevent rogue directors from setting up phoenix businesses, so protecting future creditors. By contrast, if it is given preference, it will not be so incentivised to manage its credit exposure and may be more inclined to press for liquidation of insolvent companies rather than rescue.
24. HMRC also has powers to allow businesses extra time to pay taxes due, which it was given for good reasons. Its inclination to use these powers may well decline if it is a preferred creditor.

25. We suggest that it would be preferable for HMRC to exercise its powers to the full as appropriate on a case by case basis rather than seeking to have preference over all assets at the expense of other creditors.

Adverse consequences

26. Whenever one class of creditors is given an advantage in insolvency, it is at the expense of others. In this case, HMRC preference will reduce returns to floating charge holders and/or unsecured creditors such as small suppliers and pension schemes. Given the lack of detailed data in the consultation document itself, it is somewhat difficult to quantify potential losses as between different types of creditor. In particular, the impact may be significantly different if the prescribed part is increased as proposed in recent consultations.
27. While quantification may be difficult, we believe that there will be less finance available if HMRC is given preference, especially for businesses with large numbers of employees (and associated tax liabilities and cash flows). A reduction in the number of company voluntary arrangements and an increase in liquidations should be anticipated.
28. The fact that the amounts at stake may be relatively small in aggregate compared to total unsecured creditor losses on insolvency or total secured lending is not sufficient reason to dismiss the interests of those affected as HMRC has done. The impact in any given case will depend upon the facts of the case, and in some cases the impact may be severe (for instance enough to push a supplier into insolvency itself).
29. Because the proposal partially reverses the reforms of the Enterprise Act 2002, it brings into question whether government any longer believes in the philosophy of an enterprise culture. This is likely to affect perception of the UK as a good place to do business. While it might be difficult to quantify the financial impact of this in a reliable way, perceptions can be important, particularly if the UK is perceived to be moving backwards compared to other leading democratic countries.
30. The change is likely to result in changes in business behaviour as lenders, particularly floating charge holders, may wish to protect themselves against the increased risk. For instance:
    - businesses may seek ways to restructure themselves to be more attractive for floating charge holders, eg putting staff and assets into separate subsidiaries
    - lenders who can currently rely upon floating charges over book debts may instead insist on borrowers having factoring or invoice discounting facilities in place, under which the book debts are sold to the lender (and so no longer an asset of the borrower)
    - there may be increased use of sale and leaseback transactions in relation to relevant assets, or more extensive use of retention of title by suppliers.
31. Business may incur costs and suffer inconvenience in making these sorts of arrangement even though the arrangements would not in themselves increase productivity (or benefit the UK's economy). This would simply be the logical consequence of a policy that significantly lessens the protection afforded by a floating charge (the floating charge being a flexible and efficient form of security).
32. Lenders can also be expected to put more pressure on directors to give personal guarantees to try to reduce their credit risk if floating charge protection is reduced. This may in turn deter directors from seeking finance to expand or continue in business, so damping competition and discouraging enterprise.

ANSWERS TO SPECIFIC QUESTIONS

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?

33. Secondary preference was introduced only in 2015 and applies only to certain businesses in certain circumstances (eg, banks and building societies holding deposits exceeding the

£85,000 FSCS protection). Government needs to consider the impact on the UK's insolvency regime as a whole (and the perception of it by others) before expanding a category introduced for a specific purpose to cover a much broader one.

34. On the other hand, if the debts fall within ordinary preference, they would rank alongside creditors in that class such as employees, and so reduce amounts that might otherwise be payable to them (but still ahead of other taxpayers such as small suppliers or consumers who have made cash deposits). For every alternative there will be different losers and HMRC will need to decide at whose expense it profits.

35. The consultation document described the second category of creditors as "Insolvency practitioner's fees and expenses". We believe that this would better have been described as "expenses of winding up" in line with the Insolvency Act and Insolvency Rules and it is important that any proposals that might impact this category take into account the nature of claims involved. The expenses of winding up include various categories of expense, including expenses incurred in preserving, realising or getting in any of the assets of the company. A priority applies between these categories and the fees of insolvency practitioners is towards the bottom of the list. In the post insolvency period, the tax arising on chargeable gains ranks behind a limited part of insolvency practitioner fees, but all other post insolvency taxes, including tax on income/profits and direct taxes, rank entirely ahead of insolvency practitioner fees in the orders of priority.

36. Para 3.11 of the consultation says that penalties and interest from the taxes will also form part of HMRC's preferential claim. This seems particularly unfair to unsecured creditors and floating charge holders as they have no equivalent rights to apply penalties. As noted above, it is also difficult to see how HMRC's characterisation of the relevant debts as being, in effect, amounts held by the employer on trust could extend to penalties and interest.

37. As regards possible other protections available to HMRC, please see our comments on use of HMRC's existing powers above. It would, presumably, also be open to government to require that businesses should pay the amounts of tax when due into a ring fenced account held "on trust" (ie, formally to create the sort of trust arrangement that the consultation infers already exists in some sense). This might remove the assets from the insolvent estate entirely, but would be administratively burdensome and would deplete the working capital available to business (and begs the question why HMRC would not simply require the amounts to be paid immediately to it).

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

38. The proposal will introduce another layer of complexity, requiring those involved to identify exactly which HMRC claims have preference and which do not.

39. In many cases, failing businesses do not keep good records and rectifying errors can be a time consuming (and expensive) process. The proposal will require tax debts to be identified in more detail, to distinguish between those that are preferred and others, and if businesses fail to keep appropriate records, it will increase the work required of office holders on insolvency.

40. Office holders will also need to consider claims by HMRC and reconcile them with the employer records. Unless HMRC has robust and accurate record keeping systems that clearly identify the different categories of taxes and amount outstanding in respect of each of them, this exercise will also become more time consuming and costly.

41. We are concerned that HMRC's systems are not sufficiently robust and accurate and that the risk of system errors is a very significant risk to the efficient operation of the proposal. We have raised our concerns about HMRC's systems before, for instance, in our Tax Faculty's REP 163/16 and associated blog on "*PAYE in real time - post implementation review"*. HMRC is aware of the issues (and has a disputed charges team to handle the fallout) and we do not repeat all our concerns here but would be happy to discuss further if this would be helpful. We are raising the point here because we believe government needs to consider whether HMRC's systems will be able to cope with further levels of complexity when they

appear to be struggling with current demands in relation to the taxes covered by the proposal.

42. Businesses are generally required to pay taxes to HMRC electronically and, in practice, make payments in a single sum covering PAYE, employer related NICs, employee related NICs, apprenticeship levy and student loans, without explicitly directing that the payment be set against a particular element of the debt. There is a risk that HMRC might seek to apply amounts received before insolvency against non-preferred debts rather than preferred debts, to maximise its advantage in the event of insolvency. If the proposal is to operate in a fair and objective way, government will need to explain how receipts should will be applied against relevant debts (and HMRC's systems would need to apply accordingly).
43. HMRC may also need to produce records to office holders to show how it has calculated amounts of preferential or non-preferential debt and, as noted above, we are concerned that its systems are not sufficiently robust in that context.
44. Similarly, crown set-off applies on insolvency and it will be necessary for debts to be correctly identified to enable set-off to be applied proportionately against preferential and non-preferential debts.
45. Insolvency practitioners frequently find that HMRC is not well equipped to deal with various aspects of insolvency related processes. These proposals are likely to result in further difficulties, as outlined above. Also, HMRC may need to be actively engaged in the processes more frequently because the number of cases where returns will be made only to preferential and secured creditors is likely to increase.
46. Any increase in costs or delay in the insolvency process comes at the expense of other creditors so it is important that HMRC is properly resourced to apply any new regime. The appointment by HMRC of an insolvency customer service manager was a helpful development but we believe that more needs to be done. We would be happy to comment further on this if that would be helpful.

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?

47. See above regarding the impact on insolvency practitioners.
48. In part because of the retrospective nature of the proposal, it is likely that lenders (floating charge holders in particular) will need to reassess their credit risks and, potentially, terms of lending.
49. In some cases, lending facilities may no longer be available and affected businesses will therefore need to find alternatives (or cease business).
50. The order of priorities is already quite complicated and this proposal will result in additional complexity. This may affect the ease of doing business in the UK (or perception of doing so), as those who wish to understand their risks will need to understand the regime.
51. The increase in the prescribed part proposed in a separate consultation document should improve HMRC's position (along with other unsecured creditors) and government should consider whether pursuing that measure might not be more proportionate for all concerned than this proposal for HMRC preference.

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.

52. As outlined above, we believe that a consequence of the proposal will be that business rescue will become more challenging and less available. HMRC will lose its incentive to support businesses and to use its financial resources to help smaller unsecured creditors in the hope of longer-term advantage if it is more likely to recover what it is owed by liquidation.

53. In particular, we believe that the preference will make it harder for company voluntary arrangements to be agreed.

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

54. The proposal would give preference to relevant tax debts whenever they arose (ie with retroactive effect). This does not incentivise HMRC to manage debts effectively. It could exacerbate the amount of work required to ascertain the debts to which preference applies, and so the costs of insolvency. It also increases the amount at stake compared to the position where a cut-off period applies, so exacerbating the concerns outlined in this response.
55. Credit rating agencies will need to re-rate Crown debt as preferential and, given the retroactive nature of the proposal, this may lead to an abrupt down-grading of individual companies' credit ratings, in some cases reducing availability of finance and causing liquidity problems.
56. We suggest that, if this proposal goes ahead, only debts arising in a specified period before insolvency should have preference (as was the case before the Enterprise Act 2002), say 6 months.
57. The amount of work required for lenders and businesses to review credit arrangements might be mitigated if the proposal were to apply only to loans made after the implementation date.
58. The proposal puts HMRC (who are often the most influential creditor under the current regime) in a position where it might be incentivised to cause delay in proceedings starting before the implementation date with a view to gaining priority over all the relevant debts at a fixed point in the future. Again, this might be mitigated if the preference only applied to new debts.

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

59. Please see our Key points and answer to Q2 above.

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

60. The impact assessment has a number of shortcomings. It is unclear if HMRC has considered how it might reduce the amounts owed by other means (eg, systems improvements, debt management and exercising its powers more fully) or to what extent the Enterprise Act and other reforms (based on the absence of preference) have succeeded in their aims. It might have been helpful to provide figures for the amount of taxes involved over the past three or four years, rather than just a single year.
61. The impact assessment states that government does not expect the proposal to have a material impact on lending and that the Office of Budget Responsibility made no adjustments to its forecasts, but it provides no evidence of feedback from lenders or business to support that conclusion. If the proposal results in any reduction in lenders' willingness to lend, this could have a material impact on those businesses who are dependent on credit. While many financial institutions have fixed charges, floating charges are nevertheless important to them.
62. HMRC dismisses the interests of unsecured creditors on the grounds that only relatively small amounts (in aggregate) are at stake, in particular that they recover only 4% of their claims. Yet if it applied that sort of reasoning to its own interests, it is difficult to see why it would be making this proposal (which impacts a minute proportion of total tax raised).
63. There will be some cases where floating charge holders or unsecured creditors will be severely impacted by the preference and their concerns should be given proper consideration. The sentiment of investors will be influenced by the risk of being impacted.
64. The fact that the average amount recovered by unsecured creditors (which include small businesses such as suppliers) is so low might be a source of concern rather than a reason to

dismiss their interests; some small businesses operate on relatively small margins. The impact assessment says that there will be some impact on small firms in relation to the "small firms impact test", but it does not seek to quantify this. In practice, many more small unsecured creditors will receive nothing when they are owed money by insolvent businesses.

65. Data is not provided to allow for analysis of the different options readers are invited to consider. It is also unclear whether, or how, the proposed increase in the prescribed part might impact the calculations.

66. It is unclear why the impact to the exchequer should increase and then tail off, but if the perceived benefit is likely to decline in the longer term, that would be an important consideration.

67. The OBR budget 2018 policy costing referred to says that "costing accounts for a behavioural response whereby the measure has a deterrent effect on future insolvency as some taxpayers become compliant". We query whether giving government preference would in itself lead to a reduction in insolvencies (except to the extent that it results in a reduction in enterprise generally). The proposal affects all businesses whether or not they are "compliant".

68. It is unclear whether the analysis anticipates behavioural changes by banks and other creditors that we believe are likely as outlined above. If it does not, the potential benefits may be significantly lower than anticipated.

69. The OBR analysis states that the taxes concerned are held "temporarily in trust" and we question whether that is correct or why, if a trust arrangement exists, it would be considered as a temporary one.

70. The analysis states that the measure seeks to tackle artificial and unfair tax avoidance or evasion by misuse of insolvency processes (phoenixism). Misuse of insolvency processes was subject to a separate discussion paper, and HMRC announced that it will legislate to make directors and others involved in the abuse jointly and severally liable on insolvency. We have reservations about that proposal too and believe that a fuller impact assessment is required to show the amounts at stake under each proposal separately and the estimated impact if one proposal is pursued but not the other.

71. HMRC gave assurances that, in addressing cases of abuse, it would protect the rights of companies in genuine difficulty and creditors. In particular (in its discussion paper referred to above) it stated:

> "The vast majority of insolvencies are not artificial in this way – they relate to genuine commercial difficulties .... Companies who are in genuine difficulty and have not engaged in tax avoidance, tax evasion or repeated non-payment of taxes should be absolutely clear that their rights will continue to be protected."

And in its summary of responses published in November 2018 it stated:

> "The government believes that this measure will allow greater fairness in the tax system by providing a coherent response to tackling the behaviour of those who abuse the insolvency rules. It will not undermine other creditors' rights to payment of their liabilities."

While the above comments were made in the context of specific proposals to combat abuse, they acknowledge the importance of protecting creditor rights generally and it is disappointing that government should now make a proposal on preference which manifestly undermines other creditors' rights.