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NEWS

UK tax authority to be preferred creditor

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Philip Hammond

Insolvency practitioners have criticised UK government plans to make tax collection authority Her Majesty's Revenue & Customs (HMRC) a secondary preferential creditor in insolvencies.

Chancellor of the Exchequer Philip Hammond made the announcement in the course of his annual budget speech to the House of Commons on 29 October.
He presented the change as part of a "clamp down" on tax avoidance.

"We'll make HMRC a preferred creditor in business insolvencies to ensure that tax which has been collected on behalf of HMRC is actually paid to HMRC," he said.

A briefing document published by HM Treasury, the UK's finance ministry, said the change would bring in an extra £185 million (US$235 million) in taxes per year.

The change reverses a move made in the 2002 Enterprise Act by then-Chancellor Gordon Brown – later a prime minister himself – to remove the protected creditor status enjoyed by HMRC since the 19th century.

Since then, the Treasury document says, "many creditors other than HMRC have a higher priority claim on the assets of an insolvent company – even for taxes paid by employees and customers that the business hold temporarily before passing them onto the government".

Financial institutions will remain above HMRC in the pecking order for fixed charges over assets, the Treasury says. It adds that since unsecured creditors "are usually unable to recover any of their debts" anyway – recovering on average about 4% of debts owed to them – they will mostly be unaffected.

The revised order of preference will include HMRC among "preferential creditors" below insolvency practitioners and holders of fixed charges, but above holders of floating charges.

Insolvency practitioners have criticised the plans.

"By HM Treasury's own admission, the average recovery rate for unsecured creditors in insolvencies is already only 4p in the pound," Kirkland & Ellis partner **Kon Asimacopoulos** tells GRR. "This proposal will inevitably reduce it even further."

"It underscores the necessity to accelerate measures to avoid insolvencies in the first place and promote rescue."

Norton Rose Fulbright consultant **Hamish Anderson** says any preference of one creditor over another cannot be good news for recovery. "The hard truth is that the introduction of any element of preference will be at the expense of other creditors. The only way that would not be the case is where there is a surplus."

Anderson adds that the trend in other major jurisdictions such as Germany and Australia has been for tax authorities to shed their preferred creditor status. "So this is somewhat rowing against the tide."

But he notes the Treasury's own assurance that the measure should not have a material impact on lending. "£185 million may be quite a lot to you and me, but it's nothing compared to £57 billion in bank lending."

Michael Fiddy, global co-chair of restructuring at DLA Piper, calls the move an "odd direction of travel".

"It does seem an unusual policy change, a bit out of the blue, and I'm not entirely clear what mischief they are trying to solve, though it's presumably to obtain more revenue."

he says. “But I’m not totally convinced it’s aligned with the rescue culture, as it puts directors under all sorts of pressures.”

Fiddy points out several practical questions the change leaves unanswered. For instance, he says it is at present unclear whether businesses will be obliged to set up trusts for VAT or PAYE funds under which employers subtract their employees’ tax obligations. “It would appear that it would extract cashflow from a business, at a time when cash is at a premium.”

"I think generally people have been surprised by this, it hadn't been trailed by HMRC," says Morrison & Foerster of counsel **Howard Morris**. "One can see their logic, but it means unsecured creditors will get that much less."

Morris wonders if the knowledge that it will be a preferred creditor might make HMRC more willing to press for winding-up of distressed companies. "It could make HMRC more aggressive and less co-operative," he suggests.

"Essentially what the government appears to be trying to do is jump up the queue in these insolvency cases and as a result get itself a bigger slice of the cake," says **Brian Johnson**, a business recovery and insolvency partner at HW Fisher & Company.

"This feels like a regressive move," he adds. "The danger is this could have the effect of reducing bank lending to businesses, both in terms of rescue loans but also business loans more broadly. Banks would have to take a much closer look at their lending risk profile in light of the evidence that tehy would get less back if the business became insolvent. Ultimately it could lead to tighter business lending conditions and could stymie entrepreneurialism."

Graham Bushby, head of the restructuring team at advisory firm RSM, said that “in the briefest of mentions in his Budget” Hammond “effectively wound back the clock”.

“This will clearly reduce the level of potential recovery for a lender under its floating charge and more than likely also reduce the level of funds made available for unsecured creditors.”

“This move will be very unwelcome news to lenders and trade creditors, particularly at a time when insolvencies are on the rise.”

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