The return of the sledgehammer?

Management of taxes



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Jon Claypole and *Tony Monger* consider the impact of HMRC becoming the ‘preferred creditor’ again

Key Points

What is the issue?

Those of us old enough to remember the Enterprise Act 2002 being enacted (the authors included) have expressed significant surprise at the news that HMRC will once again be the ‘preferred creditor’ in respect of those taxes which businesses collect ‘temporarily in trust’.

What does it mean to me?

Some of the justification for this change appears to be that HMRC considers itself to be an ‘involuntary creditor’ of businesses because it cannot choose which companies to engage with. To add justification to the change it is said that the funds collected will be used to fund public services.

What can I take away?

Given the significant success HMRC has had in addressing tax avoidance (which we commend) such that the tax avoidance market is in its dying throes, this proposed measure does to us seem to be one sledgehammer too far.

In his Budget on 29 October 2018 the Chancellor Philip Hammond, roughly two thirds into his speech, said: ‘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’.

Those of us old enough to remember the Enterprise Act 2002 being enacted (the authors included) have expressed significant surprise at this development and what appears to be an about turn by the Government.

The headline news is that from April 2020 HMRC is to, once again, become a preferred creditor in respect of those taxes which businesses collect ‘temporarily in

trust' on behalf of other taxpayers and will apply to VAT, PAYE, employees' NIC and Construction Industry Scheme deductions. It is not proposed to apply to those taxes that the business is liable to pay itself such as corporation tax and employers' NIC.

Justifications: claimed and suspected

Some of the justification for this change appears to be that HMRC considers itself to be an 'involuntary creditor' of businesses because it cannot choose which companies to engage with. To add justification to the change it is said that the funds collected will be used to fund public services. This reason is regularly cited as justifying change and of course it is a very noble cause.

There are however two parts to the proposed changes, the second being 'to tackle and prevent taxpayers from artificially and unfairly avoiding tax by misusing insolvency to retain their avoidance or evasion gains, or benefit from repeated non-payment of tax (known as 'phoenixism')', the proposal being for Directors to be held jointly and severally liable for a company's liabilities.

The authors speculate whether this is the real reason for the change.

Recent HMRC activity

The authors have seen HMRC significantly increase its interest in companies that have become insolvent because of what it perceives as tax avoidance and HMRC has recently been pursuing Directors/Shareholders of companies who it believes have personally benefitted. We have seen examples of where HMRC has removed the incumbent liquidator and appointed its own liquidator. The HMRC-appointed liquidator has then threatened a broad range of insolvency offences (wrongful trading/misfeasance etc) in an attempt to pressure the Directors/Shareholders to make good the tax due from the perceived tax avoidance, even where the final tax position on the said tax avoidance has not been resolved either because the investigation hasn't concluded or the relevant appeals remain open and are yet to be resolved through the Tribunal/Courts.

On several occasions we have heard liquidators and their legal representatives cite the argument that when the tax avoidance was undertaken, the Directors/Shareholders should have ensured that the company set aside the equivalent of the tax advantage (or saved in layman's terms) just in case the

planning was unsuccessful. Given most tax planning was the subject of Tax Counsel opinion and other tax and legal advice, there was in our opinion no need to set aside the funds (although we must recognise that HMRC have won the vast majority of litigated avoidance cases). Given we have seen this argument put forward by different liquidators and their legal representatives, we rather suspect it is one that HMRC might be 'requesting' they put forward.

In our experience little regard appears to be given to the counter arguments being put forward in these situations and HMRC is content to aggressively pursue Directors/Shareholders regardless. The most disturbing scenario we have experienced to date was of a widow who, whilst it is acknowledged was a shareholder of a company and received dividends from it, was in substance a mother bringing up a young family. Her husband tragically passed away and, whilst she was still in mourning, HMRC threatened Court action unless she made good to the liquidation 100% of the tax that HMRC considered was due on the perceived tax avoidance, despite the investigation into that tax avoidance still being unresolved.

The likely savings?

Turning back to the proposals, it's always worth looking at the Government's own estimates of the Policy costings/savings for clues as to the rationale. In the year of introduction the estimated savings are merely £10m, going as high as £195m in 2022/23. The tax base for this measure consists of company insolvencies from tax avoidance, evasion and phoenixism – although exactly how HMRC can claim to predict such growth is unclear. This commentary seems to confirm our suspicion that the real driver for this change is tackling the loss of tax from perceived tax avoidance. What is interesting in the Government's own costing commentary is its statement that 'The main area of uncertainty in this costing relates to the size of the tax base and the behavioural response.' In short it seems to us the Government really doesn't know the impact this measure will have and we question whether the provision is really necessary.

The authors also find it slightly odd that the proposed implementation has been deferred a year. Given the attack on tax avoidance one would have expected the measure to be implemented either immediately or from April 2019 especially as it doesn't appear to have retrospective effect.

The commercial issues arising from the proposed measure could be many and varied and we have sought input from our restructuring specialist colleagues when considering them.

Two immediate observations are that the proposed measure will push ordinary trade creditors much further down the pecking order and could well transfer losses from the Exchequer to the private sector – with, for example, suppliers being left out of pocket. Further it could also have an impact on the cost of borrowing, with banks and lenders wanting the potential additional risk they would be taking on to be reflected in the rates they charge. This of course is likely to have an immediate impact. Both these issues are however very significant for businesses.

Another thought is this measure cannot be beneficial to the UK presenting itself as being good for business at a time when, in light of Brexit, we should be doing everything we can to be open for business. The authors acknowledge much is being done, e.g. lower corporation tax rates etc., but this measure with the commercial implications arising from it sends a conflicting message.

One comment we would also add is how HMRC will behave when this measure comes into force. There is already a view that HMRC is becoming increasingly 'trigger happy' where the underlying business is financially viable but suffering temporary cashflow issues. There is a concern it will be even more so.

An irony in the history

In considering this proposal, it is pertinent to recall why HMRC's previous position as preferential creditor was eradicated by the Enterprise Act 2002. A White Paper titled 'Insolvency – A Second Chance' preceded the legislation and in it The Rt Hon Patricia Hewitt MP Secretary of State for Trade and Industry said: 'we want an enterprising economy to make the UK the best place in the world to do business.' She added that: 'Companies in financial difficulties must not be allowed to go to the wall unnecessarily and we propose to create a streamlined administration procedure which will ensure that all interest groups get a fair say and have an opportunity to influence the outcome. As an integral part of this package of reforms, we propose to remove the Crown's preferential rights in all insolvencies, a step which will bring major benefits to trade and other unsecured creditors, including small businesses.'

The authors note that the apparent focus on the proposed measure is to address loss of tax arising from perceived tax avoidance rather than any wider general mischief arising from insolvency. Given the significant success HMRC has had in addressing tax avoidance (which we commend) such that the tax avoidance market is in its dying throes, this proposed measure does to us seem to be one sledgehammer too far. In our view the damaging commercial impacts of the proposed measure far outweigh the unknown tax remittances the Exchequer may receive. The remaining ‘nut’ of tax avoidance is now very small indeed and it seems particularly ironic that, when HMRC has so often quoted the need for a ‘level playing field for all taxpayers’ as the justification for wiping out tax avoidance, that the measure that they are reintroducing was previously removed for exactly that same reason.