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The proposal to reinstate Crown preference was announced as part of the Autumn Budget last year and came as a surprise to many. The expected consultation paper published by HMRC this week seeks the views of individuals, shareholders, directors, lenders, companies and insolvency practitioners on the proposal to reinstate Crown preference in part.

However whilst this is a consultation, one might conclude from the language of the paper that the decision to introduce this change is a foregone conclusion. The paper glosses over several important considerations: the impact on funders, the culture of business rescue and the impact on unsecured creditors which we consider further below.

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What is proposed?

Presently, when a company enters into an insolvency process, HMRC’s claim for unpaid taxes is an unsecured claim meaning HMRC stand alongside other unsecured
creditors and its claim is dealt with on an equal footing. In simple terms, unsecured creditor claims rank behind fixed charge holders, insolvency practitioner fees and expenses, other preferential creditors and floating charge holders. The order of payment is prescribed by statute.

It is proposed that the statutory order of payments will be altered so that HMRC’s claim will rank ahead of floating charge holders in respect of tax payments due to it for VAT, PAYE, NIC (employee contributions) and CIS being taxes paid by third parties to the insolvent company. In respect of the tax liabilities of the company (income tax, CGT, corporation tax and employer NIC) those unpaid taxes will still rank and be dealt with as unsecured claims.

Therefore, HMRC will become a preferred creditor, although only in part. The preferred element of HMRC’s claim will however include any penalties and interest due and include historic debt “irrespective of how old” that might be.

HMRC’s primary justification for this change is loss of revenue, but the impact on the Exchequer’s pocket was a consideration when Crown preference was abolished. The conclusion reached then was that the benefit to creditors and business rescue outweighed that loss of revenue. So what has changed?

When will the law change?

The change will apply to insolvencies commencing after 6 April 2020 HMRC.

Why was Crown preference abolished in the first place?

Crown preference was abolished in 2003 following the Enterprise Act because it was considered unfair to other creditors. Abolition was widely welcomed by industry: insolvency professionals, funders, professional organisations, creditors – the list goes on.

The change, driven by a desire to encourage enterprise and business rescue, came alongside other changes to the insolvency process including the introduction of an out of court process to appoint administrators and the introduction of the prescribed part with the intention that the package of measures would help support the rescue of viable businesses.

What is the impact of the proposal to reinstate Crown preference?

Lenders and business rescue

At the same time as HMRC’s preferential status was abolished, the prescribed part was introduced. This was to avoid floating charge holders receiving a windfall payment and ring fenced a pot of money for unsecured creditors out of floating charge realisations. The ring-fenced amount currently stands at a maximum sum of £600,000 with proposals to increase this to £800,000 at some point this year.

If HMRC return to preferential status, floating charge holders face a double
whammy. Not only will they rank behind HMRC as preferred creditor, the balance of floating charge assets is further reduced by the increase in the prescribed part.

HMRC seem to discount the effect of preferential status on lenders commenting in the paper that the government does not expect this to have “a material impact”. It cites the fact that the loss to lenders will be a very small fraction of total lending compared to the financial benefits to HMRC. This is a very narrow view and ignores why Crown preference was abolished in the first instance and the wider impact that this would have on businesses in general.

To address additional losses, financiers are already considering whether they ought to make increased provision. If they do, this could have the effect of increasing lending costs, reducing finance options and making it more difficult and costly for businesses to leverage funds on floating charge assets to fund working capital. The abolition of Crown preference was premised on encouraging enterprise, its return is likely to have the opposite effect.

**Unsecured creditors**

It has been a hard fight over the past few years to overcome creditor apathy.

Changes have been made to address this with the Insolvency Rules 2016 (making it easier for unsecured creditors to engage in the insolvency process and for clearer lines of communication), the introduction of the pre-pack pool (to dispel concerns about the pre-pack process and provide greater transparency) and the introduction of the prescribed part (to enable a return to unsecured creditors).

If Crown preference is reintroduced whilst any return to unsecured creditors may currently only be small (the consultation quotes that unsecured creditors recover on average 4% of their debt), reducing that recovery in many cases to nil removes any interest that unsecured creditors have in the process – why would they then engage at all?

**Is there justification for the change?**

HMRC say that this change is necessary because since 2003 losses to the Exchequer have increased and taxes paid to businesses (by third parties) should, instead of paying creditors of the insolvent business, be paid to HMRC to fund public services. Whilst that may be true and additional spending on public services is always welcome how much difference would this actually make? We come back to the point we made earlier that this was considered at the time of abolition and the benefits of enterprise and business rescue were thought to outweigh this. Why should HMRC be placed back in a better position than other unsecured creditors now?

Monies paid to a business are paid into the company’s bank account and are available to the company without restriction. It is not uncommon to find that monies representing VAT payments or PAYE are used to fund the day to day trading of the company and providing HMRC receives a payment equivalent to the tax received and taxes are paid, then surely it is up to the company to decide how monies it receives are applied. We don’t think anyone would argue with this
provided all creditors are paid.

With an intervening insolvency the landscape changes, but it changes for all: lenders, creditors, shareholders, everyone. Most lose out because it is rare that unsecured creditors are paid in full, but the pari passu principle ensures all unsecured creditors are treated fairly. Secured creditors are only treated differently because they hold security for monies lent to the company.

HMRC is not a secured creditor and yes, the business may have received a payment from a customer representing tax due to HMRC i.e VAT, but that payment is not impressed with a trust in favour of HMRC nor does HMRC have any proprietary right to that money.

There are many other third parties who are in a similar position where a payment made in “good faith” to the now insolvent business would ordinarily have flowed down the supply chain to them, for example sub-contractors. HMRC may argue that it is an involuntary creditor, but other creditors are effectively in the same position when they have no control over credit control processes and no real say in when they are actually paid. Should HMRC be able to jump the queue and put itself in a better position by changing legislation when other unsecured creditors cannot exercise the same parliamentary clout?

**Conclusion**

In real terms, any additional returns to the Government through these measures are unlikely to be significant when compared to the Exchequers’ total receipts but the impact on business rescue and enterprise could be seriously undermined.

Is the proposal really creating a level playing field as suggested in the consultation paper or are we just taking a step back in time and progress?

To see our earlier article on this click [here](https://www.natlawreview.com/article/hmrc-versus-company-rescue-hmrc-issues-consultation-paper-proposed-return-crown) and to access the consultation paper click [here](https://www.natlawreview.com/article/hmrc-versus-company-rescue-hmrc-issues-consultation-paper-proposed-return-crown). Anyone wishing to respond to the consultation has until 27 May 2019 to do so.

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