CHANGING PRIORITIES IN UK COMPANY INSOLVENCIES

Date: 27 February 2019

UK Restructuring & Insolvency Alert

By: Jonathan Lawrence

In a consultation issued by the UK tax authority, HM Revenue & Customs (HMRC), on 26 February 2019, a change in the order of asset distribution in the insolvency of UK companies has been proposed. The amendments would newly favour certain taxes collected and held by an insolvent entity ahead of certain secured and unsecured creditors and would come into force in April 2020.

WHAT IS THE CURRENT ORDER OF PRIORITY ON DISTRIBUTION AFTER INSOLVENCY?

The current order of distribution is set out in the Insolvency Act 1986 and the Insolvency Rules 2016. Broadly, asset realisations in UK insolvencies are paid out in the following order:

1. *Secured creditors with a fixed charge (after costs of realisation)*: Fixed charge holders are often banks and other asset-based lenders who hold security over a specific asset. When a fixed charge is provided to the lender, the borrower loses the right to sell or trade the item, which might include property, plant, machinery and vehicles.
2. *Insolvency practitioners' fees and expenses*: Comprising the insolvency practitioner's remuneration and costs of administering the insolvency process. Costs and expenses are incurred when realising assets, distributing funds, providing accounts and reports and investigating the conduct of directors.
3. *Preferential unsecured creditors*: These are split into two classes:

Ordinary preferential creditors: Include employees entitled to arrears of wages, holiday pay, and other statutory payments up to a certain limit. This also includes money deposits that fall within the Financial Services Compensation Scheme (FSCS).

Secondary preferential creditors: Are only paid once ordinary preferential creditors are paid. They include currently, in brief, those parts of a money deposit which do not fall within the protection of the FSCS.

4. *Prescribed Part creditors*: The law ring-fences a fund that is used by the insolvency officer holder to pay a dividend to non-preferential unsecured creditors. The Prescribed Part is calculated as 50% of the first £10,000 available and 20% thereafter up to a maximum of £600,000. There is a separate proposal to raise this cap to £800,000 or more.

5. *Secured creditors with a floating charge*: Assets subject to a floating charge often include stock, raw materials, work-in-progress, fixtures and fittings – basically any other assets not subject to a fixed charge. Assets of this type can be traded in the normal course of business.
6. *Non-preferential unsecured creditors*: These include trade creditors, suppliers, customers, contractors and some staff claims. Currently all tax claims are non-preferential unsecured debts and so have no special priority over other debts, despite the fact the taxes were intended to be held temporarily before being paid into the UK treasury.
7. *Shareholders or individuals*: Shareholders are the final group to be paid. Because they have taken a business risk in providing money to the company, they are not entitled to a distribution until all other creditor groups have been paid.

Each class of creditor must be paid in full before the insolvency officer holder can distribute funds to the next group in order of priority. It is intended that HMRC would become a secondary preferential creditor (level 3b) for taxes paid by employees and customers, instead of being a non-preferential unsecured creditor (level 6).

HOW WOULD THIS PROPOSAL AFFECT THE CURRENT ORDER OF PRIORITY?

For all formal insolvencies that commenced after 6 April 2020, HMRC would move up the creditor hierarchy for the distribution of assets with respect to certain taxes held by any insolvent entity. HMRC would become a secondary preferential creditor for the specific taxes paid to a business by employees and customers, and any interest or penalties arising from such debts.

This means HMRC would move ahead of holders of floating charges (mainly financial institutions) and other non-preferential unsecured creditors, but remain below holders of fixed charges (also primarily financial institutions) and higher-ranking preferential creditors.

WHAT TAX DEBTS WOULD IT AFFECT?

This measure would give HMRC greater statutory rights in respect of the payment of tax debts for pay as you earn tax (PAYE), National Insurance contributions (NIC - employee contributions only), Construction Industry Scheme (CIS) and value added tax (VAT) that are due at the commencement of the insolvency. The payment would be from the assets of those insolvent taxpayers.

The rules would remain unchanged for liabilities relating to taxes directly levied on businesses or individuals themselves, such as Income Tax, Capital Gains Tax, Corporation Tax and Employer National Insurance Contributions. HMRC would continue to be a non-preferential unsecured creditor in respect of these other tax debts. As this measure only relates to employee NIC, HMRC would separate employee debts from employer debts when submitting claims.

It is not proposed to introduce any time limit in respect of debts that are due. Where any of the above tax debts have not been paid to the UK treasury, HMRC considers that it should be treated preferentially, irrespective of how old the debt might be. Any penalties or interest arisen from these taxes would also form part of HMRC's preferential claim.

COMMENT AND FEEDBACK DEADLINE

If enacted, this change would primarily lessen the recoveries made by secured creditors, given the change of priority. However, the UK Government does not expect the proposed change to have a material impact on bank appetite to lend. This is because:

- Financial institutions would remain above HMRC in the creditor hierarchy for fixed charges they hold over assets (level 1).
- The debts the secured lenders would no longer recover are a very small fraction of total lending. Bank lending to small and medium enterprises alone in the UK was £57 billion in the 12 months to July 2018, compared to an estimated maximum yield of £185 million in the tax year 2022/2023 from this proposed new measure.
- Other unsecured creditors - such as suppliers - are usually unable to recover any of their debts in insolvency situations and so most will be unaffected. They currently only recover 4% of debts owed on average.

The consultation is open for comments from interested parties until 27 May 2019.