

COVID 19: UK INSOLVENCY REFORM – CROWN PREFERENCE RETURNS FROM 1 DECEMBER 2020

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EXECUTIVE SUMMARY

On a UK company's insolvency, the UK tax authority (HMRC) will become a preferential creditor in respect of certain unpaid taxes (Crown Preference) with effect from 1 December 2020. Despite lobbying against the move (including in light of the COVID-19 pandemic), the UK government has persisted with the change, perhaps in an attempt to shore up its tax take.

THE REFORM IN CONTEXT

Prior to the Enterprise Act 2002 (Enterprise Act), HMRC ranked ahead of floating charge security holders (such as banks) in respect of unpaid taxes of insolvent companies. The Enterprise Act then removed this preferential status. Currently and prior to 1 December 2020, HMRC is an ordinary unsecured creditor in a company's insolvency. This means that it ranks alongside other unsecured creditors (and behind floating charge holders).

The new law partially reverses the effect of the Enterprise Act so that, from 1 December 2020, HMRC will rank ahead of floating charge holders and unsecured creditors in respect of certain unpaid taxes that the relevant company collects on behalf of HMRC. These taxes include value added tax, pay as you earn income tax and employees' national insurance contributions (Priority Taxes). There are no transitional arrangements for the introduction of the new law, which means that HMRC will have preferential status for Priority Taxes ahead of floating charges created at any time before or after 1 December 2020. Nor is the new Crown Preference subject to any time limit or financial cap. This means HMRC will also have priority in relation to historic arrears of Priority Taxes.

The current position will not change in respect of taxes that HMRC collects directly (e.g. corporation tax and employers' national insurance contributions). HMRC will remain an ordinary unsecured creditor in respect of these taxes.

IMPACT ON BANK LENDERS AND OTHER SECURED CREDITORS

At present, a lender who is relying on its borrower's floating charge assets enjoys priority over HMRC in respect of unpaid taxes if its borrower company becomes insolvent. This is because HMRC currently ranks alongside other ordinary, unsecured creditors in the insolvency distribution waterfall.

However, after 1 December 2020, such a lender will need to be aware that an insolvent company's unpaid Priority Taxes could have a significant detrimental impact on the lender's recoveries from the insolvency. This is because

such Priority Tax liabilities will be paid to HMRC from the proceeds of floating charge assets before amounts owing to the floating charge holder itself and to other unsecured creditors.

IMPACT ON BORROWERS

The increased risk to lenders and other secured creditors means that borrowers may find that the amount of funding such lenders are willing to make available to them is significantly reduced. Such lenders are likely to take a conservative view of the risk and take steps to enhance their security position, reduce their exposure against assets subject to a floating charge and impose tighter controls on borrowers.

FIXED VERSUS FLOATING CHARGES

The reintroduction of Crown Preference does not affect fixed-charge security holders, who will continue to rank ahead of preferential creditors, including HMRC. Lenders may therefore revisit the security packages they have in place on existing deals and examine their underwriting and operational procedures for new business in order to increase the likelihood that, wherever possible, they have the benefit of fixed (rather than floating) security.

TAX DUE DILIGENCE AND ONGOING MONITORING

Where lenders continue to rely on floating charges, they will need to have a good understanding of the borrower's tax compliance and may want to see evidence of accurate tax records going back several years as a condition precedent to financing. In addition, lenders are likely to require enhanced representations and warranties in relation to tax compliance and the ability to audit the borrower's tax affairs in order to ensure that Priority Taxes have been paid up to date.

CONCLUSION

The return of Crown Preference is of particular concern in the current economic climate, when many businesses are struggling with the impact of the COVID-19 pandemic. Floating charge funding is one of the most frequently used tools for business turnaround, and the restoration of the Crown Preference may make rescue finance harder to find for distressed businesses.

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