The return of 'Crown Preference': a blow to creditors and the UK's business rescue culture

Briefing from insolvency and restructuring trade body R3

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Overview

At the October 2018 Budget, the Chancellor announced that HMRC is to become a 'secondary preferential creditor' in corporate insolvencies. As a result, from 6 April 2020, certain tax debts owed by an insolvent company – including VAT, PAYE, and NICs – will be repaid to HMRC in priority to debts owed to floating charge holders and unsecured creditors, including a company's pension scheme and its suppliers. This move will partly reverse the Enterprise Act 2002 which, in order to support an 'enterprise culture' in the UK, ended HMRC's original 'preferential status' – known as 'Crown Preference' – and established HMRC as an unsecured creditor.

R3 urges the Government to rethink its position: restoring 'Crown Preference' could reverse successive governments' attempts to encourage a culture of business rescue, and undermine the Government's recent work to strengthen the UK's insolvency framework. The proposal may have a significant and negative impact on access to finance in the UK, and will increase the impact of corporate insolvencies on pension schemes, employees, consumers, and the wider business community. The long-term damage likely to be caused by the proposal greatly outweighs the short-term gains expected by the Treasury. The Government would see greater benefits if HMRC were to engage more fully in insolvency procedures, rather than try to jump the queue.

The Government's proposal

In insolvency procedures, creditors are repaid according to a strict, statutory hierarchy. Because an insolvent company is very unlikely to be able to repay all its debts, the lower a creditor is down the hierarchy, the less of their money – if anything – they are likely to see back. The Government's plan is to move some HMRC debts 'up' the hierarchy. Affected tax debts include PAYE, employee NICs, and VAT. Other tax debts, such as Corporation tax or employer NICs, will remain an unsecured debt. Unlike the original 'Crown Preference', tax debts will qualify for preferential status regardless of when they arose. Previously, only tax debts arising in the 12 months prior to insolvency benefitted from preferential status. The proposal is 'retrospective': while it will apply to insolvencies starting after 6 April 2020, any tax debts from before this date will have preferential status.

What this means

Impact on pensions, suppliers, customers and lenders: The creditors most affected by the changes are those leapfrogged by HMRC: 'floating charge' creditors (who lend against a changing asset, such as stock) and unsecured creditors (such as the company pension scheme, some employee claims, and the company's suppliers or customers – including small businesses and consumers). The extra money HMRC gets as part of the proposed reform will be coming from what would otherwise be repaid to these other creditors. The lack of a time 'cap' for the new 'Crown Preference' means unsecured and floating charge creditors could get even less back in insolvencies than they did before the Enterprise Act 2002.

The impact on business rescue and funding: This squeeze on 'floating charge' lenders could have a big impact on business rescue and funding. Floating charge lending, such as asset-based lending or invoice discounting, is a very common forms of business finance. With these lenders facing the possibility of not seeing any of their money back if a company becomes insolvent, they will be less willing to lend, particularly to those companies already in financial distress (but who may be in a position to turn themselves around with fresh funding). This isn't good news for the UK's businesses, which need reliable access to finance to operate. Some business sectors, such as retail, depend on 'floating charge' lending more than others.

Practical issues: As proposed, the policy would lead to a number of practical difficulties which do not appear to have been considered by the Government. The proposal's 'retrospective' nature means floating charge lenders will have to undertake a detailed historic and ongoing review of the tax positions of the companies to whom they have leant, in order to check for tax debts which may now outrank their claims. Lenders may also seek to insure themselves against tax liabilities. This will increase the cost of obtaining floating charge financing. Companies may be prompted to keep tax debts in separate trust accounts, leading to additional business costs. As a preferential creditor, HMRC will have additional responsibilities in insolvency procedures, creating the risk of a bottleneck: HMRC's lack of engagement can *already* cause delays in insolvency procedures; more tasks for HMRC may mean more delays, exacerbating the impact of the proposal on other creditors.

A change of direction needed

In order to prevent damage to pension schemes, supply chains, consumers, and business lending, the Government should drop its plans to restore 'Crown Preference'. At the very least, the Government must scale back the scope of its proposal: a cap on the size of HMRC's 'preferential claim', restrictions on the age of tax debts affected, and fewer responsibilities for preferential creditors in insolvencies would limit the damage this proposal will cause. Ultimately, the Government would see a better return from insolvencies if HMRC were to engage more actively in insolvency procedures than it does now.

Next steps

In February 2019, the Government published a consultation on the proposal, seeking views from interested parties ahead of introducing legislation in the Finance Bill 2019-20.The consultation closes in May 2019.

Background

Until the Enterprise Act 2002, tax debts enjoyed preferential status over most other creditors. The Act, which removed 'Crown Preference', was part of a number of reforms introduced to encourage business rescue, and to make the insolvency process fairer on unsecured creditors (including trade creditors and company pension schemes, among others). It was thought that removing 'Crown Preference' would provide HMRC with an incentive to support business restructuring proposals, and to tackle the perception that HMRC was winding up distressed but ultimately viable companies in order to increase the 'tax take'.

The order of priority for repayment in corporate insolvencies is:

1. **'Fixed charge' creditors** – Creditors whose lending to a company is secured against a definable object (e.g. a mortgage on a building/warehouse).
2. **Insolvency process costs** – Including wages or rent due during the process, or the fees of the office holder.
3. **Preferential creditors** – This currently covers some payments due to employees, and money owed as part of the Financial Services Compensation Scheme. From 6 April 2020, some tax debts will be 'preferential'.
4. **'Floating charge' creditors** – Lending secured against a class of asset (e.g. 'stock' in a warehouse, but not specific items of stock). Asset-based lending is a common type of floating charge lending.
5. **Unsecured creditors** – Almost all other creditors, including pension schemes, customers and trade creditors. HMRC is currently an unsecured creditor.
6. **Shareholders**