



ARTICLE

A Tale of Two Crowns

Coronaviruses are named for the crown-like spikes on their surface. The combination of the “Two Crowns” - COVID-19 alongside the return of Crown Preference - will result in a significantly more material impact than was originally intended, given the COVID-19 VAT deferral scheme which has resulted in over £28bn of cumulative VAT deferrals.

The New Waterfall¹

- A. Preferential Creditors (Schedule 6): primarily employee related²
- B. Secondary Preferential Creditors: Priority Taxes³
- C. Prescribed Part⁴
- D. Floating Charge Holders
- E. Unsecured Creditors

- 1. In respect of floating charge assets
- 2. Schedule 6 of the Insolvency Act – e.g. certain unpaid wages, certain pension contributions and holiday pay
- 3. VAT, PAYE, Employees’ National Insurance Contributions, student loan deductions and Construction Industry Scheme deductions
- 4. Prescribed Part includes HMRC claims which rank as unsecured – Prescribed Part cap increased to £800k (primarily in respect of floating charges created from 6 April 2020)

In this briefing memo, Lisa Rickelton (Restructuring) and Alistair Winning (Tax) discuss the practical consequences of Crown Preference, alongside crown set-off rules in the context of insolvency, and provide worked examples, giving a deeper dive into the issues raised by VAT groups in which members have joint and several liability.

Summary of Provisions

The return of Crown Preference had been due to come into force on 6 April 2020; however, this was delayed to 1 December 2020 due to COVID-19.

HMRC will rank ahead of floating charge creditors and unsecured creditors in respect of certain taxes which are collected by a company on behalf of HMRC – primarily VAT, PAYE and employees’ National Insurance Contributions (“Priority Taxes”). Prior to 1 December 2020, these taxes rank as unsecured.

Key Points to Note:

- The new waterfall applies to all insolvencies which commence from 1 December 2020 – the date of the creation of the floating charge is irrelevant, unlike the transitional provisions on the increase of the Prescribed Part cap to £800k.
- The existing Schedule 6 preferential (generally employee) creditors will rank ahead of the new Priority Taxes which will have a secondary preferential claim.

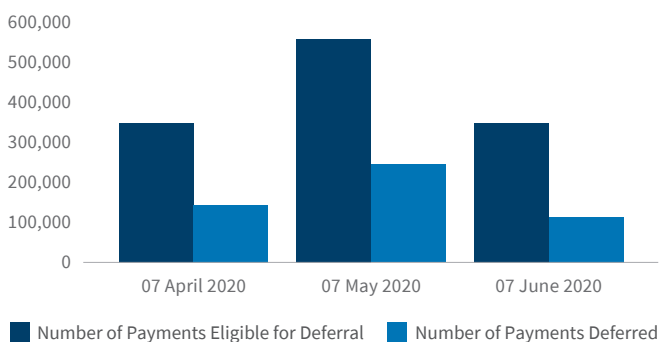
- There is no cap on HMRC’s secondary preferential claim for Priority Taxes – either by quantum or by time period.
- HMRC will remain an unsecured creditor in respect of taxes that HMRC collects directly e.g. corporation tax, employers’ National Insurance.
- These rules are in addition to the existing legal framework which allows HMRC to offset pre-administration credits against pre-administration debts of HMRC or other government departments under Crown Set-off.

COVID-19 HMRC deferrals

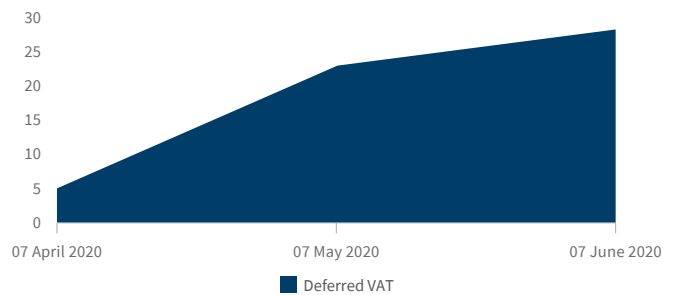
On 20 March 2020, HMRC announced that all UK VAT registered businesses were able to automatically defer their VAT liability that arose in the period between 20 March 2020 and 30 June 2020. This deferred VAT was interest free and not subject to the normal late payment penalties, but as initially announced, would need to be repaid by the 31 March 2021. The government has subsequently confirmed that businesses can opt-in to a scheme for the deferred VAT to be paid in smaller amounts up to the end of March 2022.

The published government figures confirm that while less than 50% of eligible payments were actually deferred, this amounted to £28.2bn of total VAT deferred. However, this is likely to be an underestimate, as it does not include the businesses that were required to make monthly Payments on Account and deferred their payment due on the 30 June 2020.

VAT PAYMENT DEFERRALS



DEFERRED VAT (£BN)



Furthermore, whilst there have been no formal schemes established for PAYE and other taxes, HMRC announced that they were willing to agree specific Time to Pay arrangements with businesses to defer such tax liabilities. In practice, in our experience, getting HMRC to agree to Time to Pay arrangements has not been a straightforward endeavour. However, it is likely that some businesses have been successful in deferring further tax payments.

Consequently, as a result of the COVID-19 crisis, there is a significant amount of deferred tax due to HMRC which, potentially, could form part of any insolvency claim by HMRC should an insolvency event occur prior to these deferred Priority Tax liabilities being settled.

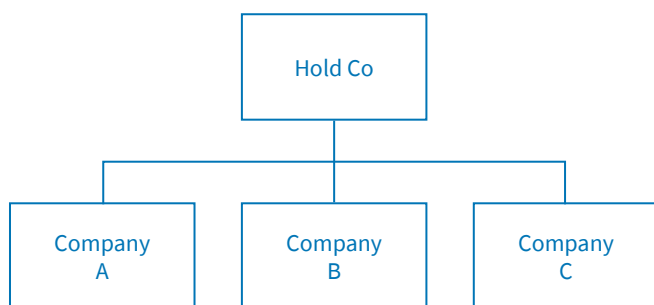
Example Scenarios

Each business will have its own VAT and PAYE profile depending on the nature of the business and how it structurally operates. However, there are certain businesses and sectors that are naturally exposed to high levels of VAT and PAYE.

For example, professional services firms, outsourced services providers (including staffing agencies), restaurant and catering firms and high margin retailers are likely to have large VAT and PAYE liabilities. In contrast, online retailers, export companies and logistics and freight companies that utilise an outsourcing model, are likely to have little of either.

To understand the effect that the Crown Preference rules could have, it is important to fully consider the nature of nature of the business, its corporate and operational structure and what are the predominant taxes that impact the business.

Below we have summarised some example scenarios of how the new rules work, together with a refresh of the existing Crown Set-off and the joint and several liability impacts of VAT Groupings to provide a picture of HMRC’s powers from 1 December 2020.



A corporate group consists of a Hold Co and three subsidiaries all of which are members of a VAT group. Company A is the main trading company and the Representative Member of the VAT group and is the borrower of lending subject to a floating charge. Neither company B nor C has any borrowing, and they do not guarantee A's borrowing.

Example 1

Company A enters insolvency with the following debts:

- VAT due to HMRC: £5m
- PAYE due to HMRC: £15m
- Corporation Tax due to HMRC: £1m

Company A has no fixed charge borrowing and has floating charge realisable assets of £25m.

Neither Company B, Company C nor the Hold Co enter into insolvency nor do they have any tax liabilities. HMRC's creditor claim position is as follows post 1 December 2020:

- The £5m of VAT is subject to HMRC's Preferential Creditor status. As all members of a VAT group are jointly and severally liable for all VAT debts, potentially, HMRC could demand payment of the VAT debt from Company B or Company C. However, in practice this is unlikely and HMRC would typically only pursue another VAT group company for its share in any liability of the VAT group in the event the Representative Member fails to pay.
- The £15m of PAYE is subject to HMRC's Preferential Creditor status.
- The balance of £5m of realised assets are distributable to the Prescribed Part, Floating Charge Holders and Unsecured Creditors respectively in accordance with the insolvency waterfall.
- The £1m of Corporation Tax is not subject to HMRC's Preferential Creditor status and they are an unsecured creditor for that debt.

Example 2

As per Example 1, except Company A has a VAT credit of £5m at the time of insolvency:

- The £5m credit is subject to Crown Set-off against other tax debts of Company A and can be applied against either the PAYE liability or the Corporate tax liability.
- The remaining PAYE liability (post Crown Set-off) is subject to HMRC's Preferential Creditor Status.
- The remaining Corporate Tax liability (post Crown Set-off) is an unsecured debt.
- Between £14m and £15m of realised assets are distributable to the Prescribed Part, Floating Charge Holders and Unsecured Creditors respectively depending on which tax HMRC off-set (which is at HMRC's discretion).

Example 3

Company A, B and C all enter into insolvency, with Company A's tax liabilities and realisable floating charge assets as in Example 1 above. Company B and C both also have PAYE liabilities of £5m but no realisable assets.

- The £5m of VAT is subject to HMRC's Preferential Creditor status for Company A.
- The £15m of Company A's PAYE liability is subject to HMRC's Preferential Creditor status for Company A.
- The £5m of PAYE liability of Companies B and C is subject to HMRC's Preferential Creditor status for those companies. As they have no assets, HMRC will receive no payment. The Preferential Creditor position is specific to that debtor and HMRC cannot add the debt of Company B or C to that of A. It is relevant to note that PAYE is not subject to joint and several liability which applies to a VAT group.
- £5m of realised assets from Company A are distributable to the Prescribed Part, Floating Charged Holders and Unsecured Creditors respectively.
- The £1m of Corporation Tax is an unsecured debt.

Example 4

Company A has a VAT credit of £5m and a Corporate tax liability of £1m. It also had £25m of realisable floating charge assets. Company B acts as the employer of the group and has a PAYE liability of £15m but no realisable assets. Company C has no tax liabilities and £10m realisable assets. All three companies enter into insolvency.

- The £5m is subject to Crown Set-off, but only in respect of Company A's Corporate Tax liability. Crown Set-off does not apply to other tax debts of the group as it only applies where the credit and debt are with the same legal entity. Therefore, £4m would be repaid to Company A from HMRC and would be a realisation in the administration estate.
- The £15m PAYE liability of Company B is subject to HMRC's Preferential Creditor status, but as it has no assets, no realisation will be achieved. As per example 3, HMRC cannot add the £15m of Company B's liability to the HMRC debts of Company A.
- £29m of realised assets (the £25m plus the £4m HMRC payment) from Company A are distributable to the Prescribed Part, Floating Charge Holders and Unsecured Creditors respectively.

Example 5

Company A, B and C all enter into insolvency, with Company A's tax liabilities and realisable floating charge assets as in Example 1 above. However, the total VAT liability of Company A (as VAT representative member) is £9m. £5m of the VAT liability relates to Company A's share and £2m each relates to Company B and C (both of which have £10m of realisable assets).

- The £9m of VAT is subject to HMRC's Preferential Creditor status for Company A, because A is the representative member of the VAT group. A would have a £2m claim against each of B and C in respect of the VAT – but this would only rank as an unsecured claim in their insolvencies.
- The £15m of Company A's PAYE liability is subject to HMRC's Preferential Creditor status for Company A.
- £1m of realised assets from Company A are distributable to the Prescribed Part, Floating Charged Holders and Unsecured Creditors respectively.
- The £1m of Corporate Tax is an unsecured debt.

In this scenario, if Company A did not have sufficient assets to meet the preferential claim for VAT, HMRC may look to Company B and Company C – although they are jointly and severally liable for the full amount, in practice HMRC would typically only look to recover the respective share of the liability (i.e. £2m each).

In Example 5, if say Company C was the VAT representative member, HMRC would look to this entity for payment in full of the VAT liability as a preferential claim.

£m Company:	Ex 1	Ex 2	Example 3			Example 4			Example 5		
	A	A	A	B	C	A	B	C	A	B	C
VAT (liability) / credit	(5)	5	(5)	0	0	5	0	0	(5)	(2)	(2)
PAYE liability	(15)	(15)	(15)	(5)	(5)	0	(15)	0	(15)	0	0
Corporation Tax	(1)	(1)	(1)	0	0	(1)	0	0	(1)	0	0
Recoveries	25	25	25	0	0	29	0	10	25	10	10
Preferential dividends - VAT	(5)	0	(5)	0	0	0	0	0	(9)	0	0
Preferential dividends - PAYE	(15)	(11)	(15)	0	0	0	0	0	(15)	0	0
Available after Preferential creditors	5	14	5	0	0	29	0	10	1	10	10

Notes: All examples assume no other preferential claims (e.g. employees), and all examples assume no fixed charge realisations. Example 2 assumes £1m of VAT credit has been applied by HMRC against Corporation Tax liability.

Conclusions and Recommendations for Lenders

Unfortunately, once an insolvency is imminent, there is little that can be done. However, being cognisant of the issues during initial lending, when undertaking lending reviews and when considering borrower support requests will assist in managing the issues:

- Approach to lending structure:
 - o Assess the impact of additional preferential claims when making lending decisions – particularly rescue finance.
 - o Review / revise advance rates on asset-based lending subject to floating charges.
 - o Where feasible consider fixed charge rather than floating:
 - Receivables factoring or fixed charge invoice financing rather than relying on a floating charge over receivables.
 - Fixed charges over inventory is also possible albeit requires control which can be challenging to achieve.
 - Consider chattel mortgages over valuable plant and machinery to obtain a fixed charge.
 - o Additionally, note that any new floating charges (ranking equally or in priority) created from 6 April 2020 would be subject to the increased Prescribed Part cap of £800k.

- Understand the structure of the borrower Group:
 - o Is there potential joint and several VAT liability between group entities with floating charge assets?
 - o Are employees (and therefore PAYE / employees' NI) employed in an entity with material floating charge assets or in a head office company / service company with limited assets?
- Understand the profile of Priority Taxes – material arrears can arise even in the short term:
 - o Is VAT paid quarterly or monthly?
 - o Is this a business sector with disproportionately high VAT or PAYE?
 - o Monitoring to ensure no build up of arrears will help to ensure no nasty surprises – consider building into covenant reporting for certain borrowers.
- Additional points to note:
 - o As preferential creditors cannot be bound by a CVA without their consent, it is unlikely that CVA's will propose any compromise to HMRC preferential claims.
 - o If a company enters the new CIGA moratorium, the pre-moratorium HMRC claims (both preferential and unsecured) will be subject to the moratorium.

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