

UK Crown Preference Returns – Creditors Beware!

April 16, 2020

Background

In the 2018 Autumn Budget, the Chancellor announced his intention to reintroduce Crown Preference with effect from 6 April 2020. Due to the attempts to prorogue Parliament and the General Election last year, the necessary legislation was not passed. However, it has now been introduced in the Finance Bill 2020, with the later start date of 1 December 2020.

This reintroduction of Crown Preference will give HM Revenue and Customs (HMRC) a preferential right to claim ahead of floating charge holders in respect of certain unpaid taxes in company insolvencies. Without this preference, HMRC can only claim as an unsecured creditor, behind fixed charge holders, insolvency process costs, preferential creditors and floating charge holders.

The abolition of Crown Preference pursuant to the Enterprise Act 2002 came into force on 20 June 2003. It was part of a package of reforms designed to foster an enterprise culture in the UK and to make the insolvency process fairer on unsecured creditors. Since 2003, HMRC tax claims have ranked as ordinary unsecured debts on insolvency of a company, meaning that HMRC is often one of the last groups paid on an insolvency of a company.

This has enabled lenders to businesses to rely more on floating charges over a borrower's assets for security, allowing borrowers to raise finance against their assets whilst preserving flexibility in running their businesses.

What Does the Change Mean?

The reintroduction of Crown Preference means that, in the event of an insolvency, HMRC would rank behind fixed charge holders and ordinary preferential creditors (employees) but ahead of floating charge holders and unsecured creditors. HMRC's preference extends only to monies collected by the debtor in respect of value added tax and 'relevant deductions' which include:

- PAYE Income Tax;
- Employee National Insurance Contributions;
- Student Loan deductions; and
- Construction Industry Scheme deductions.

There is *no cap* on the amount HMRC can claim as a preferential creditor for the amounts listed above.

Crown Preference does not apply to debts owed to HMRC in respect of Corporation Tax or Employer National Insurance Contributions, and HMRC will continue to rank as ordinary unsecured creditor in respect of these debts.

What Is the Impact?

The revival of Crown Preference stems from Government pressure to increase revenue collection. The Government estimates that this preferential creditor status would increase recovery of taxes by approximately £185m each year. The Government's justification for the change is that debts owed to HMRC should be put back into the public purse rather than be given to creditors in the private sector.

A large proportion of lending in the UK is currently secured by way of a floating charge, allowing businesses flexibility to deal with their assets. Accordingly, a primary effect of the Crown Preference amendments is to change the recovery profile for floating charge holders and subordinate them to HMRC collections in respect of value added

taxation and relevant deductions described above. Katten anticipates the following consequential impacts on such transactions:

- There will be an increased focus from lenders to ensure their security can be characterised as a fixed rather than floating charge. Ascertaining whether a charge is fixed or floating is not always clear cut and depends on the level of control the lender can demonstrate over the asset and whether the borrower is at liberty to dispose of it.
- Accordingly, security arrangements and lending documentation are likely to become more restrictive over a borrower's assets. Specific assets which are likely to be subject to more enhanced controls include:
 - bank accounts: lenders are likely to more frequently want signing rights over company bank account, inhibiting a borrower's flexibility to manage cash (*i.e.*, *fixed charge vs floating charge*); and
 - material trade debtors: lenders may seek to move towards factoring arrangements, which will require cumbersome assignment arrangements to be observed.

In some cases HMRC may seek to challenge purported fixed charges.

- Lenders may, therefore, require borrowers to maintain reserves in ring-fenced accounts to ensure tax liabilities are fully funded, thereby locking up such cash and preventing the borrower from using it.
- Lenders are likely to require comprehensive tax due diligence from borrowers at the outset, resulting in greater disclosures as to the borrower's day one tax position and ongoing reporting (which will require lenders to spend time reviewing those reports).

Prescribed Part

In parallel to the announcement confirming the reintroduction of Crown Preference from 1 December 2020, it was also declared that the "prescribed part" would be increased from £600,000 to £800,000 as from 6 April 2020. The prescribed part refers to the proceeds realised from floating charge assets which are safeguarded for distribution to preferential creditors (employees) before the remaining proceeds are paid to the floating charge holder and then unsecured creditors. These changes affect not only floating charges created from 6 April 2020, but will also impact pre-dating floating charges which rank equally or behind such floating charges.

Floating charge lenders will, therefore, be mindful they may be subordinated by (1) a further £200,000 to preferred creditors; and (2) an uncapped amount to HMRC in respect of value added tax and the other relevant deductions.

Conclusion

An obvious effect of the amendments proposed in Finance Bill 2020 is that the appetite of lenders for providing finance secured against floating charge assets will diminish. To the extent lenders remain prepared to provide such financing, we anticipate they will take a more cautious approach and require an enhanced level of tax due diligence from their borrowers, together with more restrictive controls over the borrowers assets and the preservation of its cash to fund claims over the estate which will now rank ahead of them.

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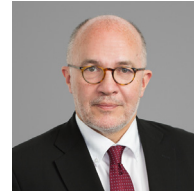
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