

Companies in difficulty (Lecture B1243 – 15.18 minutes)

When a company encounters difficulties there are lots of different things which need to be considered. However, we will first consider the formal issues procedures which might affect such a company.

Creditors' voluntary liquidation

The unsecured creditors of a company decide that the company is insolvent and appoint a liquidator on the basis that every £1 owed is a vote.

In order to have a vote registered, each creditor must have submitted their statement of claim or proof of debt form to confirm the amount they are claiming from the company. A proposed liquidator will have to give, prior to their appointment, a written undertaking to the creditors that they are independent and that there is no conflict of interest in their accepting the appointment.

Only the unsecured creditors vote on the appointment and if secured creditors vote then they lose the benefit of their security against the assets.

Insolvency is judged with on the basis that a business cannot meet its liabilities and the liabilities of the business are greater than the assets. The liquidator takes possession of all company property and confirms the assets of the company as well as notifying HMRC of his appointment.

Within a Creditors' Voluntary Liquidation, there is a prescribed order in which creditors are paid. This is obviously important for the company in liquidation but also for the creditors, particularly those small businesses who might be owed a debt which might determine the validity of their own business.

The order is:

- Fixed charge/mortgage holders: including any person who has any kind of fixed charge security including HP providers, debts subject to factoring agreements. If there is more than one fixed charge holder in respect of the same property, they are discharged in order of their creation. Any supplier who has a retention of title clause within their terms of sales or supply and whose goods can be identified is entitled to have them returned on making a claim. Their debt would be reduced by the value so returned;
- Preferential creditor claims: in the UK the main category here is employee pay claims including back pay and holiday pay (and also pay to directors) although the amount is capped;
- Floating charge claims: these would be debts relating to anyone that has a fixed charge over the business assets;
- Unsecured creditors.

The tax implications of liquidation

The following applies:

- The liquidator must notify HMRC immediately;
- The company's accounting period comes to an end and a new accounting period begins. The new accounting period will last 12 months or to the end of the final accounting period, whichever occurs first;
- Post-appointment CT liabilities are disbursements of the liquidator;
- The group structure is broken as the parent loses beneficial ownership of its subsidiaries when it goes into liquidation;
- It is unlikely that the company will continue trading and so terminal loss relief becomes available. If the trade continues after appointment but then ceases, the cessation will not end the accounting period;
- Post-cessation receipts incurred within six years of cessation can be treated as recovered in the final period;
- Expenses incurred after the trade has ceased are ring-fenced and only available for offset against post-cessation receipts as they would be in a normal company;
- Release of loan relationship liabilities will not normally result in a taxable credit;
- It is not possible to hive down a trade into a new company as the liquidation results in loss of beneficial ownership of the assets (including shares in the subsidiary). This would have to be done prior to the liquidation to get the benefits of s944 et al.
- Group relief ceases to be available so that losses can no longer be transferred between group companies;
- There is no deemed disposal for CG purposes but there may be clawback of some reliefs;
- The company is still part of a CG group so assets could be transferred at no gain/no loss but these would be unusual given that the assets are part of the funds available for the creditors;
- Any capital gains are subject to tax with the original cost being the base cost (i.e. no rebasing to date of liquidation);
- Substantial shareholdings exemption should continue to be available for disposal of subsidiary company shares as for these purposes the group relationship is not lost. However, if those shares are sold at a loss that loss would not be allowable;
- If the company is the representative member of a VAT group, the group treatment ceases and all solvent members of the group are de-registered and re-registered. Where another member of the VAT group becomes insolvent, group treatment can continue although degrouping would normally occur to limit debts for which the insolvent member may be liable;

- The liquidator has any responsibilities relating to PAYE and CIS.

Compulsory/Court liquidation

A creditor can petition the Court to have the company put into liquidation with the Official Receiver handling the initial liquidation. This process could also be undertaken by the company directors or shareholders. This would be the approach taken by HMRC if they wished to force a company into liquidation to collect tax debts.

Any creditor who is owed more than £750 can petition for a winding up. The creditor issues a statutory demand for payment requesting payment of the debt within 21 days. Non-payment of the statutory demand would then be presented to Court as evidence that the company is insolvent. The petition is advertised in the London Gazette.

The Official Receiver reviews the position of the company and decides whether to call a meeting of creditors to appoint a liquidator. A formal liquidator would only be appointed if there are assets in the company.

The tax implications of this type of liquidation are exactly the same as outlined above.

Receivership and administration

A receiver can be appointed by someone who has security over an asset and their main role is to realise the asset or assets for the benefit of the charge holder. They have no general duty to any other creditor.

Administration is a formal process where a person is appointed to manage the business and get a better return for the creditors. The assumption is that they will try to rescue the company although it is clear that this is not always possible. If they cannot rescue the company it is likely to proceed to liquidation fairly quickly.

The tax implications are very straightforward because nothing really changes. There is no cessation of the accounting periods in a receivership but there is in an administration. There is no breaking of the group structure. Tax is due as normal.

Company Voluntary Arrangements

A company that can show that it is insolvent may enter into a Company Voluntary Arrangement (CVA). This could be proposed by the director or an administrator (if the company is in administration). Very occasionally, if you have a company in liquidation where the petition to wind up has not been challenged, the liquidator might apply for a CVA. A nominee (who must be a licensed insolvency practitioner) prepares a proposal to be considered by the creditors and there is a formal process by which it would then be considered. Each £1 owed represents a vote and more than 75% of the votes in relation to unsecured creditors must approve and accept the CVA. It is binding on the unsecured creditors once in place. It would be usual to have the support of any secured creditors too. Arrangements can last for any period of time but are typically between three and five years.

There is a Voluntary Arrangements Team within HMRC and they must be notified by the supervisor within 21 days (although the likelihood that HMRC are not a creditor will be fairly low).

Crown preference

Up until recently there was no Crown preference in respect of insolvency proceedings and all tax claims were non-preferential unsecured debts and as such had no special priority over other debts. For insolvencies that start on or after 1 December 2020, HMRC has become a secondary preferential creditor in relation to taxes held by any insolvent entity. This will only apply to those taxes which are collected and held by businesses on behalf of other taxpayers such as VAT, PAYE, NICs, student loan deductions and CIS deductions.

At the same time, directors and others connected to a company who misuse company insolvency, become joint and severally liable for specified debts owed to HMRC by the company. The measure also applies to members of LLPs.

HMRC will be able to issue a joint liability notice to an individual where these three conditions are satisfied:

1. A corporate tax liability arises or is expected to arise from:
 - Tax avoidance or evasion;
 - Repeated insolvencies where tax debts are repeatedly accumulated but never paid ;or
 - Penalties for facilitating tax avoidance or evasion.
2. The company starts insolvency proceedings (or is expected to do so) so that HMRC will not be able to collect some or all of the tax liability.
3. The individual (in relation to each of the above offences in order):
 - Was responsible for the company entering into the avoidance or evasion:
 - Directly or indirectly managed to some extent, the old and new companies:
 - Was a director of the company or a participator at the time the event causing the penalty occurred or the proceedings for the penalty were started.

‘Tax-avoidance arrangements’ means in this context:

- arrangements in respect of which a notice of HMRC’s final decision, after considering opinion of GAAR Advisory Panel, that a tax advantage is to be counteracted under the general anti-abuse rule;
- arrangements in respect of which a follower notice has been given;
- DOTAS arrangements for circumstances in which an accelerated payment notice may be given, being:
 - a) notifiable arrangements to which HMRC has allocated a reference number;
 - b) notifiable arrangements implementing a notifiable proposal where HMRC has allocated a reference number under that section to the proposed notifiable arrangements; or

- c) arrangements in respect of which the promoter must provide prescribed information by reason of the arrangements being substantially the same as notifiable arrangements;
- arrangements to which HMRC have allocated a reference number under the DOTAS for VAT and other indirect taxes or in respect of which the promoter must provide prescribed information;
 - arrangements in relation to which a relevant tribunal order has been made, where a 'relevant tribunal order' is made;
 - arrangements that:
 - are substantially the same as arrangements in relation to which a relevant tribunal order has been made (whether involving the same or different parties), and
 - have as their promoter the person specified as the promoter in the application for the order.

‘Tax-evasive conduct’ means:

- giving any deliberately false return, claim, document or information to HMRC;
- deliberately withholding information from a person, or providing a person with deliberately false information, with the intention of the person giving any false return, claim, document or information to HMRC;
- deliberately failing to comply with an obligation to notify liability to tax as specified in the table in FA 2008, Sch. 41, para. 1.

Something is ‘false’ if:

- it is false, inaccurate or misleading;
- it contains anything that is false, inaccurate or misleading; or
- it is incomplete to any significant extent.

A notice must include:

- 1) The company to which it relates;
- 2) Why the officer thinks conditions are met;
- 3) The effect of the notice;
- 4) An offer to review the officer’s decision to issue the notice and the effect of a review;
- 5) The right of appeal;
- 6) The amount of the relevant tax liability, if the existence and amount of that liability have been established, or if not, an indication that the amount will be specified in a further notice (once the amount is established a further notice must be issued to the same individual as the original notice specifying the amount and the items specified in 4) and 5)).

An individual has a right of appeal to the First-tier Tribunal (FTT) against a joint liability notice. Unless HMRC agree a longer period or the FTT gives permission, the appeal must be made within 30 days of when the notice was issued or, if HMRC has carried out a review, within 30 days of HMRC issuing their review conclusion.

When can HMRC get other taxes from individuals?

The above commentary demonstrates that it is not easy for HMRC to collect business debts from individuals, even when they are involved in the business. But there are some cases where this might be possible.

Corporation tax

There is no automatic right to collect corporation tax from directors or shareholders, subject to the legislation to be introduced as described above. However, what HMRC might try to do is argue that illegal payments have been made to participants in the company, usually as an illegal dividend. An illegal dividend is a loan to the shareholders so money can be recovered by the company (often by appointing a liquidator for an insolvent company) from those shareholders which becomes available to pay the tax.

What is an illegal dividend? The question whether a dividend is unlawful or not is not a tax issue. It is rather the application of company law to the particular facts, and the tax consequences flow from those facts.

There is a significant difference in the treatment of improperly paid dividends dependent upon the position of the recipient. Company law provides that a recipient member who knows or has reasonable grounds to believe that a distribution or part of it is unlawful is liable to repay it or that part of it to the company but not if they did not.

HMRC do not often need to consider this point as they are usually dealing with close companies where there is a strong likelihood that all shareholders are fully aware of the position.

Where a dividend is paid and it is unlawful in whole or in part and the recipient knew or had reasonable grounds to believe that it was unlawful then that shareholder holds the dividend (or part) as constructive trustee in accordance with the principles stated by Dillon L J in *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] 1 Ch at page 457.

Such a dividend (or part) is void for the purposes of the IT charge on distributions.

The company has not made a distribution as a matter of company law, and so the dividend does not form part of the recipient's income for tax purposes. The company has not parted with title to the sum that it purported to distribute, which as a consequence remains part of its assets under a constructive trust (see also *Ridge Securities Ltd v CIR* (1964) 44TC373).

Where the company concerned is a close company, it is regarded as having made a loan to the shareholder within s455, thereby triggering a charge. Relief would however be available where the dividend is repaid to the company.

The most likely reason that a dividend will be illegal is the absence of the necessary distributable reserves. The question might arise as to when that judgement is made. If it can be shown that events after the dividend was voted have contributed to a negative balance sheet, then the dividend may not be illegal. But this can be a very difficult argument to make.

PAYE

Unpaid PAYE is the liability of the employer. There are, however, situations where HMRC will seek to collect the tax from the employee or director by means of a direction. This is only ever going to be the tax relating to payments made to the individual who is then pursued.

Reg 72(5) allows HMRC to do this in 2 circumstances:

- where HMRC are of the opinion that the employer took reasonable care and the error was made in good faith (condition A);
- where HMRC are of the opinion that the employee received employment income knowing that the employer has wilfully failed to deduct the tax (condition B).

Condition A is an interesting one as the question of whether the employer has taken reasonable care or not will be a matter of fact. However, the interpretation of the facts might be different depending on your perspective. There is a feeling that HMRC are too willing to accept this as they feel the employee is likely to be a softer target than the employer.

Condition B will normally be applied in close company cases as it becomes straightforward for HMRC to argue that the person knew that tax was not being correctly deducted on payments made to them. HMRC will only adopt this route if there is a good likelihood of the director or employee paying the tax. They acknowledge that there must be firm evidence to support their view. There is obviously less of a risk with employees as opposed to directors but an employee who is an officer of an unincorporated club or an individual who is a wage clerk or financial manager might well be seen to have the ability to do this.

Directions under these regulations must be made before formal directions have been issued to the company. However, if a Reg 80 determination has been made to a company but remains unpaid, then HMRC might again seek to transfer the liability to the employee. In those cases, a Reg 81 determination would be issued to the employee but only where one of the following two conditions are met:

- Condition A is that HMRC are of the opinion that the employee in respect of whose relevant payments the determination was made has received those payments knowing that the employer has wilfully failed to deduct the amount of tax which should have been deducted from those payments;
- Condition B is that the unpaid tax represents an amount for which the employer was required to account under reg 62(5) in relation to notional payments to the employee.

NICs

The situation with National Insurance Contributions owed by an employer is slightly wider. HMRC has the power to issue Personal Liability Notices (PLNs) to an individual where:

- A body corporate has failed to pay contributions due; and
- That failure is (in the opinion of HMRC) attributable to the fraud or neglect of one or more individual who, at the time of the fraud or neglect, were officers of the company (referred to as culpable officers).

The liability can cover primary and secondary Class 1 NICs, Class 1A and 1B NICs plus interest and penalties.

The relevant legislation defines an officer as ‘any director, manager, secretary or other similar officer of the body corporate or any person purporting to act as such; and in a case where the affairs of the body corporate are managed by its members, any member of the body corporate exercising functions of management with respect to it or purporting to do so.’ This is typically going to be the director or company secretary but it can be wider than that and would include shadow directors.

HMRC do potentially have to demonstrate that the officer in question has some culpability in relation to the failure to remit the NICs to them. It may be that an officer can argue that they were not involved in this aspect of the business in order to avoid paying the additional duties.

The legislation talks about neglect or fraud.

Neglect is not defined in law but has been considered in case law. In the Upper Tribunal case of *HMRC v CM O’Rorke*, this was found to involve an objective test as to whether there has been a departure from the standard of care in dealing with affairs that would be expected of a reasonable man. In the HMRC guidance on this legislation the following factors are indicated as potentially showing that neglect has occurred:

- *no payments of PAYE or NICs for the full period of trading; or non-payment over a prolonged period of time;*
- *at the time of the failure to pay the contributions due the body corporate was making payments to, or for the benefit of, one or more officers of the body corporate, connected persons or associated businesses;*
- *where the contributions due to HMRC were knowingly and deliberately withheld;*
- *where one or more officers of the body corporate have been associated with other businesses that have failed to comply with their statutory PAYE and NIC obligations;*
- *where we are dealing with a phoenix company;*
- *at the time of the failure to pay the contributions due the company continued to make payments to other creditors;*
- *where the evidence points to the PAYE and NICs that should have been remitted to HMRC being used to fund the company activities and boost cash flow;*
- *where we are dealing with an action that placed a significant NICs liability on the body corporate at a time that the officer would or should have known that there was no reasonable prospect of the body corporate being able to satisfy the resulting NICs liability. For example, the clearing of an overdrawn director's loan account through the declaration of a salary, just prior to liquidation.*

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