EXPLANATORY MEMORANDUM TO

THE INSOLVENCY ACT 1986
(HMRC DEBTS: PRIORITY ON INSOLVENCY) REGULATIONS 2020

2020 No. 983

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of Her Majesty's Treasury and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument forms part of the legislation to amend the Insolvency Act 1986 to make HMRC a secondary preferential creditor in insolvencies after 1 December 2020. The legislation provides for the priority of certain HMRC debts: Value Added Tax (VAT) and relevant deductions made from payments to employees. This instrument specifies the relevant deductions under the legislation as follows; tax deducted under the Construction Industry Scheme (CIS), employee National Insurance contributions (NICs), income tax deducted under Pay As You Earn (PAYE) and deductions in respect of student loans.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 As the instrument is subject to negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the United Kingdom.

4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

6.1 The Treasury will make the regulations in exercise of the powers conferred by section 99(3) of the Finance Act 2020, HMRC debts: regulations.

6.2 The order of priority in insolvencies is governed by the Insolvency Act 1986 in England and Wales. Secured creditors (Fixed charges) and expenses of the insolvency are paid first, followed by preferential debts (which includes claims from the Redundancy Payment Service and Financial Services Compensation Scheme). Holders of floating charges (such as financial institutions and other lenders who

secure credit from less secure assets such as stocks, raw materials and cash) and other unsecured creditors are paid last. The current categories of preferential debt are defined by section 386 of, and Schedule 6 to, the Insolvency Act 1986. In Scotland, the listing of preferred debt is contained in section 129 of, and Schedule 3 to, the Bankruptcy (Scotland) Act 2016. In Northern Ireland the categories of preferential debt are contained in Schedule 4 to the Insolvency (Northern Ireland) Order 1989.

6.3 Legislation was introduced in sections 98 and 99 of the Finance Act 2020. These provisions allow for certain debts owed to HMRC to be included in a category of preferential debt, (or in Scotland, preferred debt) that for insolvency purposes can be paid before other debts**.** The debts covered within this legislation are those in respect of VAT or a relevant deduction. This instrument specifies the relevant deductions that can be paid before other debts; CIS, employee NICs, PAYE and student loan deductions.

7. Policy background

7.1 HMRC currently has limited scope to recover outstanding tax debt once a business becomes insolvent because of its status as a non-preferential unsecured creditor. This means HMRC ranks behind fixed charge holders and preferential creditors in the 'queue' that determines creditor hierarchy. Until 2003, Inland Revenue and Her Majesty's Customs and Excise had preferential status for certain tax debts in cases of individual or corporate insolvency. This meant that HMRC ranked behind creditors with a fixed charge, but ahead of those with a floating charge, who were in turn ahead of unsecured creditors and shareholders. This was known as Crown Preference and was removed completely from Inland Revenue and Customs and Excise with effect from 15 September 2003 by section 251 of the Enterprise Act 2002. As a result of HMRC having lost preferential status, taxes paid by customers and employees are often treated as assets by the insolvent business and rarely reach HMRC as intended.

7.2 In part due to this change, HMRC writes off around £3.5 billion each year due to insolvency. Many of the losses represent unpaid PAYE, NICs and VAT debt. PAYE, NICs, CIS and VAT are collected by businesses on behalf of HMRC. When businesses fail to pay over these deductions to HMRC and become insolvent, tax debts such as VAT and other relevant deductions from employees and customers which are intended to fund public services are lost to the Exchequer and form part of the general estate available to pay all unsecured creditors.

7.3 Finance Act 2020 gives HMRC priority as a secondary preferential creditor for VAT and relevant deductions. This instrument will specify HMRC's preferential status in the collection of debts for relevant deductions (CIS, employee NICs, PAYE and student loans) that are due at the commencement of the insolvency from the assets of insolvent taxpayers. HMRC will rank above unsecured creditors and holders of floating charge security, but below fixed charge creditors.

7.4 This does not signify a return to full Crown Preference. From 1 December 2020, once ordinary preferential creditors have been paid, HMRC will be a secondary preferential creditor for taxes held on behalf of employees and customers. These changes only apply to VAT and CIS, employee NICs, PAYE and student loan deductions.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 There are no plans for consolidation.

10. Consultation outcome

On 26 February 2019, the government published a consultation document "Protecting Your Taxes in Insolvency" which invited comments from interested parties, particularly those affected by this change. The consultation sought views on how HMRC could implement this change as effectively as possible. These parties included businesses, lenders, insolvency practitioners, advisors and representative bodies. The 3-month consultation ended on 27 May 2019. 41 responses were received covering a range of issues related to implementation of the measure. The responses were used to inform the revised Finance Bill legislation, which was published in summer 2019. Generally, respondents were against HMRC having priority status primarily due to the potential impact this may have on lending practices and access to finance. The full summary of responses can be found here: https://www.gov.uk/government/consultations/protecting-your-taxes-in-insolvency

11. Guidance

11.1 A factsheet will be produced prior to the implementation date of 1 December 2020. The factsheet will show the new priority of debts which will be within scope of the legislation.

12. Impact

12.1 The impact on business, charities or voluntary bodies is dependent on whether they are businesses and civil society organisations who are creditors involved in an insolvency where HMRC receives a dividend upon its secondary preferential claim. Prioritising the recovery of HMRC's tax debt could mean that parts of the lending industry such as banks are affected, as they are the main holders of floating charges. They, along with other creditors, could receive a reduced dividend and may change their lending practices as a result of this measure.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information and Impact Note covering this instrument was published on 11 March 2020 alongside the draft legislation and is available on the website at https://www.gov.uk/government/publications/introduction-of-changes-to-protect-your-tax-in-insolvency/introduction-of-changes-to-protect-your-tax-in-insolvency. It remains an accurate summary of the impacts that apply to this instrument.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses. However, it will only apply to small businesses that have become insolvent or to those that are unsecured creditors of businesses that have become insolvent.

13.2 There is no specific action proposed to apply these regulations differently to small businesses. Insolvency practitioners handle all creditor claims so there should be minimum burdens placed on small businesses to comply in the event of insolvency.

13.3 The final decision on what action to take to assist small businesses is based on the policy rationale that this legislation applies to all businesses that become insolvent who have unpaid VAT, CIS, employee NICs, PAYE and student loan debts. These

monies were paid by employees and customers in good faith that they would be passed to government to fund public services.

14. Monitoring & review

14.1 The policy will be monitored through ongoing communications with affected taxpayer groups and insolvency practitioners.

14.2 The regulation does not include a statutory review clause because the legislation relates to taxes, duties, levies or other charges and falls within the exemption in section 28(3)(a) of the Small Business, Enterprise and Employment Act 2015.

15. Contact

15.1 Marcia Coke at HMRC Telephone: 03000 592 658/ 07816 210290 or email: marcia.coke@hmrc.gov.uk can be contacted with any queries regarding the instrument.

15.2 Nick Jones, Deputy Director for Debt Management Strategy, at HMRC can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Rt Hon Jesse Norman MP, Financial Secretary to the Treasury, can confirm that this Explanatory Memorandum meets the required standard.