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27 June 2018

Dear sir/madam,

Comments by the Association of Business Recovery Professionals (R3) in response to the Discussion Document issued by Counter Avoidance Directorate, HMRC

'Tax Abuse and Insolvency' Published on 11 April 2018

R3 is the leading professional association for insolvency practitioners (IPs) in the UK, promoting best practice for professionals working with financially troubled individuals and businesses, promoting the work to Government and key policy makers, producing guides for insolvency professionals and members of the public, running courses and conferences to promote learning and best practice within the insolvency profession. Our members (approximately 3,000) work in firms of all sizes, from the global legal and accountancy firms through to smaller local firms and sole practices, and include insolvency lawyers and other professionals working in the insolvency and restructuring professions. In these roles our members regularly encounter insolvencies where HMRC is the principal or significant creditor. Those cases range from an inability to pay tax to a change in trading fortunes, to cases of failed tax avoidance, to the most serious instances of tax evasion and fraud.

R3 has been helped in the collation of this document by a sub-committee of R3 members including representatives of restructuring tax practitioners, members of R3 Fraud committee, insolvency practitioners and solicitors. We recognise that this is a specialised area. R3 welcomes the invitation to provide comments on the Discussion document. Proposals seeking to counter the steps taken by those who seek to unfairly avoid or evade their obligations are, of course, welcome. This is already a significant part of the work undertaken by R3's members.

It is noted that HMRC have issued a separate consultation document 'Extension of the existing security deposit legislation to include CT and CIS deductions'. R3 have provided a separate response to this consultation but do, however, note that there is overlap between the two consultations.

Executive Summary

At a high level, R3 has the following concerns about the Discussion Document and the proposals it contains:

(1) Lack of evidence and empirical analysis:

First, the views and the proposals expressed in the Discussion Document (albeit expressed in the form of a preliminary view) do not appear to have been based upon any sort of evidential analysis or empirical approach. This is most obviously apparent in the section on "How tax and insolvency regimes are misused" which provides a highly subjective assessment of perceived issues with the regimes, including apparent criticisms of officeholders[1]. There does not appear to be any attempt to identify the precise scope or prevalence of the alleged misuse of the tax and insolvency regimes, which has led (it would appear) to an excessively pessimistic view of the usefulness of insolvency to HMRC.

In the discussion document Introduction at paras 1.6-1.8 it is noted that the vast majority of insolvencies are not deliberately misused in order to facilitate the non-payment of tax. However the examples provided at in Section 2 could equally be seen in any insolvency. There is a requirement therefore to provide a very clear definition of what constitutes a 'deliberate' act so that mere negligence on the part of a director would not be caught by these proposals.

(2) There are existing remedies both in insolvency and taxation legislation

Secondly, in order to counter the perceived abuses in the tax and insolvency regimes, the Discussion Document suggests the introduction of wider recourse against company directors and officers, in particular the introduction of transfer of liability or joint and several liability[2]. R3 suggests that sight should not be lost of the fact that there are already remedies available both within the existing tax legislation and within the Insolvency Act 1986 that can be used to address many of the instances of abuse, including those examples identified in the Discussion Document. It might be more appropriate to ask, when considering the evidence, what might be done to encourage the use of these existing remedies, whether they are under-used at present and what might be done to encourage their more widespread use.

(3) The proposals are considered likely to undermine the efficient and fair operation of the tax and insolvency regimes

Thirdly, the Insolvency Act 1986 in particular is the product of decades of progressive development. It is based, and interpreted by the courts, in accordance with well-recognised principles, chief among these being the *pari passu* distribution of recoveries between unsecured creditors. The insolvency regime is founded upon principles of creditor equality and democracy. R3 is concerned that the proposals in the Discussion Document would undermine these proposals which are the foundation of the insolvency regime, and that

[1] For instance, para. 2.9, which appears critical of "commercial" or discounted settlements.
[2] Para. 3.5.

HMRC would obtain for itself in practice a preferential status not available to other (non-government) creditors who have also lost out. Wider unintended consequences are also likely to result, including undermining the role of officeholders who seek to hold wrongdoing company directors to account for the benefit of creditors as a whole. There are also questions about the fairness (and legality from a human rights perspective) of extra-judicial remedies being exercised by HMRC against individuals in the manner that appears to be contemplated.

R3 would not want the foregoing to be misinterpreted as resistance to *any* reform to the tax and insolvency regimes which might provide greater protection to HMRC and, indeed, other creditors. In this Response we suggest potential areas where such improvements might be contemplated.

Consultation Questions and Answers

1. **Do you agree that HMRC should be tackling this behaviour? Are there any other forms of abuse in insolvency in relation to tax that ought to be tackled?**

   It is in the interests of all for cases of tax abuse and avoidance to be tackled. R3 agrees that HMRC should be tackling the behaviour as outlined in Part 2 of the discussion document, if it is considered to be extensive. R3 does not consider however that the Discussion Document makes out an evidential case for legislative change and the experience of R3 members would suggest that the forms of abuse referred to are not at all common.

   The large majority of liquidations arise from genuine financial pressures and are not engineered to avoid the liabilities of HMRC. The discussion document appears to imply that HMRC considers that insolvency procedures are being misused to enable people to circumvent their tax responsibilities. By correlation it would follow that in order for an insolvency procedure to be misused in this way, there needs to be a willing insolvency practitioner to facilitate this process. It would be useful to understand the extent to which this is perceived by HMRC to be a problem as no supporting data or analysis is provided in the discussion document to enable us to gauge the extent of this problem.

   We would like to point out that where HMRC has identified that an insolvency practitioner has enabled an insolvency process to be misused in this way, they already have the power, as a creditor, to seek the removal and replacement of the insolvency practitioner.

   The current tax legislation determines how tax liabilities are determined and it is noted that in the example provided in para 2.7 of the discussion paper that there is a time delay between the date of the tax liability arising and the tax debt becoming enforceable. Whilst we understand that this causes additional problems for HMRC it is not considered that the position of HMRC is any different to any unsecured creditor whose debt falls due at a future date. Indeed at the point of insolvency there will inevitably be a number of creditors who are owed money and will be unable to take enforcement action due to the insolvency procedure being entered into. We do not consider the position of HMRC to be sufficiently different to other unsecured creditors for HMRC to be afforded different treatment in this regard.

It is noted that in the discussion paper references to "insolvent" companies are not limited to mean companies that have commenced formal insolvency proceedings, but also refer to instances where the company is functionally insolvent e.g. they have ceased trading and have tax liabilities outstanding. R3 has been supportive of Government proposals to extend the current director disqualification regime to dissolved companies (see the BEIS consultation paper on Insolvency and Corporate Governance) and has also called for steps to be introduced to enable the easier restoration of such companies to allow for the formal liquidation and thorough investigation of the companies affairs and the actions of the directors by the subsequently appointed insolvency practitioner. It is considered that many companies are currently struck off for non-filing of accounts by Companies House. HMRC, as a creditor of many of these companies, is in a position to object to the said striking off and is already pro-active in presenting winding up petitions against companies for non-payment of tax. HMRC has a significant role to play in ensuring that companies are not simply allowed to be struck off when there are liabilities outstanding (including to HMRC) and should ensure that it is supportive of existing proposals by Government to reduce the impact of such occurrences.
It should be noted however that there are significant differences between companies which have entered into a formal insolvency procedure and those which have simply been dissolved. Any legislative changes introduced therefore need to be clear about whether they relate to formal insolvency procedures or otherwise.

2. **To what extent do you consider that one of the above approaches could provide a helpful model for tackling the abuses outlined in this document?**
As set out above R3 has considerable reservations about the proposals and the likely effect on the position of other creditors and company rescues generally.

At para 3.5 the proposals seek to make those considered to be responsible for the avoidance, evasion or repeated non-payment of taxes personally liable where there is a risk that funds will be lost in insolvency or in the event that the company could not meet the tax debts (outside of formal insolvency).

Whilst it is considered that any levying of personal liability would be likely to act as an effective deterrent in respect of general tax avoidance, it is questioned how effective a deterrent this actually would be to the minority of directors who deliberately act to abuse the insolvency laws as outlined. It is considered that the type of person who would seek to avoid the payment of tax in this way would simply arrange their affairs so as to avoid the consequences (such as avoiding having personal assets to be called upon) or by putting in 'stand in' directors rather than acting as a director themselves.

Safeguards would need to be introduced to ensure that the underlying principal of limited liability is not removed by the changes introduced and to ensure that the proposals are not applied more widely to routinely recover unpaid tax from directors. A clear definition of 'responsibility' would ensure that those advising directors in the lead up to an insolvency procedure, or restructuring directors appointed to assist a company would not also be made personally liable for the company's unpaid tax. It is clear that any potential for being made personally liable in this way would deter professionals from becoming involved in assisting companies in financial distress.

3. What do you think might be the key issues with applying one of these approaches to tackle the abuses outlined in this document?

The introduction of wider recourse against company directors and offices could have the potential for a number of unintended consequences such that it has a detrimental effect on genuine businesses and deters those involved in the management of such businesses from seeking professional assistance when facing financial difficulties, for fear of becoming personally liable for tax debts of the company if placed into insolvency. Research has shown that the earlier professional help is sought in respect of a financially distressed company, the better the outcome is for all concerned.

The current insolvency legislation provides for a liquidator to have wide reaching powers of investigation and enables a liquidator to take action against a director for a number of offences committed prior to a company entering into liquidation. This can include making the director personally liable for the debts of the company, or to ensure that they make good any losses incurred or damage done to the general body of creditors. Any such action taken recovers funds for the benefit of the general body of creditors rather than any specific individual creditor.

We have concerns that should HMRC obtain the power to pursue directors personally that this will deter liquidators from taking action on behalf of the main body of creditors as there will be a risk that, having incurred costs in taking action against a director, HMRC will take such funds as are available from the director to settle the tax liabilities of the company.

The effect of the proposals suggested is to make those same directors personally liable for the debts of HMRC only, and to enable HMRC to recover funds for the benefit of HMRC only. Directors often have limited funds and any dilution of available assets will limit the ability of the liquidator to recover funds for the benefit of the general body of creditors.

This would appear to undermine the principles of the insolvency regime including the principle of creditor equality. In effect HMRC would obtain for itself a preferential status not available to other creditors who have also lost out. There are also questions about the fairness (and legality from a human rights perspective) of extra-judicial remedies being exercised by HMRC against individuals in the manner that appears to be contemplated.

Without strict safeguards being applied, if liability for a company's unpaid tax automatically falls on directors then individuals will be deterred from accepting new director appointments, and rescues of companies in distress will only proceed if parties looking to be involved are willing to pay all historical tax liabilities. Any additional costs arising will have a direct negative impact on funds being realised on the sale or rescue of such a company.

4. What views do you have for alternative approaches that could be adopted to tackle the forms of tax abuse outlined in this document?

Before seeking to establish new approaches to tackle the behaviour outlined HMRC should ensure that they are making full use of the existing powers available, both under tax legislation and the insolvency legislation. For example, if there is a concern as to the dissipation of assets pre-insolvency, HMRC has the same right as other creditors to seek freezing order protection provided the evidence is sufficient.

In many instances liquidators do not proceed with taking action against directors due to a lack of available funding (see Para 2.9 of the Discussion document). HMRC could further support liquidators in this regard by working more closely with the profession to ensure that where instances of tax avoidance have been identified, appropriate action is taken.

It is noted that there is a further consultation on the extension of the existing security deposit legislation to include Corporation Tax and Construction Industry Scheme deductions. It is unclear what impact those proposals would have on the behaviour outlined in this paper and care should be taken to ensure that conflicting proposals for new legislation aren't progressed.

Consideration could be given to the proposals outlined to extend the Director's Disqualification processes to directors of dissolved companies. If a director acts in a way which breaches his/her duties it can result in personal liability. Coupled with proposals to make directors liable to compensate specific creditors for losses caused by their actions, this may enable HMRC to tackle the minority of cases envisaged.

5. What safeguards should apply to ensure taxpayers' rights are protected?

The Companies Act 2006 and the Insolvency Act 1986 have built in safeguards to protect the interests of unsecured creditors. Similarly any new tax legislation introduced must have similar safeguards built in to ensure taxpayers' rights are protected, and the primary safeguard will be clearly defining the target for this measure.

The only safeguard stated in the discussion document at Para 3.7 is the right of appeal to the Tax Tribunal. R3 considers that in itself this is not sufficient as appeals to the Tribunal are time consuming and costly and do not address the consequences of a director having to pay the tax upfront. Should the Tribunal determine that the tax should not have been paid will an element of compensation be paid as well?

Exemptions should be clearly set out so that insolvency practitioners and others acting to restructure or rescue the company will not be unwittingly caught by the legislation. New directors (appointed after the tax liability has been incurred) and those directors not responsible for the behaviour identified should be similarly exempt.

In order to ensure that any proposals do only apply to those specific directors intended in these proposals there should be an independent review within HMRC whose approval must be sought before such action can be taken. This will ensure that action is not being taken inappropriately (for example where other courses of action are available, either to HMRC or a liquidator) or inconsistently, and that tax payers rights will not be harmed by the application of these proposals.

There should be provision for a director to seek clearance in advance when intending to go through a rescue or restructure so that compliant taxpayers may have certainty before they put themselves at risk. HMRC would however need to ensure that sufficient resources were available to turn around such requests promptly.

6. Do you consider that the above parameters for scoping the measure are appropriate?

R3 does not currently consider that the scoping parameters are appropriate as they stand. No account is currently taken of the impact on other stakeholders and there is no provision for the external adjudication of the actions proposed.

No consideration has been given to the impact on future tax take if rescues and business turnarounds are reduced as a result of these measures. There has also been no attempt to define the scope by reference to the amount of the loss to HMRC. R3 is concerned that (as with director disqualification cases) there will be a drive to take the easiest low value cases so as to meet internal targets, rather than countering the most egregious and high value types of abuse.

It is not clear from the discussion document how the behaviour described is distinct from that which can be seen in the majority of business failures where an insolvency practitioner steps in to realise assets and maximise returns for all creditors, which will often result in a tax liability not having been settled in full.

A clear definition of terms will be required.

7. **Are there any other safeguards you think should be considered to tackle these abuses?**

R3 considers that safeguards are required to ensure that powers introduced to target specific situations are not more widely applied against all other companies who are insolvent.

For example, the appointed office holder could be required to confirm that abuse of the insolvency process has taken place, as oppose to the company simply facing financial problems.

Alternatively the court could be involved with HMRC having to evidence that such behaviour has occurred before personal liability could be awarded against named individuals.

Clear legislative drafting and detailed guidance as to its applicability is required to ensure that that the legislation isn't applied more widely than currently intended in the future.

The remainder of this Response is structured as follows:

Appendix A - The status of HMRC as creditor and the principles underlying the Insolvency Act 1986;
Appendix B - The existing tax remedies;
Appendix C - The existing insolvency remedies;
Appendix D - The potential consequences of the Discussion Document's proposals;

Kind Regards

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Appendix A

The status of HMRC as Creditor and the Principles underlying the Insolvency Act 1986

Since the coming into force of the Enterprise Act 2002, HMRC no longer has the status of preferential creditor. The change was intended to benefit unsecured creditors, to whom a loss resulting from an insolvency might represent a considerable hardship:

"The evident policy of the legislature was, to that extent, to create a fund out of the floating charge holder's security to which unsecured creditors alone could have recourse, in return for the advantage afforded to floating charge holders by the abolition of the preferential status of Crown debt, which would otherwise come ahead of a floating charge"[3].

Until the 2002 Act, the balance between preferential creditors, unsecured creditors and the holders of floating charges had been the subject of long-standing criticism:

"The Enterprise Act introduced what was to many observers a long-overdue redressing of the balance between preferential creditors, unsecured creditors and the holders of floating charges. Templeman J. (as he then was) observed 30 years ago in Business Computers Ltd v. Anglo-African Leasing Ltd [1977] 1 W.L.R. 578 at 580:

"The question whether in this day and age it is necessary or desirable to permit the Crown and the holders of future floating charges the totality of the priorities which can be exercised under the existing law is not the subject of debate in this court, though I am inclined to think that it is at least debatable elsewhere."

Further, the Cork Committee in its 1982 report, Insolvency Law and Practice: Report of the Review Committee (Cmnd. 8558) at para.1410 commented as follows:

"We unhesitatingly reject the argument that debts owed to the community ought to be paid in priority to debts owed to private creditors. A bad debt owed to the State is likely to be insignificant, in terms of total Government receipts; the loss of a similar sum by a private creditor may cause substantial hardship, and bring further insolvencies in its train.""[4]

The principle of *pari passu* distribution (where the unsecured creditors share recoveries pro rata according to their debts) is also universally recognised. Also often referred to as the "statutory scheme", its operation has been summarised as follows:

"The essential characteristic of the statutory scheme is that the liquidator or administrator is bound to deal with the assets of the company as directed by statute for the benefit of all

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[3] Re Permacell Finesse Ltd (In Liquidation) [2008] B.C.C. 208, at [18], H.H.J Purle Q.C. (sitting as a Judge of the High Court).
[4] Ibid, [16]-[17].

creditors who come in to prove a valid claim. There is a statutory obligation on the administrators of [the company] to treat the general creditors in a particular way ... If ... the asset is the absolute beneficial property of the company there is no general power in the liquidator, the administrators or the court to amend or modify the statutory scheme so as to transfer that asset or to declare it to be held for the benefit of another person. To do that would be to give a preference to another person who enjoys no preference under the statutory scheme."[5]

By extending the opportunity of HMRC to claim against company directors directly, either by the 'transfer of liability' or 'joint and several liability' routes proposed in the Discussion Document, HMRC would in practice obtain for itself a preferential status. While it is true that the order of priorities within the insolvency would not be interfered with (since HMRC would still rank as an unsecured creditor of the company), it would obtain an alternative route of recovery not available to the general body of creditors, against the directors personally.

This bypassing of the insolvency by HMRC is of more than academic concern. It may be that in a nil-asset liquidation, that the only asset available to the officeholder is a claim against one or more of the company's directors. Such a claim might be brought under section 212 of the Insolvency Act 1986, and the proceeds would be divided between creditors according to the statutory scheme. However, if this potential route of recovery is lost, this is to detriment of creditors as a whole other than HMRC.

It is for this reason that claims against the company's former officers under section 212 of the Insolvency Act 1986, even when brought by a dissatisfied creditor rather than a liquidator, result in a recovery to the company for the benefit of creditors as a whole and not that individual creditor[6].

The effect (if not strictly the form) of the proposals is therefore to grant HMRC a preferential status. The potential adverse consequences of this (touched upon above) are addressed further detail below in **Appendix D**.

[5] Re Polly Peck International Plc (in admin.) (No.5) [1998] 2 B.C.L.C. 185 at 201, Mummery L.J..
[6] Oldham v. Kyrris [2004] B.C.C. 111.

Appendix B

The Existing Tax Remedies Already Available

Within the tax legislation there are existing remedies or protections available to HMRC to counter the types of abuse contemplated in the Discussion Documents. In particular:

- HMRC may pursue a director for unpaid corporate taxes under secondary liabilities rules (for example, sections 108 and 109E of TMA 1970, section 190 of TCGA 1992);
- Individuals are required to self-assess higher 'dividend' rates of tax on liquidation distributions from close companies (rather than lower 'capital' rates of tax), where the liquidation (or arrangements around it) are tax motivated and the individual is involved with a similar trade or activity within the following two years (sections 396B and s404A ITTOIA);
- HMRC can demand upfront payment of disputed tax or national insurance balances from directors by using follower notices, accelerated payment notices ('APNs'), or personal liability notices ('PLNs') to secure the cash whilst the dispute runs, retaining it until the dispute is resolved;
- Taxpayers may require an individual guarantee or Customs Comprehensive Guarantee (CCG) authorisation to enter goods into a customs procedure and/or defer customs duty. To get a CCG, a business needs to have no serious or repeated infringements of customs or tax rules and no record of serious criminal offences related to their business activities. In practice this means they may need to settle outstanding taxes or demonstrate measure to avoid repeated infringements in order to continue to operate;
- Directors may be held to be personally liable for PAYE under the Income Tax (PAYE) Regulations 2003/2682 reg 97ZB and NIC under the Social Security Administration Act 1992 s.121C

The Discussion Document does not explore in any detail the costs or benefits of these existing measures, whether they are effective in this context, nor what marginal impact the new rules may have. If there is a compelling case for action, HMRC should consider whether it may be addressed by these alternative remedies.

Appendix C

The Existing Insolvency Remedies

In addition there are existing remedies within the insolvency legislation which may be used to obtain redress for HMRC either through a direct right of action or through a liquidator. These remedies (and the circumstances of tax evasion in which they might be deployed) include the following[7]:

Either a liquidator or a creditor (and therefore HMRC) may bring a claim against a director of a company in liquidation or administration for misfeasance under section 212 of the IA86. These claims might include:

(a) Where the director has caused the insolvent company to enter into a tax scheme for his personal profit and as a result the Company has been exposed to a liability to tax, that liability may be claimed against the director;

(b) Where the director has caused the company to enter into transactions for the purpose of effecting tax-free payments to himself (for instance the payment of company money into an EBT), those payments, and not simply the liability to tax, may be claimed from the director.

A liquidator may bring claims to set aside transactions entered into pursuant to a tax avoidance scheme and to claim the benefits from the recipients. Often tax avoidance schemes require transactions to be entered into by the company which are intended to circumvent tax legislation, but which are:

(a) for no consideration (for instance, payments to a connected company to circumvent transfer pricing) or;
(b) ultra vires (for instance, payments to an EBT to effect disguised distributions to shareholders).

In either case claims can be brought by a liquidator under section 238 (in respect of transactions for no or no adequate consideration) or 212 (in the case of ultra vires transactions);

Where a director has caused a company to continue to incur liabilities (often to HMRC) at a time when he or she knew or should have known that the company would not avoid liquidation (often because of the accrued tax liability to HMRC), the liquidator may bring a claim for wrongful trading pursuant to section 214 of the IA86;

Where a director has used a phoenix company with a similar name to continue the business of an insolvent company, and this company also becomes insolvent, personal claims can be made by creditors pursuant to section 216 of the IA86. In addition, often where a director uses successive companies to incur and then avoid liabilities to HMRC, there is usually a

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[7] This list of insolvency remedies is not intended to be exhaustive, but intended to set out the principal remedies that might be used.

transfer of the business from oldco to newco, often for inadequate consideration, for which the director may be made personally liable under section 212 of the IA86.

The above are examples, and there are other claims under the IA86 (and company law more generally) which may be brought against directors who abuse the insolvency regime.

There are additional steps that may be taken to punish those directors who abuse the insolvency regime, and encourage good corporate behaviour more generally.

Appendix D

The Potential Consequences of the Discussion Document's Proposals

R3 suggest that any proposed changes to the insolvency regime to enhance HMRC's ability to recover should deal fairly with: (a) other creditors who have also lost out as a result of an insolvency and (b) those practitioners who seek to achieve recoveries for creditors as a whole (including HMRC), often at considerable financial risk. This is consistent with the well-developed policy behind the operation of the Insolvency Act 1986.

By extending the opportunity of HMRC to claim against company directors, either by the transfer of liability or joint and several liability routes proposed in the Discussion Document, HMRC would obtain preferential status, albeit by a different route. The following is a simple example of how this might work to the detriment of the general body of creditors as well as the office-holders:

> The company goes in liquidation, having incurred substantial debts to HMRC, as well as to other unsecured creditors. By the time that the company is wound up and a liquidator appointed, there are not assets within the company;
>
> On investigation it appears to the liquidator that the director has taken substantial sums from the company for his own personal use, in breach of his duties;
>
> The liquidator commences a claim for breach of duty against the director. Because there are no funds within the estate: (a) the time cost that he has incurred in conducting investigations and bringing the claim is at his own risk (i.e. to be paid for his work, he must achieve a recovery against the director); (b) the lawyers acting for the liquidator are instructed on a conditional fee basis; and consequently (c) any return to unsecured creditors depends upon the liquidator and his legal representatives preparedness to work on this basis;
>
> Assuming that the personal liability of the director to HMRC were introduced, HMRC would have a direct right of claim against the same director as was the subject to the misfeasance proceedings brought by the liquidator. This is in addition to HMRC's right as an unsecured creditor to receive its share of the benefits of the liquidator's claim;
>
> The director has limited assets. He decides to settle his liability to HMRC which exhausts most of his available assets.
>
> This leaves the liquidator in the position that he has brought proceedings for the general body of creditors, and has incurred considerable cost in doing so. However, he now faces the prospect of a lengthy and costly trial with no prospect of a meaningful recovery at the end of the claim. He therefore settles the claim for a nominal sum, far below that required to meet the costs of the claim, let alone achieve a distribution to creditors.