Tax aspects of insolvency

Contents

Foreword

This guide is for the benefit of accountants, solicitors and other professionals who wish to be aware of taxation aspects of the main insolvency issues encountered by their clients.

It is a practical guide and focusses on circumstances where advisors and their clients remain responsible for the completion and submission of tax and VAT Returns. It does not detail the tax aspects of insolvency procedures carried out by the Insolvency Practitioner (IP).

Developed by Michael Drumm and Sean Cavanagh of CavanaghKelly, it is prepared in an informal style avoiding direct reference to technical legislation. It forms part of a suite of guides developed on Business Rescue and Insolvency.

Awareness of taxation issues can greatly help to identify planning actions which can be carried out before the insolvency event. Accountants and Tax Advisors may find the sections on CVAs, MVLs and Debt Release procedures to be of particular interest.

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Whilst every effort has been made to ensure the contents of this guide are factually correct, it is not intended to cover every aspect of taxation.

We strongly recommend that specific advice and guidance be sought in respect of the particular aspects of each situation.

The legislation is stated as at January 2019.

Company Taxation

Company Voluntary Arrangement (CVA)

What is a CVA?

A CVA is a legally binding agreement between a company and its creditors as a alternative procedure to liquidation. The company continues to trade as before and the directors remain in control. There are important tax reliefs to be obtained via the CVA procedure.

Corporation Tax

In a CVA there is no cessation of trade for corporation tax. The directors and company remain in control and in respect of corporation tax assessments and returns, these remain the responsibility of the company.

The full or partial release of a debt represents a profit for the debtor company. Where a debt is released, in a formal statutory procedure such as a CVA, the tax credit write back in the company accounts will normally be tax free. This will be an important benefit to the company as it will strengthen its balance sheet going forward and make it easier for it to meet banking covenants.

Corporation Tax due for the pre CVA period falls into the CVA arrangement and post CVA Corporation Tax Returns will be prepared by the company in the normal way.

VAT

There is no automatic deregistration in a CVA and all VAT Returns normally remain the company's responsibility. The Insolvency Practitioner (IP) will inform HMRC on Form VAT 769 of their appointment and it will be necessary to split the VAT Return in the period of the CVA appointment to pre and post appointment.

HMRC will send the company two paper VAT Returns for the pre and post appointment periods. Any returns not completed and submitted online by the company before an IP is appointed must be submitted by paper.

Any pre-appointment liability will be included in HMRC's claim in the CVA. Any VAT repayments due at the commencement of the CVA will go to the IP but these will be subject to any Crown set-off. This is often disappointing to the debtor company as it will affect cash flow.

VAT bad debt relief will be available to suppliers whose bills remain unpaid in whole or in part following the CVA, subject to the usual conditions.

A CVA does not itself, break a group VAT Registration.

PAYE/NIC

Assuming the business is continued by the company and they retain the employees, they operate PAYE in the normal way. However the existing employer record is ceased (it ceases on the day prior to approval of the CVA) and a new employer record is created (on form INSOL 219).

This process of creating a new record is normally handled by the IP. However the ongoing operation of PAYE remains the responsibility of the company.

Construction Industry Scheme (CIS) Returns

The company remains responsible for all Returns in the period pre and post CVA.

Employees

A CVA is an insolvency event and so employees who have to be laid off will have their statutory redundancy entitlement and other claims paid by Redundancy Payments Service of the Department for the Economy who then claim in the CVA.

Redundancy payments of up to £30,000 are receivable tax free by the employee. The ability to reduce employee numbers and include the liabilities in a CVA can be a crucially important saving for the company.

Administration

What is an Administration?

An Administration is a rescue mechanism designed to protect a company from its creditors while a restructuring plan is worked out. It differs from a CVA in that the rescue is administered by an IP who controls the process.

Corporation Tax

The appointment of an administrator triggers the end of an accounting period for tax purposes and a new tax period starts. Although group structures are not broken, the introduction of a new accounting period can negatively impact on group loss relief claims.

There are important tax planning issues in administrations, especially in respect of hive downs and prepacks (a process whereby the sale of a business and / or any assets of the company is agreed before the appointment of an administrator) and these will be part of the pre-administration planning process.

Some of the matters to consider are:

- Whether the trade continues and if so will it be transferred to a new company (newco) via a prepack. If so and if there are tax losses, it is better that these losses go with the trade and the tax advantages retained (S.343 ICTA 1988). It is important to note that there are restrictions in the amount of tax losses which can be transferred – the restriction applies to the extent to which the 'relevant liabilities' exceed the 'relevant assets' of the transferor company. As companies seeking to go into administration will be insolvent, relevant liabilities should exceed relevant assets and so the tax losses which can be utilised in the newco will be reduced.
- Whether property or other asset sales may be better effected prior to administration to use up tax losses. If this is a possibility, the tax losses could be used by the company itself. If a sale is made after the commencement of the administration, capital gains tax has to be paid in full as an expense of the administration.
- Whether group relief (if relevant) continues to be available. This is a complex area of tax legislation and specific advice should be sought for each particular situation.

VAT

For VAT purposes, the company is responsible for all returns up to the date of administration and the administrator is responsible for post administration returns. This is an important distinction between a CVA and an Administration. If the trade is being transferred via a hive down or prepack, the Transfer of Going Concern (TOGC) rules may apply for VAT purposes.

Company Taxation

PAYE

For PAYE, the existing PAYE Scheme ceases on the day before the administration and a new scheme is opened with a new PAYE reference.

Employees

Administration does not mean that a company's employees are automatically dismissed. The administrator may adopt any contract of employment within 14 days of appointment.

Employees who keep their jobs after the first 2 weeks become preferential creditors. The administrator takes responsibility for their employment rights after the initial 2 weeks until the business is sold or the company has to be liquidated.

CIS

If there is a CIS, the company's CIS record is closed and a new record created but the company remains responsible for complying with all regulations going forward.

It can continue to receive payments for work done under CIS either gross or under deductions.

If a company goes into administration, an application should be made to HMRC for the CIS deductions to be paid immediately.

Commentary

There are important tax issues to be considered as part of the administration process and they often will impact on the ultimate dividend to creditors.

Recent Update

HMRC preferred creditor status

The government announced in November 2018 that from April 2020 HMRC will become a preferred creditor in respect of VAT, PAYE (employee contributions) and Construction Industry Scheme (CIS) deductions.

HMRC will then be able to claim up to 100% of their debt whereas, at present, as an unsecured creditor, they would accept the same percentage of their debt as trade suppliers. This will effectively reduce the dividend available to unsecured creditors, and may lead to further disengagement in the insolvency process by unsecured creditors.

This will apply to both Company and Personal Insolvencies.

Liquidation

Creditors' Voluntary Liquidation (CVL)

What is a CVL?

A CVL is the most common form of company insolvency (there are on average 50 CVLs per year in Northern Ireland compared to an annual average of 15 for administrations and 25 for CVAs) and it comes about as the Company has had to close its business and, in the vast majority of cases, the business has to come to an end.

The tax planning or tax advisory options available to a company or its advisors are limited and will be restricted to assisting the liquidator to agree the claim by HMRC for unpaid PAYE/NIC, VAT and CIS if relevant.

The liquidator, when appointed, takes control of all the company assets, sells them and after deducting the costs of the liquidation, makes a payment (called a dividend) to creditors.

Advisors should be aware that HMRC has become more focussed in recent years in relation to the non-payment of Crown debts, mainly VAT and PAYE/NIC. After a consultation in April 2018, it made two very important announcements in the November 2018 budget:

- From April 2020 HMRC will become a secondary 'preferred creditor' in all insolvency situations. This will effectively reduce the dividend available to unsecured creditors. More detail can be found on page 5.

- Directors and other persons involved in tax avoidance, evasion or phoenixism can now be made jointly and severally liable for company tax liabilities where it is found that the company has deliberately entered insolvency.

The potential to lift the corporate veil may expose directors and others to personal liability in respect of unpaid tax.

It is very important, in interpreting this announcement, to be aware that in the vast majority of cases, companies fighting to save their business have to juggle numerous obligations to all creditors. Where this can be demonstrated (and properly recorded), directors or their advisors should not have any reason to fear action from HMRC when, after trying everything, the company has to go into insolvency.

Other tax points of interest include:

- The value of the shares will be NIL and income tax relief will be available to the shareholders.
- Payment to a bank by a director or shareholder in respect of a personal guarantee (PG) may be eligible for tax relief providing the payment is in relation to a qualifying debt.

Members' Voluntary Liquidation (MVL)

What is an MVL?

An MVL is a solvent liquidation and is very commonly used by shareholders to extract funds from a company when it has reached the end of its economic life.

It is also an area where beneficial tax planning opportunities can be implemented. Some important points include:

- Entrepreneurs Relief (ER):
  All shareholders who extract value from their company will wish to take advantage of the 10% Capital Gains Tax (CGT) rate which is available if they qualify for ER. It is therefore critical to ensure that these conditions are met.
- Extract Dividends Prior to the MVL:
  Shareholders should consider taking dividends prior to the MVL in order to use any available personal allowances and basic rate income tax bands.
- Asset Distribution/Distribution in Specie:
  In many cases the retiring shareholders wish to take company assets instead of a cash distribution. ER will be available if the conditions are met but the company may have to pay CGT as the asset is deemed to have been disposed of at open market value (stamp duty may also apply).
- Ensure that the distribution qualifies as a capital distribution. HMRC is now looking closely at MVLs to try to treat a distribution in a MVL as an income distribution rather than a capital one. If shareholders are only winding up the company to trigger the 10% Tax Rate, and then restart the business in a New Company, it is vulnerable to attack under the new 'TAAR' Rules on Phoenixism. However, where the business is genuinely closing down, there should be no exposure to a challenge by HMRC.
- ER only applies to a trading company. Be wary that large cash balances sitting on company balance sheets could prevent the company from being considered a 'trading company'.
- Following the Lehman Bros. court case, HMRC is now claiming statutory interest at 8% from the date an MVL commences. This 8% will be charged even if the corporation tax due date hasn't yet arrived. Our advice is pay any tax due before the start of the MVL, even possibly estimating this where an exact figure cannot be ascertained.
- Normally VAT deregistration is dealt with by the company's tax adviser/accountant on form VAT 7 before the commencement of the MVL. It is necessary to state the value of all vatable assets at the date of winding-up and pay the VAT on this . If the VAT on these assets is less than £1,000, HMRC do not collect this and so it is not payable.

Other Arrangements

Dissolution

If a distribution is less than £25,000, consider the ‘striking off’ procedure and avoid Liquidation Costs. A repayment of up to £25,000 is treated by HMRC as a capital distribution for tax purposes. The 2006 Companies Act permits a simplified Capital Reduction procedure to repay share capital and non-distributable capital reserves to shareholders. The directors can then dissolve the company under the ‘Dissolution’ procedure which is very simple and avoids liquidation costs. Just complete form DS01 from Companies House and send it with the appropriate fee to Companies House in Linenhall Street, Belfast.

Demergers

A demerger means the separation of a company’s business into 2 or more parts.

A business implementing a demerger will of course wish to be aware of potential tax charges. There are 3 main mechanisms for a demerger:

- Statutory (dividend) demerger
- Capital Reduction demerger
- Liquidation demerger

The tax rules applying to each are outside the scope of this guide. Liquidation demergers continue to be widely used and there are important tax issues, perhaps the most important being to obtain HMRC clearance so that the demerger is being carried out for bona fide commercial reasons.

If clearance is received, reconstruction relief should prevent the demerger from creating taxable capital gains at either shareholder or company level.

Fixed Charge Receivership

A fixed charge receiver is appointed by a secured creditor of a company over specific assets of the company. The receiver’s powers and duties are usually restricted to collecting income and disposing of the assets over which the receiver has been appointed. Because a fixed charge receiver acts as agent for the company, the company remains liable to pay the tax on any income or gains. That of course means that the company continues to complete CT and VAT Returns as normal. However if the receiver sells any of the company’s goods, they must account to HMRC for VAT using Form 833.

Company Debt Releases

Corporation Tax Relief (outside of formal insolvency)

A release of debt would typically result in a P&L debit and credit for the creditor and debtor companies, respectively.

That accounting credit will generally be brought into account by the borrower as taxable income, unless an exemption or relief applies. For example, if the company is in a formal insolvency procedure this will provide relief.

However, in situations where a borrower is in financial distress but not in formal insolvency, other options need to be considered.

In these scenarios, companies may be eligible for Corporation Tax relief under the ‘financial distress’ exemption via s. 322 of the CTA 2009.

Commentary

When does the above exception apply?

A borrower company is not required to recognise taxable income in respect of a debt release if, immediately before the debt is released, it is reasonable to assume that without the release (and any arrangements of which the release forms part), there would be a material risk that within the next 12 months, the borrower would be unable to pay its debts.

There are some aspects of the s. 322 exemption that are worth highlighting:

- The term ‘unable to pay its debts’ is based on U.K. insolvency law and means that the company is unable to pay its debts as they fall due or that the value of the company’s assets is less than the amount of its liabilities.
- Material risk - the inclusion of this wording and the 12-month time limit in the legislation indicates that the exemption is intended to apply only in circumstances where a company faces a tangible threat of insolvency i.e. it is there to prevent solvent companies from benefiting from the tax exemption.
- Reasonable to assume unable to pay debts - It is important to have evidence of the company’s position in the event of a subsequent HMRC enquiry. HMRC guidance does provide a list of the information one should review including breaches of financial covenants, negotiations with third party creditors, enforcement actions, management accounts and forecasts showing material cash flow shortfalls and an insolvent balance sheet (viewed by HMRC as the strongest evidence of the reasonable assumption test).

Without a proper assessment of whether they qualify under this test, companies face substantial risks of a tax charge at the prevailing corporation tax rate on income equal to the amount of debt released. Given these uncertainties, those involved in a restructuring need to ensure that sufficient focus is given to the above matters in implementing any restructuring solution.

Personal Taxation

Individual Voluntary Arrangement (IVA)

What is an IVA?

An IVA is a very popular mechanism whereby a business can agree a proposal with their creditors for the write off of its debts and allow it to continue trading. The proposal has to be accepted by 75% in value of the creditors.

Income Tax

The client continues to be in full control of the business, and the accountant will continue to advise on the Income Tax / VAT Returns going forward.

On appointment as supervisor in an IVA, the supervisor will advise HMRC and a new unique taxpayer reference (UTR) number will be issued.

For the year of the IVA, one 'SA 100' Self Assessment Return is required but it must show both the old and the new UTR and must be filed under the old UTR.

In the tax year post the IVA, the 'SA 100' is submitted with the new UTR. The debtor remains liable for the filing of tax returns and the payment of tax. The debtor and tax adviser will need to use the new UTR for all future filing.

HMRC will make a claim in the IVA for the tax year in which the IVA occurs.

A crucial role for the acting accountant / tax advisor will be to help the debtor's business to ensure that all Tax and VAT Returns are up to date. This is very often a principal reason why HMRC (who often hold the critical vote if they represent over 25% of the debt) vote against the proposal.

Capital Gains Tax (CGT)

Any CGT on sales of assets is treated as an expense of the arrangement. This tax cannot be assessed until the end of the tax year of sale and can cause delays in completing a case.

VAT

VAT Returns also remain the responsibility of the debtor. There is no automatic deregistration, and as with other taxes, HMRC will claim for VAT in the IVA up to the date of the IVA (split Return to be submitted for the relevant VAT period).

The critical point to note is that in an IVA, the debtor is responsible for submission of all Returns.

Tax Rebates and Set Off

It is important to be aware of any income tax/VAT Refunds due for the period prior to the date of the IVA. If these are not received by the date of the IVA, they will be used by HMRC for set-off against other tax debts. This can have a negative effect on cash flow planning. Also any post arrangement repayments will usually be set against post arrangement liabilities.

Release of Debt

The release or part release of a debt under a voluntary arrangement will generate a tax free uplift for the debtors business and this will greatly help to restore the balance sheet and help towards meeting bank covenants.

Bad Debt Relief

Creditors can claim VAT on bad debts providing they have paid the VAT on the supply. A claim can be made after 6 months but the 6 months clock starts from the date the tax was due, not the date of the invoice.

It is important to remember the debt has to be written off in the accounts. Use of a credit note is not sufficient.

Cost of the Voluntary Arrangement

The costs of the arrangement are probably not tax allowable as they may not satisfy the 'wholly and exclusively for the purposes of the trade' test.

Commentary

The failure rate of IVAs has risen over the last 4 years. One of the reasons for this is the incorrect estimation of the tax owed to HMRC. Tax will continue to be an important element in determining the success of an IVA.

Bankruptcy

What is Bankruptcy?

Bankruptcy is a form of personal insolvency for a person or other entity who cannot repay debts to creditors.

Bankruptcy means that the debtor's assets vest in the trustee and therefore taxation matters are usually dealt with by the trustee. The bankrupt's tax advisors work will normally be restricted to dealing with matters up to the date of bankruptcy.

Income tax

When the trustee is appointed and HMRC notified, they issue a new UTR. However, the bankrupt can continue to trade providing they notify the trustee and submit a Tax Return as normal, using the new UTR number.

It is vital that the tax return is issued as a paper return and is submitted by the bankrupt's accountant to the tax bankruptcy office in Cardiff and preferably with the letters 'BY' on the return. If it is submitted online it will result in delays in processing.

The bankruptcy brings the tax period to an end and any tax due in the year of bankruptcy is submitted as part of the claim by HMRC.

When the bankruptcy comes to an end, the taxpayer reverts to use of the old UTR.

VAT

For VAT, deregistration is automatic unless the trustee advises HMRC otherwise. If the bankrupt continues to trade and sales are over the VAT Registration threshold, they must obtain a new VAT number and submit Returns in the normal way.

Bad Debt Relief

This procedure is the same as for IVAs (see page 11).

Completion of Bankruptcy

Normally the bankruptcy will cease 12 months after the commencement date.

Tax Refund

Any tax loss incurred in the year of bankruptcy can be carried back 3 years so that tax paid in any of those years could generate a tax refund for the debtor.

Individual Debt Releases

Income Tax (outside of formal insolvency)

A formal release of a trade debt, i.e. a debt arising from the supply of tax deductible goods or services, is a taxable trading receipt for income tax purposes, unless the debt release forms part of a statutory insolvency arrangement.

In contrast, a formal release of a loan used to fund general business expenses or to acquire capital assets does not generally fall within the scope of income tax, except where a trading deduction was originally given for an expense giving rise to part of the debt. E.g. if a loan written off includes an element of interest which was 'rolled up' in the loan balance rather than being paid, the interest element will be subject to income tax as a trading receipt.

Taxation

How CavanaghKelly can help

Many business decisions have a tax impact which should be considered and assessed prior to making any final choices. Effective tax planning can make a significant impact on how a business develops. This is no different in a business rescue scenario. Consulted at the right time, our team at CavanaghKelly can provide the right advice to identify tax planning actions which can be carried out before the insolvency event.

The approach and strategy to be applied will of course be dependent on each individual case, however the earlier advice is sought, the wider the range of options available, increasing the likelihood of a positive resolution for those involved.

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