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Covid-19 Insolvency and Tax Measures in the U.K.: The Interplay of Interventions

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INTRODUCTION

Faced with the Covid-19 pandemic, many jurisdictions have introduced emergency fiscal and tax measures to mitigate the impact of continued containment and support economic recovery.¹ Actions are being taken by tax administrations to ease the burdens on taxpayers and to support businesses experiencing cash flow problems, difficulties in meeting tax reporting and payment obligations, or other hardships. While such emergency measures are useful in helping businesses deal with the extraordinary economic circum-

stances, many companies will be unable to continue trading as a going concern, even in the presence of substantial liquidity support. As within any economic downturn, let alone the current exceptional one, insolvencies are expected to rise. Alongside the tax measures, insolvency law has therefore also become a forefront issue.

Within the United Kingdom, the Office of National Statistics has stated that the domestic economy shrunk by 20.4% in April 2020, compared with March 2020. This represents the largest contraction since monthly records began in 1997. Against this background, the U.K. government has introduced and promoted a range of complimentary policy measures to support businesses in financial distress. Alongside a series of tax measures, one widely publicised and adopted fiscal measure is the Coronavirus Job Retention Scheme (“CJRS”), which allows employers to claim for 80% of their employees’ contractual entitlement to wages (including employer national insurance and pension contributions). As of 12 July 2020, 9.4 million jobs had been furloughed by 1.2 million employers, with a total claim value of GBP 28.7 billion.² With high street brands entering administration, questions have therefore arisen over how the CJRS interacts with relevant insolvency law. In addition, the recent Corporate Insolvency and Governance Act 2020 (“the Act”) provides for several significant insolvency law measures to also support businesses throughout the ongoing crisis.

Acknowledging the natural importance of insolvency law in the economic crisis policy mix, this insight therefore provides an overview of such developments in the United Kingdom and how these interplay with recent domestic taxation interventions, from the perspective of insolvency and tax practitioners.

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¹ The OECD has published a database of the tax and fiscal policy responses taken in light of the Covid-19 crisis. *Tackling Coronavirus (COVID-19): Contribution to a Global Effort*. Available: <http://www.oecd.org/tax/tax-policy/>

² HM Revenue and Customs, HMRC Coronavirus (COVID-19) Statistics (updated 28 July 2020).

THE CORONAVIRUS JOB RETENTION SCHEME

Up until this point, there has been little legal authority providing businesses with guidance on how the new government initiatives, such as the CJRS, interacts with insolvency law. In *Re Debenhams Retail Ltd* [2020] EWHC 921 (Ch) and *Re Carluccio's Ltd* [2020] EWHC 886 (Ch), the High Court provided two decisions to assist the insolvency profession. These decisions were on a rather narrow point as to the circumstances in which employment contracts would be “adopted” as super-priorities in administrations where offers are made to vary them to make use of the CJRS (under paragraph 99, Schedule B1 of the Insolvency Act 1986). Pursuant to *Re Debenhams Retail Ltd* and *Re Carluccio's Ltd*, if administrators of a company make a CJRS application for an employee or make a payment to an employee under the CJRS, their varied contract will likely be “adopted” and so rank ahead of both the provable claims of other creditors and the administrator’s expenses. Indeed, the administrators appealed against this in *Re Debenhams Ltd (In Administration)* [2020] EWCA Civ 600, where their appeal was dismissed.

Insolvency practitioners, such as administrators in this instance, may be concerned that the definition of “adoption” under paragraph 99, Schedule B1 of the Insolvency Act 1986 has potentially been extended by these decisions. However, these decisions will at least provide administrators with assurance that they will be able to avoid “adopting” *unvaried* employment contracts by seeking consent to vary them in accordance with the terms of the CJRS as soon as possible. Failing this, employees who refuse to consent to such variation can be made redundant. In addition, while the generous programme is set to be scaled back from August 2020, it is also worth noting that even in circumstances of impending insolvency proceedings, directors are not required to make use of the CJRS.

From a tax perspective, practitioners should be aware that if companies do take advantage of the scheme, grants paid to employers under the CJRS are treated as income chargeable to corporation tax. At the same time, the payments made to furloughed employees, and associated employer costs, are deductible in calculating the taxable profits of the business. Importantly, HMRC will have the power to recover payments, by imposing a 100% tax charge, from anyone who has received a payment under the schemes to which they are not fully entitled or anyone who has not used a CJRS payment to pay furloughed employee costs. In this light, when assessing their eligibility for the scheme, multinational enterprises (MNEs) should take into account any pre-existing transfer pricing arrangements adopted within the group in respect of U.K. employee costs. For example, if a U.K. company

can continue to recharge employee costs to an overseas entity under an existing arrangement, it may be ineligible for CJRS support.

THE CORPORATE INSOLVENCY AND GOVERNANCE ACT 2020

With the Act, the U.K. government has promoted and passed a comprehensive set of company and insolvency measures through the legislature, to further assist businesses. The Act has been largely well-received from professions and business groups and came into force on 26 June 2020 following Royal Assent. On the insolvency side, amongst others, the Act broadly introduces a new moratorium, temporarily prohibits creditors from filing statutory demands and winding-up petitions for Covid-19-related debts, provides for a new restructuring plan, prohibits certain termination clauses, and temporarily suspends liability for wrongful trading.

The New Moratorium and Protections From Statutory Demands and Winding-Up Petitions

A moratorium is not an alien concept in U.K. insolvency law and so companies that have entered administration are afforded a safe period, preventing creditors from enforcing their claims against or seeking a winding up of the company (paragraphs 42 and 43, schedule B1 of the Insolvency Act 1986). In line with the existing broader “rescue culture” in U.K. insolvency law, the policy behind this concept is to allow administrators the time to attempt to rescue the company and to prevent creditors from taking unilateral actions that could undermine these efforts. The new moratorium in the Act takes this further and provides a short initial safe period of 20 business days, with the opportunity of an extension, in which most companies can be protected from enforcement action without having entered administration (section 1 of the Act, inserting Part A1 into the Insolvency Act 1986 for Great Britain). This is subject to the company filing relevant documents with the court, such as a statement from a proposed insolvency practitioner, who will act as “the monitor” of the moratorium and will verify that such a safe period will likely result in the rescue of the company as a going concern (section 1 of the Act, inserting Part A1, Chapter 2 into the Insolvency Act 1986 for Great Britain).

The OECD recognised the use of a moratorium as a tool in indirectly strengthening corporate cash flow

during the Covid-19 crisis.³ However, rather than necessarily allowing for a significant restructuring of a company, as set out in the government's guidance, insolvency practitioners should be aware that it appears more aimed at helping companies that are "cashflow insolvent" in the short term.⁴ Indeed, this is supplemented by schedule 10 of the Act that prohibits statutory demands during the "relevant period" from 1 March to 30 September 2020. In addition, it also restricts winding up petitions during the "relevant period" from 27 April 2020 to 30 September 2020, where generally the unpaid debt is due to Covid-19. While this may raise the question as to which provision to rely on, if faced with litigation, companies that receive legal advice will likely plead in the alternative. In any event, the new moratorium would appear to be designed to provide general protections for companies that have incurred debts irrespective of Covid-19.⁵

The "relevant period," for the purposes of schedule 10 of the Act, arguably represents the immediate duration of the crisis in its foreseeable state. From a tax perspective, practitioners will know that this appears to be broadly in line with the fact that HMRC paused most of its enforcement activity until 1 July 2020 and would not have petitioned for bankruptcy or winding-up, unless considered essential — for example in cases of fraud or criminal matters.⁶ While, as at the time of writing, HMRC has not indicated its intention to extend the announced pause in enforcement activity, protection against an HMRC winding-up petition would be available until 30 September 2020 under the Act. This policy direction has been further reinforced by the delay of the reintroduction of HMRC's preferential creditor status, which was due to come into force from 6 April 2020 and has been delayed until 1 December 2020.⁷ Therefore, HMRC will continue to rank as an unsecured creditor in any liquidation until that time and the affected taxes (including value-added tax (VAT), Pay As You Earn (PAYE) income tax and employee national insurance contributions) that an insolvent company temporarily

holds on behalf of employees and customers may be used to pay other creditors, rather than settling tax debts.

The New Restructuring Plan

Under schedule 9 of the Act (inserting Part 26A into the Companies Act 2006), the new restructuring plan ("RP") allows for a cross-class cramdown of creditors akin to the U.S. Chapter 11 bankruptcy model⁸, which has been cited as an effective example of a pre-existing framework.⁹ Further to the existing and popular scheme of arrangement, the purpose of the RP is to prevent a single class of creditors from blocking a scheme when it is in the broader company's and creditors' interests.¹⁰ To obtain an RP, at least 75% of creditors measured by value within a class, must vote in favour. Where a class does not vote in favour, the court will have discretion to sanction the RP where the class that voted against it will be no worse off than they would be under the next most likely outcome. This is provided that at least 75% of one class of creditors measured by value, who would have received a payment or had an economic interest in the next most likely outcome, votes in favour.

For an insolvency practitioner tasked with restructuring a company in the current climate, this is a welcome provision. It generally applies to most companies and helps prevent classes of creditors from holding out in an effort to be offered more than what they are due under the most likely outcome. This arguably allows for a fairer restructuring package for all parties, with improved long-term prospects for a company.

This initiative also seems to have been supplemented by tax measures provided for pre-existing insolvencies. Indeed, a number of companies were already subject to a voluntary arrangement ("VA") before the Covid-19 emergency. For such businesses, the pandemic may have exacerbated an already precarious position, affecting their ability to continue trading and potentially preventing them from meeting VA obligations. Against this background, tax practitioners should be aware that HMRC has issued guidance confirming that, in such circumstances, it will support a minimum three-month deferral of VA contributions without the need for prior approval.¹¹ HMRC has further noted that any deferral of tax that a business is

³ OECD, *Supporting Businesses in Financial Distress to Avoid Insolvency During the COVID-19 Crisis* (OECD, 27 May 2020), at 2.

⁴ Department for Business, Energy & Industrial Strategy and The Insolvency Service, *Corporate Insolvency and Governance Bill 2020: Factsheets — Moratorium* (5 June 2020).

⁵ Department for Business, Energy & Industrial Strategy and The Insolvency Service, *Corporate Insolvency and Governance Bill 2020: Factsheets — Statutory Demands and Winding-Up Notices* (5 June 2020).

⁶ HM Revenue and Customs, *Coronavirus — Insolvency Guide* (27 Mar. 2020).

⁷ HMRC Policy Paper, *Introduction of Changes to Protect Your Tax in Insolvency* (11 Mar. 2020).

⁸ Department for Business, Energy & Industrial Strategy and The Insolvency Service, *Corporate Insolvency and Governance Bill 2020: Factsheets — Restructuring Plan* (5 June 2020).

⁹ OECD, *Supporting Businesses in Financial Distress to Avoid Insolvency During the COVID-19 Crisis* (27 May 2020), at 3.

¹⁰ See n.8, above.

¹¹ See n.4, above.

entitled to under the Covid-19 financial support package will not breach an arrangement that requires tax to be paid as it falls due. These policy intentions are further supported by the automatic deferral of VAT payments of all U.K. VAT-registered businesses due between 20 March and 30 June 2020, until 31 March 2021. The VAT unpaid during this period must be paid to HMRC by the end of the 2021 financial year, which ends on 31 March 2021.¹²

Prohibition on Termination Clauses

Pursuant to section 14 of the Act (inserting section 233B into the Insolvency Act 1986 for Great Britain), there is a prohibition on invoking termination clauses in contracts with most companies that are subject to a “relevant insolvency procedure,” as provided for in the section. Therefore, where a company enters an insolvency or restructuring procedure, during which a supplier of the company would otherwise be able to contractually terminate their contract, this will be prohibited unless the company agrees or the supplier obtains permission from the court on the basis that it will be caused hardship. This prohibition, intended to maximise the possibility of a company being rescued or its business sold as a going concern, will last for the relevant “insolvency period,” the length of which will depend on what “relevant insolvency procedure” the company has undertaken.

This measure may ring alarm bells for company directors that may otherwise be considering entering an agreement to supply a company in a precarious sector of the economy. However, from an insolvency practitioner’s perspective, relief should be drawn from the qualification of hardship for any supplying company that they are assisting. Likewise, those companies that rely on supplies will have improved prospects of maintaining as a going concern as a result of this measure.

From a tax practitioner’s perspective, MNEs with a U.K. presence will need to consider the impact of the prohibition on contractual relationships involving U.K. group companies facing insolvency, including from a transfer pricing perspective, whereby the implications of potential renegotiations caused by Covid-19 should be assessed against the arm’s-length principle.¹³

¹² HM Revenue and Customs, Deferral of VAT Payments Due To Coronavirus (COVID-19) (updated 1 July 2020).

¹³ For a broader discussion of the COVID-19 impact on transfer pricing, see Matt Andrew and Richard Collier, *COVID-19 Challenges for the Arm’s-Length Principle*, Tax Notes Int’l (June 22, 2020).

Temporary Suspension of Liability for Wrongful Trading

Finally, under section 12 of the Act for Great Britain, with regards to most companies there is a temporary suspension of liability for wrongful trading during the “relevant period” from 1 March 2020 to 30 September 2020. The intended effect of this is to remove the threat of personal liability arising from wrongful trading for directors who continue to trade a company through the Covid-19 crisis, despite uncertainty over whether it will be able to avoid insolvency in the future.¹⁴

As a result, liquidators and administrators are not able to claim against an insolvent company’s directors for losses incurred to the company, or its creditors, for any worsening of the financial position of the company or its creditors that occurs during the “relevant period”. Whilst this could be a concern for insolvency practitioners, the hope is that company directors will be more inclined to take the risk of keeping a business trading as a going concern and preserve it, despite future uncertainty as to how Covid-19 restrictions may be eased or reintroduced in the event of further outbreaks. With the alternative being to merely cease trading, it is arguable that this temporary suspension will likely reduce the number of insolvencies that arise through reducing risk-averse behaviour by directors.¹⁵

CONCLUSION

The U.K. authorities have implemented significant fiscal, tax and insolvency policy measures to preserve employment levels and contain the impact of insolvencies during the ongoing crisis. The measures have been targeted to provide liquidity support and deferrals in enforcement actions, where their absence might otherwise cause hardship. Going forward, as mitigation measures are lifted, policy responses may shift from immediate support, including to help prevent insolvency, to stimulating economic recovery.

From a tax practitioner’s perspective, measures to expect could include more generous loss offset provisions for losses incurred during the crisis. Indeed, to help businesses through the financial crisis of 2007-2008, the United Kingdom via FA 2009 introduced an enhanced carry-back of losses (subject to a GBP 50,000 ceiling) for 36 instead of just 12 months, as is

¹⁴ Department for Business, Energy & Industrial Strategy and The Insolvency Service, Corporate Insolvency and Governance Bill 2020: Factsheets — Suspension of Wrongful Trading Liability (5 June 2020).

¹⁵ OECD, *Supporting Businesses in Financial Distress to Avoid Insolvency During the COVID-19 Crisis* (OECD, 27 May 2020), at 2-3.

also the case currently. At the same time, increased tax certainty through streamlined dispute resolution and prevention mechanisms, as well as guidance in applying the arm's-length standard in the Covid-19 transfer pricing landscape would also be welcome. For now, the nature of the tax measures are mainly deferrals and pauses in enforcement action, which they have in common with some of the temporary protections afforded under the Act. Going forward, a glimpse of what could be included in the Autumn Budget 2020 was revealed in the Chancellor's summer statement to the House of Commons. The measures announced include a temporary VAT rate cut from 20% to 5% for tourism and hospitality supplies between 15 July 2020 to 12 January 2021, which may

pave the way for further measures to stimulate economic recovery to come in the autumn.

From an insolvency practitioner's perspective, the measures within the Act should largely be welcomed as a broad boost to the "rescue culture," especially with regards to the new moratorium and RP. As a principle of corporate insolvency law, this has otherwise been criticised as failing to come to fruition in practice and it is now arguably being reinvigorated. While the High Court and subsequent Court of Appeal decisions on the CJRS may give some administrators cause for concern, insolvency practitioners can at least follow the guidance with relative certainty and plan variations to employee contracts accordingly.