‘‘Compromise or Fudge?’’ Reflections on the Law of the UK as it Affects the Taxation of Insolvent Companies

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"Compromise or Fudge?" Reflections on the Law of the UK as it Affects the Taxation of Insolvent Companies

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Abstract

For tax advisers, the relevance of insolvency law ebbs and flows. This article is written at the high tide, when most of us have insolvency taxation at the forefront of our minds. It asks whether the law which applies to insolvent companies in the UK, recently modified by international measures, gets the balance right between the interests of taxpayers and the interests of the State when it comes to imposing tax on a company which is unable to pay all its debts. It also points to an apparent lack of consistency in the UK's domestic tax policy.

As will be seen, the trend over the last 20 years has been to increase the rights of tax authorities as creditors in corporate insolvency in important ways, notwithstanding exceptions such as the abolition of the preferential claim for taxes. In some cases, this has corrected unjustifiable distortions and opportunities for evasion. In other cases, it has arguably gone too far. Moreover, the reforms have been made piecemeal and, particularly at a detailed level, a disconnect can be identified between, on the one hand, insolvency law and policy, and on the other, new tax legislation. The same applies in some cases to the application of (or failure to apply) existing tax legislation to the new insolvency processes.

The starting point

The starting point of this discussion is well expressed in an extract from Philip Wood, *Principles of International Insolvency*:

> "Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go round and so the law must choose who to pay. The choice cannot be avoided, compromised or fudged. On insolvency, commercial law is at its most ruthless: it must decide who is to bear the risk so that there is always a winner and a loser, victor and a victim."[1]

One question this raises in a tax context is, how far should the tax authority be a "winner" at the expense of the insolvent company and its creditors? With taxation liabilities, insolvency law has a particular role. When determining who is the winner and who is the loser, it must strike a balance between the rights of citizens and taxpayers on the one hand and the rights of the State on the other. These citizens and taxpayers will normally be people who have lost money. They will already be losers to some extent. For insolvent debtors and for smaller

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[1] P.R. Wood, *Principles of International Insolvency*, 2nd edn, (London: Sweet and Maxwell, 2007) at 3.

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creditors, the consequences of being a "victim" can be desperate. Even for larger creditors, like banks, as recent events have shown, the consequences of losses on a sufficiently wide scale can go well beyond the stability of the entity concerned and threaten enterprises and employment widely. If the tax collector takes too much of the diminished pot available, or if his administrative powers, supported by the resources of the State, are deployed with too much zeal, these consequences will be aggravated. It may be thought of great importance that tax demands do not exacerbate situations which are already deeply unfortunate.

For the State, apart from the financial consequences in individual cases, there are matters of public policy to be considered in relation to the application and collection of tax in an insolvency context, as well as macro-economic effects. Taxes have to be paid and have to be seen to be paid. Consistency of taxation and the need to ensure compliance and prevent evasion in future cases may push policy in one direction; the desirability of avoiding actions which prevent viable businesses from recovering will push the other way. Taxpayers who look at the process as it unfolds will say that troubled times are exactly the times when governments should be loosening their usual demands on businesses. They will also point out that disproportionate resentment is felt by those who see government taking advantage of a strong position to favour itself over other struggling stake holders in a business, by applying its greater financial or legal muscle and even by changing the law in its favour, unless this is against a clearly articulated policy framework. Unfortunately, recessionary times are also those when the Government needs the money most, too.[2]

The third interest involved, in addition to the creditors and the State, and many would say the most important one, is that of the debtor company itself. Since the introduction of the new administration regime in 2003, a major component of the policy behind the UK's insolvency process is, wherever possible, to preserve the debtor's continued existence as a viable entity, protecting jobs and reducing damage to the British economy. This is very clearly articulated in the legal framework of the UK's administration process since amendments in 2002[3] and it follows that a burdensome legacy of unpaid taxation on the surviving company should be avoided.

There is a fourth dimension, too. The willingness of banks and others to make loans depends on their confidence in being repaid. At the least, this affects the cost of their making loans—which comes to the same thing. The greater the priority which tax takes over validly created security, the higher the cost for UK business of borrowing money, irrespective of whether any insolvency ever happens. This potential cost will, in theory, be factored into the cost of borrowing money in good times as well as in bad ones.

This article focuses on the law on priority and enforcement of payment of taxes by insolvent companies and the policy (or lack of policy) behind that priority. But an important dimension here, probably the most important one, is administrative. HMRC's new Business Payment Support Service was reported in September 2009 to

[2] An argument sometimes put by Government departments is that the Crown is an "involuntary creditor" in respect of taxes and so needs to be put in a better position to collect them in an insolvency. This is not, in the author's view, as convincing an argument as those outlined above, given that many other innocent unsecured creditors are also "involuntary" and few of them have the same resources at their disposal to collect them. See, for a discussion and (essentially) a rejection of this line of argument, the Review Committee on Insolvency Law and Practice (the Cork Committee). *Final Report*, Cmnd.8558, Ch.32. (The Review Committee was the Committee whose recommendations were at the root of the reforms of insolvency law in 1985 and 1986).

[3] See Insolvency Act 1986 (IA 1986), Sch.B1, para.3, quoted further below.

have allowed delayed PAYE and VAT payments for 185,000 businesses.[4] A complaint in previous recessions has been the readiness of Crown departments to put businesses into formal insolvency processes, including some conspicuous examples of businesses which subsequently proved to be fundamentally viable. It would be splendid if that particular issue were avoided this time round.

UK domestic law

Abolition of preferential claim for taxes

The most positive step in recent years to redress the balance between tax and other liabilities was abolition of the preferential claims for taxes, previously provable in a liquidation or in an administrative receivership. The Crown's priority in bankruptcy under the Royal Prerogative was originally unlimited[5] but was reduced over the years and by 1985 consisted of one year of assessed taxes (income tax, corporation tax, capital gains tax),[6] 12 months of PAYE and payments under the construction industry scheme, 6 months' value added tax (VAT), car tax and certain other excise duties and certain national insurance contributions (NICs).[7] The claim for assessed taxes was abolished by the Insolvency Act 1985 (IA 1985) (which was superseded by the Insolvency Act 1986 (IA 1986) before it took effect). The remaining preferential claims for taxes were abolished by the Enterprise Act 2002 (EA 2002). The Crown now proves for pre-insolvency tax like any other unsecured creditor and ranks pari passu with them in distributions in liquidations and administrations. To compensate, since 2003, with other unsecured creditors, it shares in a "prescribed part" of floating charge assets where this is applicable.[8]

It should be noted that the abolition of the preferential claim does not affect the super-priority which HMRC enjoy in respect of post-liquidation (and post-administration) tax liabilities, discussed below. As will be seen, the government has first bite of the cherry in claiming tax if the tax arose after the date of commencement of the process. This may include tax on gains which accrued over many years, or income which has arisen during the relevant period. It does not necessarily follow that there will be tax losses available to offset this income. The rules on recognising tax losses are relatively narrow compared to the ways in which companies can incur commercial losses. For example, a company can become insolvent through the diminution in value of a capital asset, or because it has given intra-group guarantees, which may well not give rise to losses which can be claimed for tax purposes. Moreover, as will also be seen, not all the reliefs which a company can normally claim for tax losses will continue to be available once it enters insolvency.

Fixed charges

As outlined earlier in this article, the integrity of fixed charges is crucial for those lending to companies. The legal position has long been that the powers of a Law of Property

[4] *Simon's Tax Briefing*, Issue 257 (September 1, 2009) at 6.

[5] See, for detailed discussion of the historical position, *Food Controller and other Appellants v Cork* [1923] AC 647 (HL); *In re Pratt, Commissioners of Inland Revenue v Phillips* (1950) 31 TC 506 (CA) and *Re Herbert Berry Associates Ltd (In Liquidation)* (1977) 52 TC 113 (HL).

[6] See Companies Act 1985 (CA 1985), Sch.19, para.2.

[7] For the full list, see IA 1985, Sch.19, IA 1985, Sch.4 Pt.1 (which never took effect), and IA 1986, Sch.6.

[8] IA 1986, s.176A and the Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097).

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Act receiver (LPA receiver) or a fixed charge receiver to pay tax liabilities, among other things, do not confer on a taxing authority the right to sue for taxes[9] although for income tax purposes it was held under previous law that an administrative receiver could be held liable under tax legislation as a person "receiving or entitled to" income.[10] The tax liabilities are left with the company to be paid out of any remaining assets outside the charge, in accordance with the usual priorities.

The former line of authority was considered by Lightman J. in relation to a court-appointed receiver in *IRC v Piacentini (Piacentini)*.[11] The decision was applied by the same judge, giving the judgment of the Court of Appeal, to a fixed charge receivership, in *Silven Properties Ltd v Royal Bank of Scotland Plc*.[12] These cases confirm that a fixed charge receiver appointed over a UK resident company is not subject to corporation tax on income or to income tax. In relation to corporation tax on chargeable gains, the position is expressly dealt with by section 26(2) of the Taxation of Chargeable Gains Act 1992, which provides that receivers and charge holders are treated in the same way as nominees of the company.[13] Unfortunately, the analysis set out in *Piacentini*[14] does not cover all the relevant tax legislation and, for example, leaves open the possibility of argument that a UK receiver appointed over assets of a non-resident company could still be liable for income tax as a recipient of the income, but in this case in general the limitations on the charge in section 151 of the Finance Act 2003 should normally apply.

This article focuses primarily on direct taxes; the VAT position of fixed charge receivers is, however, another significant area where tax legislation remains defective, an unfortunate state of affairs given the importance of the VAT component of real property transactions. The problem is the lack of a proper basis for accounting for the tax. It was held by the Court of Appeal in *Sargent v CC&E*[15] that fixed charge and LPA receivers are required to account to HMRC for the VAT they collect as a matter of public policy. In particular, Nourse L.J. said that regulation 9 of the Value Added Tax Regulations 1995[16] which covers certain insolvency situations, does not apply to fixed charge receivers since the company does not "go into receivership" when they are appointed but that nonetheless, VAT should be paid over to what is now HMRC. To do otherwise would, the judge said,[17] be to act "dishonourably". The process adopted is to apply what is known as the "Form 833 procedure", authorised by paragraph 7 of Schedule 4 to the Value Added Tax Act 1994, but this is not satisfactory, not only as relying on concepts of honour might be

9 See *Liverpool Corp v Hope* [1938] 1 KB 751 (CA), applied in *Re John Willment (Ashford) Ltd* [1979] STC 286 (HC); *Powdrill & Lyle (Joint Liquidators of Kentish Homes Ltd) v Tower Hamlets LBC* [1993] BCC 212 (HC) and *Sargent v CEC* [1995] STC 398 (CA). It was also common ground in *Re Mesco Properties Ltd* [1979] STC 788 (CA), discussed below (text to fnn.25–27), that the gains made by fixed charge receivers were recoverable from the company's liquidator and not the receivers.

10 *IRC v Thompson* (1936) 20 TC 422 (HC). This case was superseded by the provisions making the income of UK resident companies subject to corporation tax and not income tax—see currently CTA 2009, s.3.

11 *IRC v Piacentini* [2003] EWHC 113 (Admin); [2003] STC 924.

12 *Silven Properties Ltd v Royal Bank of Scotland Plc* [2003] EWCA Civ 1409; [2004] 1 WLR 997.

13 See also *Re Mesco Properties Ltd,* above fn.9, [1979] STC 788, and *Re Toshoku Finance UK Plc (In Liquidation)* [2002] UKHL 6; [2002] STC 368, discussed below (text to fn.30).

14 *Piacentini*, above fn.11, [2003] STC 924.

15 *Sargent*, above fn.9, [1995] STC 398.

16 Value Added Tax Regulations 1995 (SI 1995/2518).

17 *Sargent,* above fn.9, [1995] STC 398 at 404 per Nourse L.J.

thought a perilous basis for tax collection, but also as it does not enable the receiver to recover input tax on the costs of disposal so that in practice various pragmatic steps must, where possible, be taken with the acquiescence of fair-minded tax collectors.

One area where the creditor's rights have recently been eroded in this context is the introduction of the statutory restriction of set-off rights introduced in the Finance Act 2008 (FA 2008). As the reader will need no reminding, the grant of a legal charge over a debt, or the crystallisation of a floating charge, operates as an assignment. Consequently, it was generally accepted that a valid legal charge[18] over debts, including tax repayments owed to a taxpayer, effected a transfer of the debt and no subsequent set-off rights could accrue. So, in the case of taxes (other than VAT), a subsequently created Crown debt did not gain priority over the original tax repayment which remained subject to the charge and intact. That is no longer the case, following the new rules introduced by section 133 of the FA 2008 allowing the Crown a set-off outside a formal insolvency procedure (liquidation administration or administrative receivership are excluded but not a fixed charge receivership) even where a debt has been transferred. This legislation was proposed in a consultation based on a series of documents entitled *Modernising Powers, Deterrents and Safeguards—Payments, Repayments and Debt*,[19] dealing primarily with matters such as payment of tax by credit card, and unfortunately did not at first take account of insolvency issues at all. That the legislation enacted finally did so, may be seen as a positive result of the consultation process.

Administrative receivership

In an administrative receivership, tax (arising before and after appointment) generally remains the liability of the company, with some notable exceptions including requirements to withhold income tax and PAYE liabilities incurred in the receivership. Consequently, it does not get paid unless the company (usually, this means the liquidator) has the funds. This position has not been seriously disputed for many years and should be considered appropriate and justifiable for the same policy reasons as for fixed charges. The position of taxpayers was improved by abolition of the preferential tax claims (see above under *Abolition of preferential claim for taxes*). Two changes to the legal regime have improved HMRC's position in minor respects. These are, first, the introduction of the "prescribed part" required to be set aside for payment of unsecured creditors, referred to above (this was intended as a counterbalance to the abolition of the preferential claim). The second is the reinstatement by the Companies Act 2006 of a rule[20] requiring payment of expenses of a concurrent liquidation out of floating charge proceeds, reversing by statute the effect of a decision of the House of Lords in a case involving the vehicle manufacturer, Leyland Daf Ltd. As the liquidation expenses can include tax (see below) this means that tax liabilities incurred in a liquidation can take priority over the distribution to the charge-holder of assets subject to a floating charge—which was often thought to be the case before the decision, *Buchler v Talbot*.[21]

[18] Possibly, also, an equitable charge although the position here was more complex.

[19] HMRC, *Modernising Powers, Deterrents and Safeguards: Payments, Repayments and Debt*. Date of issue: November 24, 2008. Available for download via *http/www.hmrc.gov.uk/about/review-powers-con-docs.htm* [Accessed March 7, 2010].

[20] Now in IA 1986, s.176ZA with effect from April 6, 2008.

[21] *Buchler v Talbot* [2004] UKHL 9; [2004] 2 AC 298.

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The importance of the administrative receivership process is diminishing as, with some important exceptions,[22] administrative receivers cannot now be appointed in respect of charges created on or after September 15, 2003. In many of the situations where previously an administrative receiver would have been appointed, an administration would now occur.

Liquidation[23]

Apart from removal of the preferential claims for taxes, discussed above, the tax position of companies in liquidation has changed very little for many years, despite an important judgment of the House of Lords in 2002, in *Re Toshoku Finance UK Plc (In Liquidation) (Re Toshoku)*[24] and various changes to the Insolvency Rules.

HMRC are unsecured creditors for the tax due at the date of commencement of the liquidation but tax arising in the course of the liquidation has been held to have a super-priority as an expense of the liquidation, following the judgment of the Court of Appeal in 1979 in *Re Mesco Properties Ltd (Mesco Properties)*.[25] This was a case where the liquidator argued (contrary to normal practice at the time) that corporation tax on gains realised following sales of property he had made, and which had been made by mortgagees and receivers, should be subordinated to the interests of other creditors under the then current Winding-Up Rules. He lost, and since 1986 the position has been that corporation tax on income is payable in accordance with rule 4.218(1)(m) of the Insolvency Rules 1986[26] as amended (the Insolvency Rules) as a "necessary disbursement". Corporation tax "on chargeable gains accruing on the realisation of any asset of the company", whether by the liquidator or a receiver or mortgagee, is expressly covered by rule 4.218(1)(p) of the Insolvency Rules. The priority given by rule 4.218 even ranks tax above the liquidator's remuneration—though, because this was thought just a bit unfair following *Mesco Properties*,[27] tax on chargeable gains is subordinated to fees up to the Official Receiver's scale, which are covered in rule 4.218(1)(o).[28]

The *Mesco Properties*[29] decision was upheld in *Re Toshoku*[30] and the latter case is an object lesson in how uncompromising the priorities for tax can be in insolvency. The company, in liquidation in the UK, had, at the date of its liquidation, a substantial interest-bearing debt (US$156.3million) owed to it by an associated company in Liechtenstein,

[22] There are currently seven specific exemptions, for "capital market arrangements", "public-private partnership projects", "utility projects", "urban regeneration project companies", certain charges in the financial markets, for registered social landlords and in relation to "protected railway companies etc"—although further exceptions may be created by statutory instrument (see IA 1986, ss.72A–72H).

[23] For simplicity, this discussion focuses on compulsory liquidations but the same principles apply to creditors' voluntary liquidations.

[24] See *Re Toshoku*, above fn.13, [2002] STC 368.

[25] See *Mesco Properties*, above fn.9, [1979] STC 788. See also *Re Beni-Falkai Mining Co* (1933) 18 TC 632 (HC).

[26] SI 1986/1925.

[27] *Mesco Properties,* above fn.9, [1979] STC 788.

[28] As will be appreciated, there is no logic for treating the different types of tax liability differently, but the author understood at the time that the person who drafted the rules in 1986 simply did not consider liabilities to tax on income and the relevant consultations did not directly involve tax practitioners.

[29] *Mesco Properties,* above fn.9, [1979] STC 788.

[30] See *Re Toshoku,* above fn.13, [2002] STC 368.

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TEE. TEE was also insolvent and in the event paid US$23 million in full and final settlement of its obligation. The US$156.3 million was outstanding for some ten months, and interest was accruing on it over that period which was never in fact paid. The UK company was assessed to corporation tax on the accruing income. As the parties agreed in the higher courts, this assessment was correct under the "loan relationship" provisions as they then stood since bad debt relief was then not available in respect of connected company indebtedness. The Inland Revenue, following *Mesco Properties*,[31] claimed that they should be entitled to claim the tax as an expense of the liquidation—thus, in preference to unsecured creditors—even though this was tax on income which would never actually be received, and unsecured creditors had already lost some US$157million, this being the deficiency of net assets. Tax, in other words, on a purely artificial profit which did not exist in the real world and in a situation where the creditors of the company had already lost any hope of recovering much of the principal of, let alone interest on, the debt concerned. The liquidator sought an order that the company should not account for the corporation tax on the notional income as a necessary disbursement because there was no benefit to the company. This was granted by the High Court, but the House of Lords held that in the face of clear words imposing a tax liability on the company, the Court had no discretion to direct what the order of payment of different liabilities should be.

The House of Lords was influenced by the fact that the Inland Revenue were actively amending the law to relieve the specific injustice in this case which has now been done by a specific relief which is currently given in section 357 of the Corporation Tax Act 2009 (CTA 2009) and allows a company to claim bad debt relief on its connected party debt where the debtor is insolvent.

It can be argued that the payment of tax liabilities pre-preferentially is unfair on unsecured creditors. For example, tax is payable as a priority in full even if it is paid in respect of capital gains accrued over many years before the insolvency began. But as the points made by Philip Wood in the quotation at the beginning of this article arguably justify,[32] clear rules are needed where a company ceases to exist and this is a case where the result is ruthless. Buckley L.J., who delivered the leading judgment in *Mesco Properties*, put it in terms of "common sense and justice" that the tax should be payable in priority to unsecured creditors.[33] In a liquidation, where there is no possibility of the company continuing to exist unburdened by debt, and potential tax evasion is a concern, it may be thought not unreasonable that the immediate public interest of collecting the maximum amount of tax should predominate even if this is at the expense of unsecured creditors.

Administration—evolution of the present regime

The considerations applying to the administration process are, however, a very different matter from liquidations. Administrations were created in 1986 and remodelled in 2002, following which the process has become the main insolvency process, in many cases replacing administrative receivership and liquidation because of its relative flexibility. Although there are numerous similarities, including in the legal provisions, the administration process is fundamentally different in purpose. The process of liquidation of

31 See *Mesco Properties,* above fn.9, [1979] STC 788.
32 Wood (2007), fn.1.
33 See *Mesco Properties,* above fn.9, [1979] STC 788 at 792.

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an insolvent company (by a compulsory winding up or a creditors' voluntary liquidation) is a means to bring the company's existence to an end, and almost always means that the company as a legal entity ceases to exist. The liquidator's role is to realise the assets of the company and to apply them in accordance with the statutory scheme, paying expenses of the liquidation and making distributions of the remaining cash, if any, to the different classes of creditors in accordance with their rights. He has wide powers to enable him to do this. The company is then dissolved. There are occasions when the company does survive a liquidation (for example, it may be returned to administration) but these occasions are rare.

The purpose of administration is different. The statute says that:

> "the administrator *must* [emphasis added] perform his functions with the objective of–
>
> (a) rescuing the company as a going concern or
> (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration) or
> (c) realising property in order to make a distribution to one or more secured or preferential creditors."[34]

Moreover, the administrator *must* perform his function with the objective specified in (a)—rescue as a going concern—unless he thinks that it is not reasonably practicable to achieve that objective, or the objective in (b) would achieve a better result for the company's creditors as a whole.[35] The basis on which he can do so is further elaborated by case law—see, notably, *Re GHE Realisations Ltd (formerly Gatehouse Estates Ltd)*.[36] He is actually *precluded* by statute from following objective (c) unless he thinks that the previous objectives are not reasonably practicable to achieve and that by following it he does not unnecessarily harm the interests of the creditors as a whole.[37] Thus, at the outset of the administration it is intended by the legislative scheme that the company should, if possible, be rescued, and the prospect of realisation of the company's assets, distributions to creditors and dissolution only arises if an administrator is unable to achieve this objective. This is a crucial distinction and, as will be appreciated, it introduces different weights into the balance of interest between the State as tax collector and other interested parties than apply in the case of a company which is to cease to exist.

Therefore, it is perhaps surprising that the expenses rules relating to taxation devised for administrations in 2002 follow closely those applying to liquidations. The reasons for this are partly historic. The IA 1986 did not make specific provision for tax liabilities at all. Tax liabilities, like other debts, were left unenforceable by proceedings during the administration without the consent of the administrator or the Court[38] and had to be dealt with if and when the company returned to solvency, which was usually, in the relatively few administrations which occurred, by a compromise of pre-administration liabilities effected by Company Voluntary Arrangement under Part 1 of the IA 1986. Under this,

[34] IA 1986, Sch.B1 para.3(1).
[35] IA 1986, Sch.B1 para.3(3). Emphasis again added.
[36] *Re GHE Realisations Ltd (formerly Gatehouse Estates Ltd)* [2005] EWHC 2400 (Ch); [2006] 1 WLR 287.
[37] IA 1986, Sch.B1 para.3(4).
[38] IA 1986, s.434 (as originally enacted).

tax liabilities up to the date of the arrangement were often compromised, but tax arising during the duration of the arrangement was often paid in full. On vacation of office by the administrator, he was required by section 19 of the IA 1986 to pay in full certain expenses, including liabilities incurred under contracts he had entered into. This section was held[39] to include PAYE and primary NICs but it was not considered to apply to corporation tax. It may be said that this was not a bad result in economic terms—the Crown got a fair proportion of its claim, all its PAYE and primary NICs and, if the company went into liquidation, in due course, its tax on income received and gains realised during the course of the liquidation. If the company survived, the tax debt did not disappear and either had to be compromised or paid in full. Meanwhile, the company did not have to pay tax unless and until the outcome of the administration was determined. However, the absence of a proper rule about administration expenses was a problem in itself, tax apart, and so far as tax was concerned, there was a potential for abuse perceived by the Inland Revenue in that no power to enforce liabilities was available during administration.

Administrations now

Following the EA 2002, the Insolvency Rules confer on tax liabilities a priority based on liquidation rules, that is to say, the same super-preference as applied in *Re Toshoku*.[40] Rule 2.67 of the Insolvency Rules, which is the relevant provision, reproduces rule 4.218 almost verbatim so far as is material, even down to failing to deal expressly with corporation tax on income. Cases continue to arise[41] where it is argued outside a tax context that the respective rules should be interpreted differently for administrations than for liquidations, but at the time of writing there has been no decision which indicates a relevant difference from a tax perspective. The introduction of a super-preference for taxation in administrations was not, it is believed, a matter of policy. At the time, it appeared to the author (then working in Inland Revenue Policy) that the priority of tax liabilities changed without debate or discussion. Given that the purpose of administration is quite unlike that of liquidation, it can be argued that different priorities should apply in the two processes.

Some examples of anomalous tax policy in administrations

Even if it is justifiable that tax liabilities are paid pre-preferentially during the course of an administration, there are aspects of the regime which are less explicable and still less justifiable in policy terms. The regime applied to companies in administration may actually impose a greater tax burden on the company or group when insolvent than it would have suffered had it remained solvent. There are at least three situations where this occurs.

The first such situation arises from the rule[42] that a company's accounting period terminates with the beginning of the administration. This means that gains on disposal of assets shortly after the administration cannot be offset by trading losses arising in the immediate pre-administration period even if, had the company remained solvent, it would

[39] See *IRC v Lawrence* [2001] 1 BCLC 204 (CA).

[40] See *Re Toshoku,* above fn.13, [2002] STC 368.

[41] Most recently, *Re Lehman Brothers International (Europe) (In Administration)* [2009] EWHC 2545 (Ch), and *Goldacre (Offices) Ltd v Nortel Networks UK Ltd (In Administration)* [2009] EWHC 3389 (Ch).

[42] CTA 2009, s.10(1)(i).

all have been part of the same period. Representations were made to the Inland Revenue on the point in the course of the progress of the FA 2003 (indeed, the Revenue themselves initiated consultations on the provisions) but the representations were unavailing. The reasons are not convincing. It is, admittedly, more complex if the accounting period ends on a different date than the date of commencement of administration (since HMRC would have to apportion their tax for the period spanning the date the company entered administration for the purpose of proving their claim for dividend purposes—if this is relevant in a particular case, which it will normally only be if the primary purpose of administration, to ensure survival of the company or its business, is not met) but it is not impossible; alternatively a specific tax relief could be drafted.

Two other situations are less clear cut and may in due course lead to litigation. One occurs in relation to group relief where some or all members of the group are in administration. The current approach of HMRC in many cases is to try and deny relief for the losses being surrendered to other group members, relying on the restrictions in section 410 of the Income and Corporation Taxes Act 1988 (ICTA). The full arguments will not be set out here as they have been addressed by the author elsewhere[43] but HMRC argue that the companies concerned are not under common control, either because an insolvency practitioner has the power to secure that the affairs of the company are conducted "in accordance with [his] wishes" for the purposes of the control test in section 840 of the ICTA 1988, or that companies in administration are not "controlled" by their shareholders for the purposes of the test. HMRC's arguments may or may not be persuasive as a matter of literal construction of the words of the statute, but of course the relevant legislation preceded the current insolvency regime by three decades and was in no sense framed to apply to administrations.[44] It is an absurdity to deny groups in administration relief for losses which they could have enjoyed where the group remained solvent overall. And the rules are not even consistent, since in a group where surrendering company and claimant are both in administration, and there are different administrators, the restriction does not, even on HMRC's interpretation, apply.

Another situation is where the company implements a voluntary arrangement which is a common outcome of administration. In these cases, the effect will normally be to create for legal purposes a trust of the relevant assets[45] which HMRC may argue should be regarded as a settlement for inheritance tax purposes, as well as breaking group relationships and causing losses to be unavailable against relevant income. This argument may be made even though the assets are really just being used to pay off the company's debts and do not benefit anyone else (apart from creditors who may thereby lose less than they would otherwise have done). The author's view is that the creation of a trust for certain legal purposes, notably to ensure continuation of the arrangement in liquidation, does not

[43] See Anthony C.R. Davis, *Taxation in Corporate Insolvency and Rescue*, 6th edn (London: Bloomsbury Professional Ltd, 2009) at paras [5.76]–[5.81].

[44] It was introduced by FA 1973, s.29.

[45] The leading case on this point is now the Court of Appeal judgment in *Re NT Gallagher & Son Ltd* [2002] EWCA Civ 404; [2002] 1 WLR 2380 which has been followed in a number of subsequent decisions including *Re Zebra Industrial Projects Ltd (In Liquidation)* [2004] EWHC 549 (Ch); [2005] BPIR 1022; *Oakley v Ultra Vehicle Design Ltd* [2005] EWHC 872 (Ch); [2006] BPIR 115 and *Re Beloit Walmsley Ltd* [2008] EWHC 1888 (Ch); [2009] 1 BCLC 584. Earlier cases, including *Re Leisure Study Group Ltd* [1994] 2 BCLC 65 (HC); *Welsby v Brelec Installations Ltd (In Liquidation)* [2000] 2 BCLC 576 (HC) and *Re Kudos Glass Ltd (In Liquidation)* [2001] 1 BCLC 390 (HC) contain a number of relevant judicial observations.

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itself determine the tax position. It must be remembered that the creditors are a defined and limited (if, in the early stages, sometimes an unascertained) class. Common sense, as much as literal and purposive construction of section 43(2) of the Inheritance Tax Act 1984, make it unlikely that the courts would determine a voluntary arrangement to constitute a "settlement". For income and corporation tax purposes, it should in many cases, depending on the drafting, be possible to support an argument that the assets remain for tax purposes the company's money based both on decided cases where the treatment of analogous arrangements have been considered, such as *IRC v City of Buenos Ayres Tramways Co (1904) Ltd*,[46] and the cases on charged bank accounts.[47] Section 3(1) of the CTA 2009, which excludes the income tax charge on income of UK resident companies and those which are non-resident but have a UK permanent establishment, may also be relevant in some cases. Otherwise, where a trust exists, it appears that the consequence may arguably be that basic rate tax must be paid and a certificate of tax deduction given to the creditors. However, there is no doubt that this is, at the least, an area of uncertainty.

None of these three tax situations sits at all easily with a policy objective enshrined in the EA 2002 of maintaining insolvent companies and businesses as viable entities wherever possible. Other examples continue to emerge.

To complete the picture, it must be acknowledged that there have been a number of situations where the tax burden has been eased for insolvent companies. As already mentioned, HMRC corrected the injustice highlighted in *Re Toshoku*,[48] discussed above, of real tax on non-existent profits where the creditors had already lost substantially (although on one view the real problem, which has not been addressed, was the priority of the tax not the treatment of connected companies). Company voluntary arrangements were initially all but impossible to implement because of two direct tax problems[49]—the difficulty for creditors of obtaining bad debt relief and a potential tax charge for the company on released debts—both of which were rectified, after lobbying, in section 144 of the Finance Act 1994. Further, a small measure of increased loss relief was introduced by the Finance Act 2009. But what is clear from all this is that there has been no sustained and consistent policy on what the attitude of the Government should be to the legal treatment of companies which are in administration.

International aspects

In contrast to some of the issues mentioned above, a number of international measures demonstrate a consistent, and mostly, in the author's view, pretty sensible trend towards enabling tax authorities to collect tax internationally in an insolvency context. Before 2002, the overriding principle, derived from the case of *Government of India v Taylor (Government of India)*[50] and sometimes known, in US parlance, as "the Revenue Rule", was that the UK Courts, like those of other nations, did not enforce foreign (non-UK)

[46] *IRC v City of Buenos Ayres Tramways Co (1904), Ltd* (1926) 12 TC 1125 (HC).

[47] See *Dunmore v McGowan* [1978] STC 217 (CA); *MacPherson v Bond* [1985] STC 678 (HC); and *Peracha v Miley* [1990] STC 512 (CA).

[48] *Re Toshoku*, above fn.13, [2002] STC 368.

[49] There was also a problem with VAT bad debt relief, rectified by FA 1990, s.11.

[50] *Government of India v Taylor* [1955] AC 491 (HL) following the earlier Irish case of *Buchanan (Peter) Ltd and Macharg v McVey (Buchanan v McVey)* [1955] AC 516n. See also the judgment of Lord Denning M.R. in *Brokaw v Seatrain UK Ltd* [1971] 2 QB 476 (CA).

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tax claims. In particular, as in *Government of India* itself, the foreign tax authorities could not prove in a UK liquidation. This principle, primarily based on considerations of national sovereignty,[51] was equally applicable to claims by liquidators and trustees in bankruptcy and their foreign equivalents where the tax authorities were the only creditors.[52] It was applied in some common law jurisdictions but not others[53] and also had wider implications, for example on the powers of courts to order examinations in insolvency proceedings.[54] As an article in this *Review* by Professor Philip Baker QC in 1993[55] explained, the principle was becoming increasingly anachronistic and difficult to justify in an international context. This is not least because it offered, as some cases have since illustrated, astonishing opportunities for international tax evaders who could run up, and ignore, tax bills in one country using a company formed in another and then avoid liquidation (and possibly any civil) proceedings in the place of incorporation.

The *Government of India*[56] principle has now been all but abolished for the purposes of UK law as it affects corporate insolvencies by two pieces of international law and the related UK legislation. These are:

(a) The European Regulation on Insolvency Proceedings[57] (ERIP) which became effective on June 1, 2002; and
(b) The UNCITRAL Model Law (the Model Law),[58] given effect to in the UK by the Cross-Border Insolvency Regulations 2006 (SI 2006/1030) (the Cross-Border Regulations) which came into force on April 4, 2006.

Three effects of these pieces of legislation may be noted. One is that they enlarge the jurisdiction of the UK courts to put foreign companies into insolvency proceedings. This is discussed further below. A second is that they can require recognition of the (in some cases, exclusive) application of foreign insolvency regimes to companies formed in the UK. And thirdly, both of these pieces of legislation expressly permit foreign tax authorities to prove in a liquidation or other specified insolvency process. In the case of ERIP, this is because article 39 says just that. In the case of the Cross-Border Regulations, article 13.1 grants access to foreign creditors to British proceedings with the same rights regarding commencement of and participation in proceedings as British creditors. Article

[51] The House of Lords also said that it would be impossible for a judge to evaluate the tax claim properly as it was under foreign law, but this argument seems outdated given the level of international sophistication shown by English courts nowadays.

[52] *QRS 1 Aps v Frandsen* [1999] STC 616 (CA).

[53] For example, *Buchanan v McVey*, above fn.50, [1955] AC 516n; *Byrne v Conroy* [1998] 3 IR 1 (both Irish cases); *Scottish National Orchestra Ltd v Thomson's Executor* [1969] SLT 325 (a Scottish case); *Priestley v Clegg* 1985 3 SA 955 (South African cases); *Ayres v Evans* (1981) 39 ALR 129 (an Australian case) and *Relfo Ltd (In Liquidation) v Varsani* 11 ITLR 720 (a recent Singaporean case).

[54] *Re Tucker (A Bankrupt)* [1988] 1WLR 497 (HC), and *Re State of Norway's Application (Nos.1 and 2)* [1990] 1 AC 723 (HL).

[55] P. Baker, "The Transnational Enforcement of Tax Liabilities" [1993] BTR 313 and see also a letter from Wolfe D. Goodman [1994 BTR 276.

[56] *Government of India,* above fn.50, [1955] AC 491.

[57] Regulation 1346/2000. Readers will need no reminding that Regulations are directly applicable in Member States which have signed them (in this case, that does not include Denmark) and do not need to be implemented separately in domestic law.

[58] The Model Law on cross-border insolvency adopted by the United Nations Commission on International Trade Law on May 30, 1997. Available at *www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html* [Accessed February 12, 2010].

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13.3 states specifically that a claim may not be challenged solely on the grounds that it is a claim by a foreign tax or social security authority unless it is in whole or in part a penalty,[59] or on other grounds apart from the nature of the claim. Interestingly, the original text of the Model Law contains a footnote with an alternative wording for this article allowing those nations adopting it to exclude foreign tax claims and/or rank them differently from domestic claims. This was not taken up by the UK Government.

In addition, the last few years have seen an increasing number of pieces of EU legislation which have enabled tax authorities to enforce liabilities within the European Union (EU).[60]

Introduction of the legislation outlined above means increased scope for enforcement of UK tax liabilities against foreign companies here and abroad, as well as of enforcement of foreign tax in the UK. The principle in *Government of India*[61] will now only apply in the UK in cases of proceedings which do not involve the EU and insolvency where the Cross-Border Regulations do not apply[62] as well as cases arising for one reason or another where foreign courts still apply the rule.[63] The effect of ERIP is to allow the courts of a Member State exclusive jurisdiction for primary proceedings over any company with its "centre of main interests" (COMI) in that country,[64] wherever the company is incorporated. As is increasingly recognised, this enlarges the jurisdiction considerably for tax enforcement so that the tax authorities can now enforce liabilities in insolvency proceedings in other jurisdictions—see, for one of the earliest cases on ERIP, the Irish case of *Re Cedarlease Ltd*[65] where an Irish liquidator enforced a UK tax liability in Ireland.

However, the new landscape creates inconsistencies with pre-existing UK law. These inconsistencies could usefully be the subject of a separate article but a few examples can

[59] Consequently, it appears that foreign tax penalties may not be provable (depending on what "penalty" means in this provision).

[60] For example: Directive 77/799/EEC, the EC Mutual Assistance Directive (as amended by Directive 2004/106/EC, implemented in the UK by FA 2003, s.197; and Directive 2008/55/EC, providing for the recovery of taxes between Member States, implemented in the UK by FA 2002, s.134 and Sch.39 and the Recovery of Duties and Taxes, etc. Due in Other Member States (Corresponding UK Claims, Procedure and Supplementary Regulations) 2004 (SI 2004/674) and, beyond the EU, the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters, given effect to in the UK by the International Mutual Administrative Assistance in Tax Matters Order 2007 (SI 2007/2126) and the Recovery of Foreign Taxes Regulations 2007 (SI 2007/3507). The story continues and legislation continues to be considered—at the time of writing, the latest press release of the Council of the European Union issued on January 19, 2010 refers to the latest draft Mutual Recovery Directive as a means to remedy limitations of current recovery provisions to combat "fraudsters have taken advantage of this to organise insolvencies in member states where they have debts", available at *www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/112456.pdf* [Accessed February 12, 2009].

[61] *Government of India,* above fn.50, [1955] AC 491.

[62] There is a long list of UK companies to which the Cross-Border Regulations do not apply and, naturally, a series of requirements before the UK courts can be required to recognise foreign insolvency proceedings.

[63] An example is the UK sequel to the Singaporean case referred to in fn.53, *Relfo Ltd (In Liquidation) v Varsani* [2009] EWHC 2297 (Ch) where the UK courts did enforce a UK tax debt held unenforceable in Singapore.

[64] See ERIP art.3.1. The Model Law has a similar test applied the same way—see *Re Stanford International Bank Ltd (In Receivership)* [2009] EWHC 1661 (Ch) (this case is under appeal at the time of writing).

[65] *Re Cedarlease Ltd* [2005] IEHC 67.

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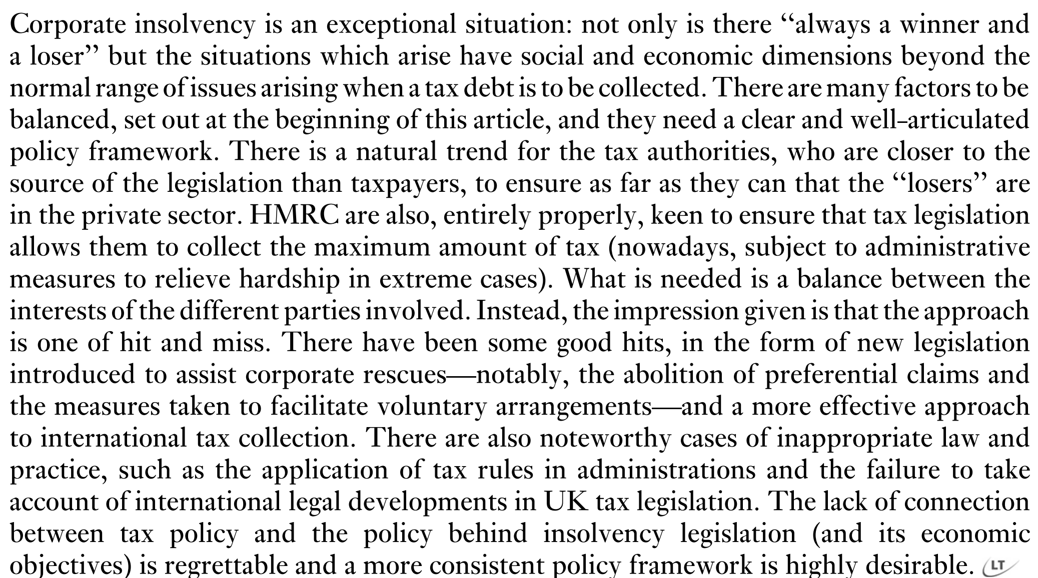
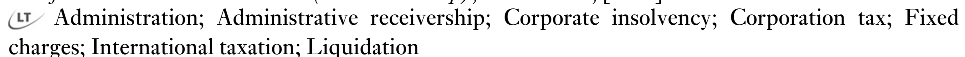
be mentioned. One is the special right to collect taxes in section 108(2) of the Taxes Management Act 1970 which allows corporation tax payable by companies incorporated under the law of jurisdictions other than the UK to be collected from the "proper officer" of the company personally, subject to a right of indemnity. In an insolvency context, this means a liquidator or administrator (although it extends to others as well—a point which might well be of concern to persons "acting as" secretary or treasurer of foreign companies in the UK if they knew about it). This provision is perhaps as clear an example of discrimination in EU Treaty terms as could be found but also infringes the principle of exclusive jurisdiction in ERIP. A second example is the conflict between UK residence for tax purposes and the COMI. Recent cases[66] indicate that the presumption in ERIP that the company's COMI is where its registered office is found is less easy to displace than was at first expected, which means that the COMI test is coming closer to the place of incorporation test with which tax advisers are familiar; nonetheless, cases will continue to arise where a company previously tax resident outside the UK enters insolvency proceedings here and therefore becomes subject to UK taxation. The same could well happen the other way round (and notably, the rule which preserves UK residence in a liquidation of a UK resident company outside the UK, section 15(3) of the CTA 2009, still exists in its original form and has not been extended to other insolvency procedures which could be relevant under ERIP). In these cases there is no straightforward solution offered by the legislation to the potential conflict between the requirements of the insolvency rules that creditors are treated according to the domestic law of the COMI and the tax laws which, as the first part of this article shows, may impose other priorities.

Conclusion



Corporate insolvency is an exceptional situation: not only is there "always a winner and a loser" but the situations which arise have social and economic dimensions beyond the normal range of issues arising when a tax debt is to be collected. There are many factors to be balanced, set out at the beginning of this article, and they need a clear and well-articulated policy framework. There is a natural trend for the tax authorities, who are closer to the source of the legislation than taxpayers, to ensure as far as they can that the "losers" are in the private sector. HMRC are also, entirely properly, keen to ensure that tax legislation allows them to collect the maximum amount of tax (nowadays, subject to administrative measures to relieve hardship in extreme cases). What is needed is a balance between the interests of the different parties involved. Instead, the impression given is that the approach is one of hit and miss. There have been some good hits, in the form of new legislation introduced to assist corporate rescues—notably, the abolition of preferential claims and the measures taken to facilitate voluntary arrangements—and a more effective approach to international tax collection. There are also noteworthy cases of inappropriate law and practice, such as the application of tax rules in administrations and the failure to take account of international legal developments in UK tax legislation. The lack of connection between tax policy and the policy behind insolvency legislation (and its economic objectives) is regrettable and a more consistent policy framework is highly desirable.

[66] Notably, *Re Eurofood IFSC Ltd* (C-341/04) [2006] ECR I-3813; [2007] 2 BCLC 151, as applied in *Re Stanford International Bank Ltd (In Receivership)*, above fn.64, [2009] EWHC 1441.



Administration; Administrative receivership; Corporate insolvency; Corporation tax; Fixed charges; International taxation; Liquidation

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