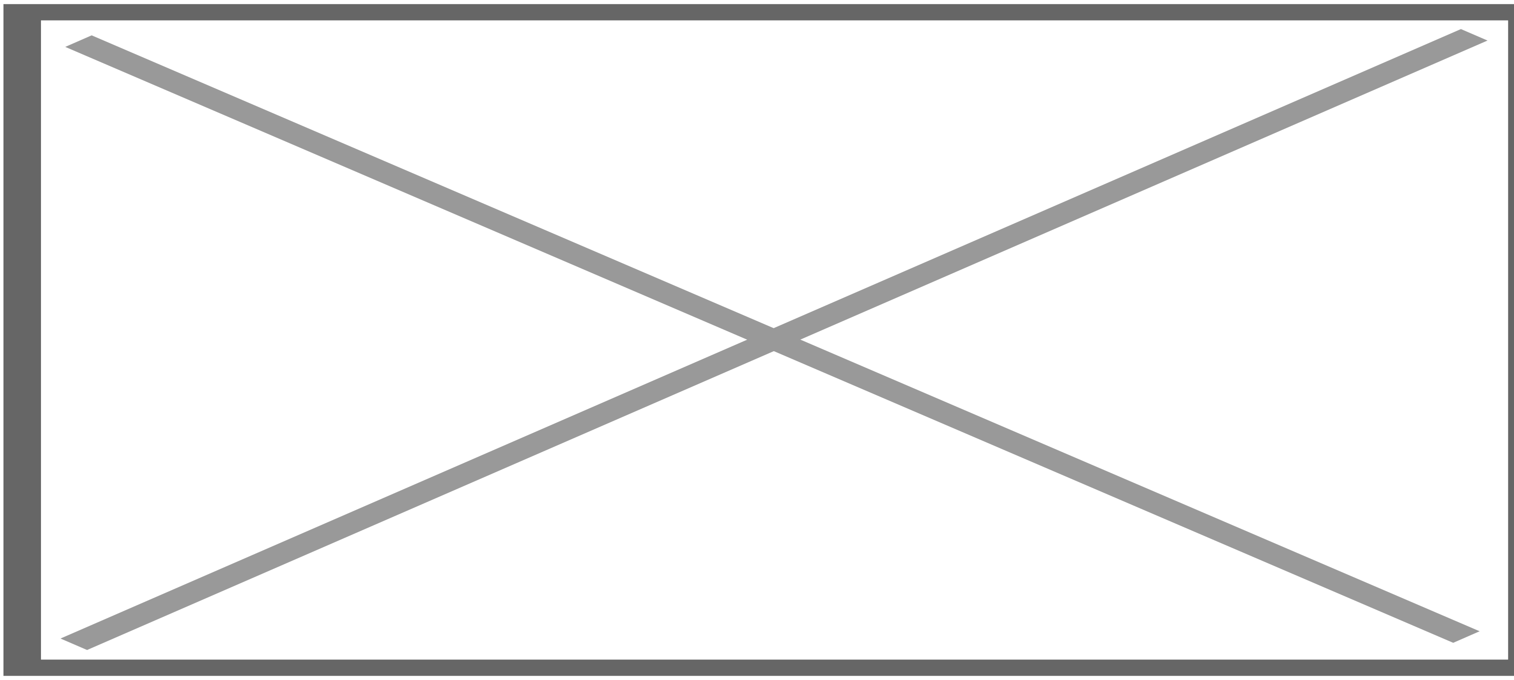
Stressed and distressed businesses: weathering the storm

Large Corporate OMB



22 August 2022

As businesses face increasingly turbulent times, we discuss a number of helpful measures and potential pitfalls within the tax code that stressed and distressed businesses should be aware of.

Key Points

What is the issue?

There is widespread expectation that the number of businesses in financial distress and potentially facing insolvency will increase significantly. Tax will often play an important role in any steps taken by a business to navigate periods of uncertainty.

What does it mean for me?

A working knowledge of the relevant tax provisions and tools available, including in respect of time to pay applications, debt reorganisations and the impact of the appointment of insolvency practitioners, may prove essential to tax advisers and their clients over the coming months.

What can I take away?

There is a rarely a ‘one size fits all’ solution. However, there are various tools available to assist distressed businesses. When these are used correctly, businesses should have the best chance of successfully navigating such periods of difficulty.

Over the past few years, businesses have been presented with an unprecedented array of challenges. Now facing economic uncertainty and double-digit inflation, combined with the government having turned off the taps that have provided significant support in relation to the Covid pandemic, there is widespread expectation that the number of businesses in financial distress and potentially facing insolvency will increase significantly. For many businesses (and their tax advisers), this will be the first time they encounter these challenges. The aim of this article is to provide an overview of some practical tax considerations of situations a business may encounter as they navigate periods of financial distress.

As a starting point, it is worth highlighting that almost any business can find itself in a position of distress, often through no fault of its own. A financially sound business may suddenly experience cash flow difficulties; for example, due to rapid increases in its cost base, the failure of critical suppliers or a large customer not paying for goods or services on time. With so many demands on management time and a rapidly changing business environment, it is easy for a business to lose focus or stumble into financial difficulty. Whatever the cause and the actions that management needs to take to overcome the challenges, tax will play a critical part.

Early interventions

There are a number of early interventions that can often provide breathing space to a business in distress. Many of these relate to good business practice, such as improving operational efficiency, managing exposures to risk, improved financial management and monitoring of liquidity. However, we have flagged two particular interventions below where tax is a key factor.

Time to pay agreements

Since the start of the pandemic, we have seen a rise in the use of both formal and informal time to pay arrangements. HMRC will often be a significant creditor in a distressed business, with a taxpayer either being in arrears or forecasting to become so in the coming months.

Agreeing a formal payment plan can allow a business the certainty to move forward, without fear of winding-up action from HMRC. However, when agreeing a plan, it is important to understand the parameters of what HMRC is prepared to accept.

HMRC will only consider a plan where it can be demonstrated that the financial difficulties are a ‘one-off’, with a clear route to recovery. It will expect the business to put forward a credible plan which pays down the arrears in the shortest possible time, whilst settling all future tax liabilities as they fall due. Only in exceptional cases will it consider a payment plan extending beyond 12 months. End loaded plans are likely to face substantial challenge or be rejected outright.

Ultimately, HMRC sees a time to pay agreement as the last resort for a business having first taken all necessary steps to obtain support from other stakeholders. Such measures may include stretching or obtaining improved terms from creditors, seeking early payment from debtors, obtaining additional funding from lenders and shareholders, curbing unnecessary expenditure and capex, collecting director loans and putting a halt on dividends and bonuses for senior management.

It is important to remember that HMRC has the benefit of seeing the pattern of other time to pay requests, so should be familiar with sector specific liquidity issues (as we saw with Covid), which may be helpful when agreeing a plan. However, each time to pay agreement will be bespoke. The key message is to engage early with HMRC once it becomes clear that a debt cannot be repaid on time, but directors should also be mindful of their statutory duties to members and creditors generally.

Additional debt funding

Whilst additional debt funding may be sought, the availability and cost of this may be impacted by HMRC's preferential status in any subsequent insolvency. Any unsecured debt, or debt secured only by a 'floating charge' (e.g. stock or work in process lending) will rank behind any preferential taxes in an insolvency. These are broadly any taxes collected by a business on behalf of HMRC, e.g. payroll taxes, CIS and VAT.

As a result, lenders are taking an increasing interest in the tax status of businesses when considering whether to advance funds, particularly where they are unable to obtain fixed charge security.

Disposal of business

One option that may be under consideration by a distressed business is the disposal of a non-core division or ancillary business. This may be to generate funds, stem the cash drain of a loss-making business or allow management to focus on its core activity. In making such a disposal, many of the usual factors will apply in considering the potential tax implications including:

- sale of trade and assets vs sale of shares;
- tax treatment of goodwill;
- availability of substantial shareholding exemption; and
- application of transfer of a business as a going concern provisions for VAT.

However, where a business is distressed, there are a number of additional points which are potentially relevant.

Allocation of consideration

A lender's security is likely to vary depending on the nature of the asset, and any allocation should therefore represent the true value of the assets disposed of, so as not to prefer one creditor group over another. This should apply notwithstanding that an unfavourable allocation may increase the overall tax liability for the vendor or reduce the tax relief available for the purchaser.

Company leaving a VAT group

Where an entity is sold which was previously part of the VAT group, all members of the VAT group will remain jointly and severally liable for any unpaid VAT that arose prior to the company leaving the group. Therefore, purchasers will need to understand the VAT risk of the group that is left behind and consider what would happen in the event that the seller subsequently fails and the debt goes unpaid (an indemnity from the seller may have little value in that circumstance). Likewise for the seller.

Use of losses

The corporate loss rules are complex and beyond the scope of this article, but some common pitfalls encountered in distressed scenarios include:

- being unable to offset (often substantial) trading losses against chargeable gains arising on assets disposed of after a cessation of trade has occurred;
- being unable to access losses/profits of a group member due to the existence of arrangements for the company to leave the group; and
- being unable to group relieve losses due to the appointment of an insolvency practitioner (see *Farnborough Airport Properties v HMRC* [2017] UKUT 394).

Debt restructuring

An option often considered when undertaking contingency planning is agreeing a consensual debt restructuring with the secured creditors of the business. This is often combined with a refinancing exercise and/or a release of connected party debt. It can be preferred to an insolvency process by a secured creditor where that could disproportionately impact value in the business, or there would be a reputational risk for the creditor of enforcing on their debt.

We have assumed here that all transactions described involve debts which fall within the definition of a loan relationship or relevant non-lending relationship (see ‘Avoiding the trap’, *Tax Adviser* (November 2018)). It is important to confirm this, as many inter-company balances in particular can fall short of this hurdle and not qualify for the relevant exemptions described as a result.

Release of connected party debt

A release of a debt owed to a connected company (broadly, a company under common control with the debtor company, see Corporation Tax Act (CTA) 2009 s 466) would generally be expected to fall within the connected companies exemption, and therefore not give rise to a taxable credit in the hands of the debtor company. Similarly, any debit arising in the creditor would equally not be deductible.

Where the debt is instead owed to an individual shareholder, no such exemption exists. Instead, a company would generally need to rely on the provisions of CTA 2009 s 322, which exempts any credit arising on a release of a debt from tax in a number of different scenarios. The most relevant of those are the ‘debt for equity’ exemption and the ‘corporate rescue exemption’.

There are a number of conditions that must be met, but for the ‘debt for equity’ exemption set out at CTA 2009 s 322(4), any release must not be a release of ‘relevant rights’ (broadly, a debt to which the old ‘corporate rescue exception’ at CTA 2009 s 361A applied); and the release must be in consideration for the issue of ordinary shares in the debtor company. Whilst the share capital issued does not need to equal the value of the debt released, it is important that shares are the only consideration given for the release (for example, scenarios where other associated rights or options are created may preclude relief) and that the shares possess genuine commercial upside for the former creditor.

Alternatively, a company may be able to rely on the ‘corporate rescue exemption’ at CTA 2009 s 322(5B). As above, this must not be a release of relevant rights and the following test must be satisfied:

> ‘immediately before the release, 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 at some time within the next 12 months the company would be unable to pay its debts.’

There are a number of ways in which a business may be able to demonstrate that this test is met, including an insolvent balance sheet or cash flow forecasts which show that it is likely to be unable to meet its liabilities at some point in the next twelve months. In many cases, there may be little, if any doubt on this point. Where the position is unclear, the directors may need to consult with experienced insolvency practitioners.

Release of third party debt

In many ways, the tax considerations on a release of a third party debt are very similar to a release of debt by an individual shareholder. Where the creditor is a mainstream lender, a release in consideration for the issue of shares may be less likely, but equally it should be easier to establish that the conditions of the corporate rescue exemption are met as a third party lender is unlikely to release a company from a portion of its debts where it is not necessary to do so.

Alternatively, a release may occur as part of a creditors' voluntary arrangement or a restructuring plan. In both cases, these are statutory insolvency arrangements within the definition at s 322(3) and so any credits arising as a result of a release in connection with such an arrangement should similarly be exempt from tax in the hands of the debtor company.

Acquisition of debt at a discount

Great care must be taken where debt which was previously held between unconnected parties becomes connected, as a result of a transaction involving the debt and/or equity of the business in question. A taxable credit, equivalent to any discount applied to the debt, may be deemed to arise where:

- debt is acquired by a connected company at a discount;
- debt is acquired by a third party at a discount, alongside a controlling shareholding in the debtor; or
- an existing lender acquires control of a company, having previously provided against amounts lent to it (see CTA 2009 ss 361 and 362).

The corporate rescue exemption, as described above, may apply to exempt any credit arising; however, there is the additional requirement in such scenarios of the creditor releasing some or all of the debt within 60 days of the connection arising.

Amendment to terms of existing debt

Where the terms of a debt are amended, for example the term (e.g. an extension of the lending period) or the applicable interest rate (e.g. an interest holiday), this may be a modification for accounting purposes, resulting in a credit to the profit and loss statement of the company.

As for most credits relating to a loan relationship, any such modification adjustment is taxable unless an exemption applies. The corporate rescue exemption may be of assistance but it is only available where the modification is 'substantial' (CTA 2009 s 323A(1)). This is an accounting concept and therefore specialist accounting support may be required in determining the tax implications of any such amendment.

Insolvency

Where a business is unable to find a consensual solution, either the creditors of the business or the directors may move to instruct an insolvency practitioner. The insolvency practitioner will act firstly with a view to rescuing the business or, if not possible, with an ultimate aim of executing a sale of its trade and/or assets, through either an administration or liquidation process. Where a sale of the businesses assets has been pre-arranged, this is known as a pre-packaged (‘pre-pack’) sale.

Once appointed, the insolvency practitioner becomes responsible for the tax affairs of the business, and specific rules within the insolvency code stipulate the order in which different taxes should be paid, depending on when the liability arose and what it relates to. For example, automatic rules may apply to set-off amounts that are due back to the company from HMRC against amounts owed to HMRC in relation to pre-appointment periods, and HMRC will have a preferential right to payment of certain tax debts ahead of floating charge or unsecured creditors.

From a practical perspective, a company entering administration or liquidation will result in the end of an accounting period for tax purposes. It may also result in any connections for loan relationship purposes or group relief groups ceasing to exist as mentioned above (depending on the level in the structure at which insolvency practitioners are appointed). However, it is still possible for an insolvency practitioner to surrender losses in respect of periods prior to their appointment, although they may seek payment for any such surrender.

Where only part of a group has entered insolvency, it may still be possible to benefit from group relief provisions on a sale of assets to another group member, both in respect of chargeable gains and stamp duty land tax, while the transfer of a trade without a change of ownership provisions also survive insolvency. This may allow for tax attributes such as tax written down values and trading losses to transfer, subject to any restriction in respect of relevant liabilities left behind.

Pitfalls for directors

As well as the various company law risks, a director of a distressed or insolvent business must be mindful of a number of potential tax related risks that could see them facing personal or even criminal liability.

Where an individual has in a five year period been a director, shadow director or participator in at least two companies which have both entered into an insolvency process with tax outstanding, and is also a director (or shadow director/participator) of another company conducting the same or similar business, HMRC may hold the individual jointly and severally liable for any tax of the new company.

Separately, where HMRC considers there to be a serious risk that a business will not pay certain taxes when they fall due (most commonly VAT and payroll taxes), it can demand security from the business. This can be particularly relevant to pre-pack sales to the extent that such debts remain unpaid in the seller. For payroll taxes, HMRC can demand security of up to four months of tax, plus any arrears, and for VAT this can be up to six months of tax, plus any arrears. In certain circumstances, HMRC can issue the demand against both the company and its directors. Where a demand for security has been issued, it is a criminal offence not to provide it.

Whilst these are both powers that HMRC will not commonly resort to, when it does they should be treated with an appropriate level of respect, given the seriousness of non-compliance.

Conclusion

When facing financial distress, a business and its directors must tread carefully to ensure that no criticism can be levied in the event of an ultimate insolvency and that personal or criminal liability does not follow. As with many things in tax, there is a rarely a ‘one size fits all’ solution and each case must be considered on its individual facts. However, there are various tools available to assist distressed businesses. When these are used correctly, businesses should have the best chance of successfully navigating such periods of difficulty.