INSOLVENCY UPDATE

Dealing with debt responsibly

According to a recent study by R3, the UK insolvency trade body, 28% of adults spent more than they earned in April, with 17% spending at least £100 more then received. Indeed, 43% of those in the 25 – 30 age group admit to spending more than they earned : perhaps indicating that younger people are happy to spend on the expectation of earning more next month. That may be acceptable in the short term, but there are numerous tales of people who fall into a spending habit that they cannot afford and debts begin to mount. If one factors into the equation the R3 finding that 22% of UK adults have no savings to fall back on, it is easy to understand why, for some, debt can quickly become a problem. It can lead to pressure, anxiety and self doubt.

When advising those with debt issues, the following points invariably arise :

- don't hide from your debts – acknowledge that they exist
- ask for help - all debt problems have a solution, albeit sometimes unpalatable
- budget, plan and budget again - and stick to it
- educate yourself about the options available so that you can negotiate and not be browbeaten by those pressing for payment. If in doubt, enlist professional help to deal with creditors
- communicate openly and honestly with your creditors in order to determine if they are willing to be flexible

Often the burden seems unduly high and the situation embarrassing, but the key is that you do not need to be alone. There are plenty people who can help.

Directors beware : liquidating your company will not necessarily save you from the clutches of HMRC

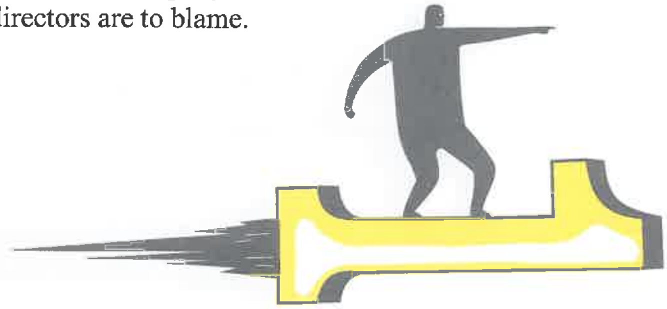
Many readers will be aware of the close HMRC attention in recent years in respect of Employee Benefit Trusts "EBT" which, in broad terms, is a trust established either in the UK or offshore by a limited liability company to hold cash or other assets for the benefit of certain employees. Quite often, the only employees of the company who benefit from an EBT are the directors.

Generally speaking, the purpose of an EBT is to incentivise employees and help retain quality staff by providing a benefit to them. When first conceived, they were not designed to be used (some might say "abused") as they have been over the last 25 years or so. An EBT and the company that creates it, are two separate legal entities which means that once the company has transferred property/cash into the EBT, it is run by trustees who have ultimate control over trust property, although they will often be guided by recommendations from the company. As the trust is a separate legal entity, it will continue to exist even if the company has a change of ownership or is liquidated.

For many years up to the mid 2010s, it was not uncommon for employers to pay bonuses to selected employees by transferring money to an offshore EBT : it is the offshore EBTs that attract HMRC interest. Typically, money is passed to an employee from the trust by way of an interest-free loan which, in practice, remained unpaid indefinitely. Perhaps unsurprisingly, HMRC considered these to be tax avoidance arrangements that sought to avoid income tax and NIC because, if the loan was never repaid, the cash was seen as representing net-of-tax money which, in normal circumstances, would have been subject to tax and NIC before being passed to the recipient.

The 2017 Finance Act introduced the concept of a loan charge which applied to all loans made subsequent to 6 April 1999 and not repaid before 5 April 2019. The charge is designed to represent the income tax and employee's NIC which would have been deducted if the monies had been processed through the company's payroll in the normal manner. Broadly, if £600,000 was transferred to an EBT and then lent to an employee, HMRC may contend that a gross salary of about £1,150,000 would have been required i.e. generating income tax and NIC liabilities of at least £550,000 : a significant loss to the Treasury. This helps to explain the large demands which many companies are facing from HMRC as a result of the legal challenge to the validity of an EBT scheme.

Instances have arisen where directors have sought to liquidate a company when it has not been possible for such company to pay the EBT assessed employee deductions to HMRC on the basis that HMRC will pursue the company for the employee deductions only to find that there are no assets, and lose interest. However, where the employee was also a director, legislation allows HMRC to pursue directors personally. Such an approach is becoming increasingly frequent when HMRC discover that the liquidated company has no assets and consider that the directors are to blame.



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In short, where a director was involved with an EBT and HMRC are able to demonstrate that the director knew, or ought to have known, that the income tax and employees' national insurance should have applied, the company status can be ignored, leaving HMRC to pursue the directors and bankrupt them if necessary.

From a liquidator's viewpoint, one option is to invoke section 212 of the Insolvency Act 1986 to pursue directors on the basis that the directors owe a fiduciary duty to act in the best interests of the company and hence, all stakeholder groups. If participating in an EBT gave rise to a loss to creditors because significant sums were transferred out of the company and creditors are prejudiced, the liquidator can pursue a director's personal assets.

Further, section 213 of the Insolvency Act 1986 allows a liquidator to argue that paying funds into an EBT was designed to defraud creditors by placing company assets beyond their reach, and that directors should be aware of the duty to ensure that a company pays tax on behalf of itself and its employees. Sometimes HMRC pursue a claim directly against a director, often in conjunction with the liquidator, thereby closing all doors of escape for such director.

When challenging an EBT, the argument is often given that an EBT must have seemed too good to be true in terms of the ability to continue to live and work normally in the UK without paying tax on substantial income earned from UK employment and thus, those who participated have only themselves to blame. The counter to this view is that all those who became involved in an EBT did so on the advice of professional advisors and hence, had every right to believe that what was being entered into was a perfectly valid scheme.

Experience shows that in recent years HMRC have their sights set firmly upon directors of companies who established EBT arrangements. Accordingly, seeking to liquidate the company in the hope that the whole saga will be swept away and forgotten is likely to be a forlorn hope for many directors.

As might be expected, an increasing number of directors are beginning to seek advice from the insolvency team at Meston Reid & Co regarding their personal financial affairs because when the money was received in their hands through an EBT it was spent rather than invested i.e. there is nothing left to settle any amount that may be due to HMRC.

A worrying time, although it is fair to state that HMRC seem to have adopted a conciliatory approach to agreeing repayment terms because they understand that EBT participators were not trying to evade tax, but merely avoid it using a scheme which is now shown to be inappropriate.

Easier mortgages now : worries later

The financial crash in 2008 created substantial bad debts for banks and other lenders, particularly those who had lent money to consumers for mortgage purposes. After a slow period of recovery by those financial institutions who survived, it became difficult to obtain a mortgage. Reasons advanced for this included tighter restrictions on lending based upon one's salary, volatile house prices and lenders keen to rebuild their balance sheets rather than provide cash to borrowers.

The position ten years later seems to be that lenders are fighting to attract consumers again by offering 95% loan to value mortgages at wafer thin margins. So much so that some lenders have gone bust (Amicus Finance PLC entered administration in December 2018) trying to match the products available from the big banks, whilst others have withdrawn from the market e.g. AA Mortgages, Magellan Homeloans and Tesco Bank. Whilst the big banks may be able to spread the risk across a broad portfolio and charge about 3% to borrowers, what will happen if the interest rate rises? Either the banks will suffer a loss (assumed an unlikely scenario) or borrowers will be asked to pay more (most likely) with the consequent effect on mortgage defaults and personal financial difficulty.

Hopefully not a case of "here we go again" but it could create untold misery and depress house prices if there is a glut of repossessions on the market.

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Conclusion

This Update is provided for general interest purposes and does not purport to offer definitive advice. Please contact either Michael J M Reid (reidm@mestonreid.com) or Michelle Byrne (byrnem@mestonreid.com) if you wish to discuss anything raised herein.

Thank you for taking the time to read this Update and feel free to pass it to anyone who you think might be interested in reading it.

Meston Reid & Co