

**“BETTER THAN NOTHING”
LIMITING THE PRIORITY FOR TAXES IN INSOLVENCY
TO ENHANCE UNSECURED CREDITOR RECOVERIES**

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INTRODUCTION

Suppose a company with assets valued at \$20 million has just filed formal liquidation proceedings having the following liabilities:

Secured claims	\$15 million
Employees wages	2 million
Taxes:	
Withheld from employee wages	1 million
Direct taxes within one year	1 million
Direct taxes within 2 years	2 million
Unsecured claims	5 million
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TOTAL:	\$26 million

What is the likelihood that unsecured creditors will recover anything in this scenario?

20 years ago, the answer almost certainly would have been “no chance,” regardless of where the proceedings were filed. Now, however, unsecured creditors might be surprised to learn that, depending where the liquidation takes place, they may actually receive a recovery on their claims.

What has been happening, and continues to develop, in the area of global insolvency law reform, explains this change.

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Much insolvency law reform in both developed and transition countries has emphasized business restructuring and rescue, often with U.S. “Chapter 11” used as a reference point. At the same time, however, lawmakers in certain European and Commonwealth countries have taken other concrete steps to improve the prospects for unsecured creditors to receive “better than nothing” returns even when businesses fail and cannot be revived.

The “tax priority” (also known as the “crown priority” in Commonwealth countries), enables revenue authorities to stand at the front of the line for payment of pre-liquidation taxes even when the claims are not secured by liens. Targeting the tax priority has become a tool for increasing returns to unsecured creditors. When combined with other measures, such as the elimination of priority for past due employee wages (by, for example, shifting responsibility for such claims to a government or multi-employer fund), and limiting the scope of the “floating charge,” lawmakers have created the potential for substantially more favorable recovery rates for unsecured creditors in liquidation proceedings.

A multi-country comparative study prepared by the International Insolvency Institute (the “III Study”) focuses on one feature of this trend: the priority afforded to tax claims in insolvency proceedings. The III Study draws on information provided by insolvency experts from 35 countries¹ as well as other authorities on insolvency law reform.

POLICY DEBATE

The priority for taxes has an ancient pedigree, dating back, at least, to the Magna Carta which proclaimed that “The King’s Debtor dying, the King shall be first paid.” As English common law was exported to other parts of the world, the idea that the government was entitled

¹ The III Study covers the laws of Argentina, Australia, Austria, Brazil, Canada, Chile, China, Egypt, Estonia, Finland, France, Germany, Ghana, Greece, Hong Kong, India, Japan, Latvia, Lithuania, Mexico, Mozambique, Netherlands, New Zealand, Philippines, Poland, Portugal, Russia, South Africa, Spain, Sweden, Thailand, Turkey, United Kingdom, United States, and Venezuela.

to priority for its revenue claims found expression even in the absence of a monarch. Civil law countries adopted a similar position and granted tax claims a “general preference” in liquidation.

Arguments for Tax Priority

The preference for government tax claims has been justified on a number of policy grounds:

- The priority protects the revenue base for the common good, and avoids shifting the burden of the debtor's unpaid taxes to other taxpayers.
- Unlike private creditors, taxing authorities are involuntary creditors, unable to choose their debtors or obtain security for debt before extending credit. The priority compensates for this disadvantage.
- Where the debtor acts as the government's tax collector (such as sales tax, value added tax, or employee withholding tax) if no priority or trust is imposed, the moneys collected by the debtor will increase the estate and unsecured creditors who have no legitimate claim to the collected funds, will receive a windfall.
- If the taxing authorities are not reasonably secure they will be discouraged from negotiating payment terms with debtors, thus forcing premature and possibly unnecessary business failures. Affording priority encourages the taxing authorities to delay current collection efforts.

Criticisms of Tax Priority

In contrast, law reform commissions and commentators have criticized unsecured creditor priorities in general, and the tax priority in particular, for a variety of reasons:

- All priority claims are inconsistent with the concept of equal treatment of creditors in a collective proceeding to the extent creditors have not made separate commercial bargains with the debtor prior to the proceeding.

- The tax priority is not needed to protect the community interest because the debt owed to the government is unlikely to be significant in terms of total government receipts, whereas the loss to private creditors, who often receive nothing in a liquidation when there are extensive priority claims, may cause substantial hardship and precipitate additional insolvencies. To the extent private creditors receive a higher return on their claims, part of the loss to the taxing authorities can be recouped through additional taxes paid by those creditors. And loss of priority does not prevent the taxing authorities from sharing in an insolvent estate *pro rata* with general unsecured creditors.
- The government is not disadvantaged by being an “involuntary creditor” because there are enhancements to its ability to collect debts that are not available to private creditors, including penalties and relatively high interest rates for untimely payment, individual liability of control persons or corporate directors in some circumstances, and expedited extra-judicial collection procedures. Furthermore, there is no general rule that involuntary creditors should receive priority; other categories of involuntary creditors (such as tort claimants) are not entitled to any kind of priority.
- Abolishing priority for tax claims would provide a greater incentive for the taxing authorities to collect taxes in a commercially reasonable manner, by removing reliance on an artificial ability to be paid ahead of other creditors. Delaying collection compromises the uniform enforcement of the tax laws and constitutes a state subsidy, which undermines the disciplinary force of an effective insolvency law.
- The argument that a “deemed trust” should be imposed on amounts withheld by the taxpayer on behalf of third persons in order to avoid a windfall to the general unsecured creditors is unpersuasive. Unless the withheld amounts have actually been

collected and segregated from the debtor's other assets, imposing a trust on the general assets of the debtor is unfair to the unsecured creditors who have continued to do business with the debtor not knowing that there is a tax delinquency.

PRIORITY CATEGORIES

The laws of the 35 countries in the III Study fall into four basic categories:

(1) countries that afford no priority to any kind of pre-bankruptcy claims,² (2) countries that afford priority to no pre-bankruptcy tax claims but retain priority for another type of claims (most often employee claims),³ (3) countries that provide limited priority for tax claims (priority may be based on type of tax, duration of tax or percentage of tax),⁴ and (4) countries that retain unlimited priority for taxes in insolvency proceedings.⁵

Several countries in the III Study have taken additional steps to enhance the chances for unsecured creditor recoveries in liquidation. Finland, Sweden, and most recently, the United Kingdom not only have abolished the priority for tax claims but also have limited the scope of the floating lien in liquidations by specifically setting aside for payment of unsecured creditors a portion of the value that otherwise would be allocated to the holder of the floating charge.

Countries that retain significant tax priorities also have taken other steps aimed at increasing recoveries for unsecured creditors. New Zealand recently passed legislation limiting the secured claim of the holder of a purchase money security interest to assets actually financed, rather than also extending to a company's inventory and accounts receivable. Argentina has decided to pay taxes and other claims entitled to general preference from no more than 50% of the assets available after payment of secured and other claims entitled to special preference.

² Austria, Estonia, Finland, and Germany.

³ Australia, Sweden, Turkey, and United Kingdom.

⁴ Canada, Chile, Egypt, France, Ghana, Hong Kong, India, Mozambique, Poland, Portugal, New Zealand, Spain, Thailand, and United States.

⁵ Argentina, Brazil, China, Greece, Japan, Latvia, Lithuania, Mexico, Netherlands, Philippines, Russia, South Africa, and Venezuela.

Even in countries where all taxes are paid before unsecured creditors receive a distribution, other important interests have recently been recognized as taking precedence over payment of tax claims. For example, while Japan still affords priority to all taxes vis-a-vis unsecured creditors, since 2005 tax claims rank behind instead of ahead of priority wage claims. And although all taxes still are entitled to priority over unsecured claims in Brazil, reforms in 2005 have recognized that unsecured tax claims should be paid after, rather than before, properly secured claims.

The trend toward limiting tax priorities, however, has not been universal. South Africa rejected Law Commission arguments against the tax priority out of concern for loss of State revenues in 1989 and has not revisited the issue. Hong Kong also rejected efforts of its Law Reform Commission in 1998 to abolish the remaining tax priority, based on the public interest. New Zealand recently rejected Law Commission recommendations made in 1999 to further reduce tax priorities (although it did make some adjustments intended to benefit unsecured creditors as noted above). In 2005, both the United States and France made significant modifications to their insolvency laws, but neither reconsidered its extensive priority scheme for taxes. In 2001, Venezuela changed its law to provide that all tax claims, not just those incurred within the two years preceding formal proceedings, should be entitled to priority in payment.

UNSECURED CREDITOR RECOVERIES

How will the unsecured creditors in the hypothetical described above fare in the jurisdictions covered by the III Study? Which countries are most likely to provide unsecured creditors with a substantial recovery and in which should they accept the fact that any payment at all is “better than nothing?”

In Finland, Austria, Estonia, and Germany, where there are no unsecured priority claims, unsecured creditors should have a good chance of receiving a substantial recovery, as much as

45%. Moreover, in Finland, if any portion of the secured claims is charged with a floating lien, half of that amount also will be allocated to unsecured creditors.

In Sweden, the United Kingdom, Australia, and Turkey, which grant no priority to tax claims but give priority to wage claims, general unsecured creditors can expect a 33% recovery. As in Finland, if a portion of the secured claim is a floating charge, Sweden will in addition allocate 45% of that amount to unsecured creditors and the United Kingdom will allocate as much as an additional £600,000.

Canada and Chile present the next best opportunity for recovery (25%) because these countries grant priority only for taxes that are withheld, and not for other taxes. Unsecured creditors in Argentina also can recover a similar amount because tax and other general preference claims cannot take more than 50% of the assets in excess of secured claims and other special preferences.

In Ghana, Hong Kong, India, Poland, Portugal, and Thailand, general creditors can expect to recover approximately 15% of their claims because the tax priority is limited to taxes incurred within one year (six months in the case of Thailand) before formal liquidation proceedings are commenced.

In Spain, unsecured creditors may recover 8% of their claims. Although withholding taxes and wage claims are entitled to priority, Spain changed its law in 2004 to provide that 50% of other taxes should be classified as general unsecured claims.

In the remaining countries, Brazil, China, Egypt, France, Greece, Japan, Latvia, Lithuania, Mexico, Mozambique, Netherlands, New Zealand, Philippines, Russia, South Africa, the United States, and Venezuela, on this set of facts, unsecured creditors probably are safe in assuming that any offer of payment is “better than nothing.”

CONCLUSIONS

What relevance do these developments have to unsecured creditors if the debtor has a viable business and is seeking a consensual arrangement with creditors or attempting to restructure under court supervision?

First, it is important for creditors to understand what they are likely to receive in a liquidation as a starting point for negotiating a repayment plan if the company intends to continue operations. Depending on the jurisdiction where the business is located, unsecured creditors may not have to assume that “anything is better than nothing.”

Second, in countries where the general preference or priority for tax claims has been eliminated (or limited), non-priority tax claims may be subject to the same voting rules and limitations as other general unsecured creditors, making it possible to confirm a consensual plan of arrangement or reorganization even when the taxes will not be paid in full or the taxing authorities object to deferred or reduced payment.

Third, even in countries where the tax priorities are retained, if reorganization is a goal of the national insolvency laws, it is likely that there are rules that give the debtor breathing space by staying collection of the taxes, and specifically allow consensual or non-consensual extended payment of arrearages as part of a restructuring plan. For example, in a commercial insolvency proceeding in Mexico, taxing authorities now are authorized to partially waive pre-bankruptcy tax claims as part of a reorganization plan, depending on the amount of taxes owed relative to other claims. And as part of France’s new “safeguard” procedure, tax creditors may agree to a reduction of tax debts, as well as interest and penalties. In the United States where there is an extensive set of priority rules for taxes but reorganization is favored, Chapter 11 provides that taxing authorities can be forced to accept payment of their priority claims over six years as long as interest is paid at a market rate. Similarly, even though in Japan all taxes are paid ahead of

unsecured claims in liquidation, recent amendments to the Japanese insolvency laws allow a three year grace period for payment of taxes in a reorganization plan where interest is paid.

It remains to be seen whether the trend to limit tax priorities will gain further momentum and whether recent changes to the position of taxing authorities will have a measurable impact on unsecured creditor recoveries and the ability of businesses to reorganize. The III will continue its review of this important aspect of tax and commercial practice and will closely follow the developing international trends in the area.

[*Author's Note:* Readers with experiences in countries other than those covered in the III Study are invited to share their country's position with the III by contacting the author at bkday@opic.gov. Updates of the III Study and its findings will be posted on the III website at www.iiiglobal.org.]