No Mercy for fraudsters

Nicholas McLeman considers the recent High Court case of Mercy Global and explains HMRC's various powers to pursue liabilities from directors personally

The library of case law concerning tax fraud matters is ever growing and the recent High Court case of Mercy Global Consult Ltd (In Liquidation) V Adegbuyi-Jackson & Ors [2023] Bvc 45 ('Mercy') highlights the legal recourse available to companies to hold their directors to account for fraudulent transactions.

Mercy provided umbrella payroll services for workers in the healthcare sector. The company was concerned with the provision of workers to recruitment agencies, who would then make an onward provision of these workers to end users, most notably NHS Trusts.

HMRC launched a labour supply chain investigation into the company, and it was alleged that it was embroiled in a large-scale fraud. The company's director did not fully co-operate with HMRC's investigation and so in the absence of full business records, HMRC raised best-judgement VAT assessments on the company totalling over £21 million.

Appeals were not pursued against the assessments, and Mercy entered liquidation shortly after their issue.

The liquidators expanded on the investigations conducted by HMRC by seeking third party information from Mercy's customers. It was concluded that the VAT fraud conducted by the firm was significantly more extensive than HMRC initially assessed, as customer payments had been diverted to over 25 associated entities.

The company made a claim against the perpetrators of the fraud: its former director, Adegbuyi-Jackson, on the basis that the unpaid VAT was misappropriated; and against Adegbuyi-Jackson's wife on the basis of knowing receipt and dishonest assistance; and against corporate co-conspirators of the fraud associated of the former director.

None of the defendants participated in the trial, although some co-defendants reached a pre-trial settlement with the liquidators. Those who had not co-operated and reached settlement with the liquidators prior to the hearing had been debarred from providing a defence for failure to comply with court orders.

Whilst a debarring order does have the effect of preventing a defendant from participating in proceedings, it does not mean that the case is automatically decided in the favour of the claimant. Therefore, the High Court still has a duty to consider the merits of the company's claims.

The former director's written defence which, although it was struck out once he was disbarred from the proceedings, received consideration by Judge Johns, primarily argued that VAT was not payable on the company's supplies of labour due to the 'Nursing Agency Concession'. A second argument was that if VAT was in fact due, it should only be payable on the margin, or 'profit' retained by the company.

The Nursing Agency Concession is an extra statutory concession which allows nursing agencies (or employment businesses that provide health professionals) to exempt the supply of nursing staff supplied as a principle to a third party.

The company was therefore not operating the nursing agency concession, whether it would have been available to them.

These arguments, however, ran contrary to how the company invoiced its customers. VAT was charged on the full value invoice to recruitment agencies. This VAT was duly paid to the company by its clients, who claimed the amounts as Input Tax.

Whist full VAT was invoiced to customers, these amounts were not being passed onto HMRC. Many customer payments were diverted to other companies under the former director's control, and documents were forged to disguise these diversions.

Judge Johns considered that this was not a case of a business trading without realising that VAT was chargeable and only later waking up to an unexpected VAT liability. The High Court were therefore satisfied that a large-scale labour supply chain fraud had taken place, and the former director was in breach of his duties by orchestrating the fraud.

The majority of misappropriated VAT was either paid to Adegbuyi-Jackson and his wife personally or were used to acquire assets for them. The liquidators were able to clearly trace the flow of funds which showed that the proceeds of the fraud had been used to acquire various personal assets.

Judge Johns found that "no intelligent and honest director could reasonably have believed the fraud was in [the company's] interest. Dishonesty is therefore established".

As a result, the company was granted an equitable interest in these personal assets to allow the company to recoup the full amount of its liability to HMRC in order to put the company into the position in which it would have been, had the director's breaches of duty not occurred.

Whilst the Mercy case may be an extreme example of a large-scale aggressive fraud, with very clear-cut misappropriations of funds, HMRC have for a number of years held various powers to secure tax liabilities, and to potentially pursue directors and responsible officers personally for company liabilities. Various anti-avoidance provisions that may also be in point where the relevant director/s attempt to sell or exit the business or enter liquidation in an attempt to escape liability.

HMRC as a preferential creditor

With effect from 1 December 2020, HMRC has regained secondary preferential creditor status in relation to certain taxes held by any insolvent entity.

This reform only applies to taxes that are collected and held temporarily by businesses on behalf of other taxpayers, such as VAT, PAYE, employee NICs, student loan deductions, and Construction Industry Scheme deductions.

There is no time limit in respect of debts that are due. Where any of the above tax debts have not been paid to the Exchequer, HMRC consider that it should be treated preferentially, irrespective of how old the debt might be.

This is likely to meant that, should a company commence the liquidation process without sufficient funds to settle tax liabilities outstanding as a result of a fraud investigation, HMRC will use their influence with the appointed Insolvency Practitioner to carry out investigations and to take action against the former directors.

This will mean that the director's behaviour and actions would be closely scrutinised. HMRC will remain an unsecured creditor for taxes owed by businesses themselves, such as income tax, capital gains tax, corporation tax and employer NICs.

Restructuring

If HMRC become aware of restructuring action taking place prior to the closure of a complex tax enquiry, there is a possibility that this would be viewed as an attempt to avoid any potential liabilities that may arise as a result of their enquiries or be perceived as an attempt to create a tax loss within the company.

This often likely precipitates the issue of 'best judgement' assessments and/or penalties based upon the information currently available to them to ensure any liabilities that they reasonable believe could become due are crystalised prior to any winding up or liquidation of the business.

Should the reorganisation take place before estimated or final assessments and penalties are issued, then HMRC under their powers are also able to transfer a wide range of tax debts to the Director/s who were in office during the periods to which the liabilities relate.

Joint and Several Liability Notice (JSLN)

The Finance Act 2020 introduced new powers for HMRC to issue notices of Joint and Several Liability to directors, shadow director and other individuals connected with the management of companies, where said individual has repeatedly failed to meet tax liabilities through insolvency.

These notices effectively transfer any tax liabilities of a company to the individuals involved with its management, which may result in personal assets being used to pay the tax due.

HMRC may issue a JSLN to an individual if four conditions have been met. These conditions apply to any tax liabilities relating to any period that ends on or after 22 July 2020 as follows.

Condition A is if, in the last five years, the individual has been a director of, a shadow director of, or a participator in, at least two 'old companies' that were subject to an insolvency procedure and had a tax liability.

Condition B is that a 'new company' is, or has been, carrying on a similar trade or activity to the old companies.

Condition C is that the individual has been a director of, a shadow director of, or a participator in, or is concerned, whether directly or indirectly, or takes part, in the management of the new company within a five-year period.

Condition D is that the total tax liability of the relevant old companies must be more than both £10,000 and 50% of the total amount of those companies' liabilities to their unsecured creditors.

HMRC are time limited in issuing a JSLN in that it must be issued within two years from when HMRC became aware that conditions above are met.

Should HMRC successfully issue a JSLN to a former director, they would be jointly and severally liable with the new company for any outstanding tax liability of the new company both at the time of issue of the notice, and for a five-year period following its issue.

Capital Gains Tax anti-avoidance provisions

A Targeted Anti-Avoidance Rule (TAAR) applies to certain transactions taking place on or after 6 April 2016. This TAAR treats distributions made to an individual in respect of share capital in the winding up of a UK resident company as a distribution subject to income tax, rather than subject to capital gains tax, if four conditions are met.

HMRC's view as stated in 'Spotlight 47', published on 4 February 2019, confirms that the TAAR also applies to arrangements aimed at defeating the intention of the legislation, for example by selling the company to a third party in contrived circumstances rather than winding it up.

A successful counteraction under the anti-avoidance provisions would result in any distribution made to the former director being taxed under the higher dividend income tax rates rather than being taxed as a capital transaction.

For a counteraction to be validly issued, all of the following four conditions must be met.

Condition A: the individual receiving the distribution had at least a 5% interest in the company immediately before the winding up.

Condition B: the company was a 'close company' at any point in the two years ending with the start of the winding up. A 'close company' is broadly one that under the control of five or fewer participators.

Condition C: the individual receiving the distribution continues to carry on, or be involved with, the same trade or a trade similar to that of the wound-up company at any time within two years from the date of the distribution.

Condition D: it is reasonable to assume that the main purpose, or one of the main purposes of the winding up is the avoidance or reduction of a charge to Income Tax.

Condition C is widely drafted to prevent the rule being easily avoided by changing the structure in which the trade or activity is carried out, for example by transferring the company's trade.

This condition is not only met where a new company is created after the winding up of the company in question, it will also apply where you receive a distribution and you continue to carry on, in any form, directly or indirectly, the same or similar activity as that carried out by the disposed-of business.

'Involved with' is not a defined term and it is deliberately wide in scope. Its aim is to prevent the TAAR being avoided by connected parties working together to circumvent the other conditions.

Key takeaways

HMRC has a wide range of powers to secure tax liabilities from both companies and their directors. These powers are not easily avoided as they are further enhanced in certain situations such as insolvency.

But it is not just HMRC that may be seeking payment, as the liquidators of an insolvent business have the power to recoup misappropriated funds.

• *Nick McLeman is a Tax Investigation Consultant within Simmons Gainsford's Tax Investigation and Dispute Resolution team. Email* Nicholas.McLeman@sgllp.co.uk *or call 020 7291 5650.*