

## HMRC INSPECTIONS AND ENQUIRIES – THE NEW REGIME

### Introduction

A new regime commenced in April 2009 governing the way in which HM Revenue & Customs can engage in business compliance checks and accounts investigations. The enabling legislation, Sch. 36 of the Finance Act 2008, makes greater demand on the taxpayer for provision of information and, effectively, allows HMRC to undertake statutorily authorised fishing expeditions. New and harsh penalty rules are also introduced.

HMRC officers can enter any premises (which includes vehicles and private residences if business activity is carried on there), and may inspect:-

- The premises
- Business assets on the premises
- Business documents on the premises

Business documents may be removed or copied if HMRC feels it is justified. Only 7 days notification is required (verbally or in writing) although more time is likely to be granted. The decision to inspect is unappealable and steep penalties apply for taxpayer obstruction.

### Compliance inspections

The new compliance inspections are likely to be multi-disciplinary, i.e. an HMRC officer will be cross-trained to deal with, VAT, PAYE, CIS, Income Tax and Corporation Tax aspects of a taxpayer's affairs.

Failure to have up-to-date records will also certainly prove to be damaging to the taxpayer. Steps should be taken to ensure that accounting records in particular are written up and complete if the inspection shows these to be inadequate a formal enquiry is likely to follow.

The new regime makes it relatively easy for HMRC to extend an enquiry into a business to the taxpayer's private affairs or to demand private documents such as bank and credit card statements where these can be associated with the business.

### HMRC Structures

There are a number of HMRC branches that can carry out enquiry work from dealing with senior frauds, technical areas of avoidance, and specialist units such as Construction Industry Scheme and IR35.

### How could you be selected?

- By reason of the compliance inspection referred to above.
- Computer selection based on risk analysis of specific aspects and areas in accounts.
- Specific targeting (made easier by computer analysis of all cases that are.
  - Consistently just below the £30,000 threshold for 3-line accounts.
  - Consistently just below the VAT threshold.
- The obvious use of round sum figures for stock and cash in hand.
- Sharp variations in the gross profit percentages or when compared with previous years or deviations from normative rate of gross profit for a particular trade.
- Not notifying HMRC when there has been a change in the nature of a trade (e.g. a retailer may branch into wholesale operations where gross margins are considerably lower).
- Lack of evidence of disallowances of a proportion of expenses for private use.
- Use of estimates where actual receipted expenditure could reasonably be expected, particularly for protective clothing and tool purchases.
- Estimates for such items as *use of home* and *laundry* should be calculated rather than claimed as rounded lump sums.
- For companies, director's current (loan) accounts are at greater risk of scrutiny when they are overdrawn.

### The Settlement

If an enquiry leads to additional assessments then tax, interest and penalties will become payable. However, the extent of the penalties will depend upon whether the adjustments to profits are:

- Culpable or non-culpable.
- Whether culpable additions have arisen by negligence and fraud.

Non-culpable items arise where the right amount of tax was deducted but the required declaration was not made on the tax return (e.g. bank interest paid under deduction of tax). Negligence is something unintentional whereas fraud is intentional. It therefore follows that negligence is not a minor form of fraud.

## **Penalties – the new regime**

These only apply for returns due to be submitted after 6 April 2009. The effect of the new regime will be that:

- (a) Innocent error where a taxpayer has taken reasonable care will incur no penalty.
- (b) Penalties that do arise will be considerably higher than previously.

The classes of behaviour and the penalty level they attract are:

<b><u>Nature of Inaccuracy</u></b>	<b><u>Full Statutory Penalty</u></b>	<b>Penalty allowing for maximum mitigation</b>	
		<b><u>Prompted Disclosure</u></b>	<b><u>Unprompted Disclosure</u></b>
(a) Careless	30%	15%	0%
(b) Deliberate but unconcealed	70%	35%	20%
(c) Deliberate and concealed	100%	50%	30%

### **Mitigation will be based on**

Disclosure	up to	30%
Co-operation	up to	40%
Seriousness	up to	30%

It should be noted that mitigation does not extend to the whole penalty but only to the difference between the full penalty and relevant lower percentage. Disclosure is only treated as unprompted when a taxpayer has no reason to believe that HMRC have discovered or are about to discover an inaccuracy.

There are numerous other penalties for procured misdemeanours including *timing errors* where the penalty is 5% for each year outstanding. Therefore, repeated understatement of trade receivables or under-valuations of stock over a period of years could result in a growing penalty.

**Penalties for deliberate errors can be taken from company officers where the officers have gained personally and the company is insolvent.**

## **Tax and penalties related back to earlier years**

HMRC have the power to relate back the errors found in the enquiry year to earlier tax years; up to 6 years in the case of negligence and up to 20 in the case of fraud, multiplying very considerably the tax, late payment interest and penalties demanded.

Criminal prosecution is also possible. It is therefore very important that a taxpayer's current record-keeping does not give HMRC the possibility of imposing their new draconian powers.

## **Actions a taxpayer should take**

It is essential that taxpayers act immediately to protect their interests in the following ways:

- All business records should be retained for HMRC inspection. These include records such as the business diary, delivery and despatch notes, estimates and quotations given whether or not the work was secured.
- A copy of sales invoices (preferably sequentially numbered) should be retained even if the customer does not require an invoice. In a retail trade, the till Z readings should be retained as a minimum but preferably (storage space permitting) the full till rolls too.
- Receipts should be requested and included in the business records for all business expenses. Items frequently forgotten are motor insurance, road fund licence, protective clothing and loose tool replacements.
- Evidence should be retained to support private use adjustments for motor expenses and telephone/mobile. For example a log could be kept for a representative period justifying a particular percentage disallowance.
- All bank and credit card statements, business and private should be retained including joint accounts on which the taxpayer is named. These should be filed meticulously every month ensuring that there is a complete sequence. It is expensive to obtain copies from the bank later, if HMRC demand to see them.
- In particular, it is strongly recommended that as bank statements are filed, you write a description of miscellaneous bankings so that an immediate explanation can be given when an enquiry is carried out. HMRC take the position that any unexplained deposit is undeclared business income and it will therefore attract the highest rate of penalty.
- Business records should be kept up to date. They should not be re-written at a later date from 'rough records' because HMRC place a great deal of store on *contemporaneous* (done at the time) record-keeping.
- **Insure themselves / take up additional tax enquiry protection services with a reputable specialist insurer and provider of Fee Protection Insurance or utilise their Accountancy Practice's group cover policy / services in order to ensure that any possible intrusions by HMRC will be dealt with as efficiently and expeditiously as is possible.**