

I AM BEING INVESTIGATED BY HMRC: **WHAT CAN I EXPECT?**

Since 1997, the UK personal income tax system has been operated on a 'self-assessment' basis. Taxpayers who should file a tax return have to notify HM Revenue & Customs (HMRC) that they may be liable and that a return should be issued to them.

**There are strict deadlines for notifying HMRC.
Penalties can apply if you do not act in time.**

For personal tax returns, the forms are designed in a prescribed format. This means that since 1997, HMRC have been able to model a 'normal' case for your situation, based on your location and type of business. If your figures are outside an acceptable range it is likely that you will be chosen for enquiry. Your case is also likely to be reviewed if there may have been press articles about your successes or if you have been involved with a court case, such as an employee dispute.

In some cases people have not informed HMRC of a potential liability to tax. HMRC have been informed about you by a 'friend', or have discovered transactions with you in other taxpayers' records, or through their extensive network of cross-checking information from other sources. Whatever the reason for the enquiry, it will not stop unless instructed by a tribunal or until HMRC are satisfied that you have paid the correct tax.

The fundamental approach of the UK tax system is that the taxpayer is guilty until they prove themselves innocent. It is considered your duty to prove to HMRC's satisfaction that you have paid the correct amount of tax. HMRC's published documents maintain that they will approach every situation with an open mind, but if they are able to put a case together that, in their view, casts reasonable doubt on the information supplied by the taxpayer, they have the power to raise assessments for whatever amount they consider reasonable.

For the purposes of this document, let us assume that you have notified them and completed the appropriate tax returns. After notifying you of the enquiry in writing, they will let you know what information they require. Sometimes this can be very simple and if you provide them with the information they require, the enquiry closes. However, if you are self employed, the process will be far more complicated.

For people in business there will usually be a business records review. HMRC will review the records you have supplied to ensure that they support the information on the tax return. Your tax return will show the profits that should be taxed. They will be looking to see if the records support that figure, whether the income disclosed is correct and whether the expenses are real and allowable for tax purposes.

Let's think about the expenses first. It is rare for taxpayers to miss off expenses that they could have claimed. So HMRC will consider whether the expenses are supported by receipts (and if not, why not?) It is not always possible to get a receipt, so they will look at the surrounding circumstances to ensure a claim is real.

They do not have the power to tell you how to run your business, so they cannot say an expense is not allowable because you could have done it cheaper. The test is whether the expense is wholly and exclusively for the business. For example, if you buy a rail ticket for a business journey, they cannot disallow it because you travelled first class. If the expense is not 'wholly and exclusively' for the business a fair apportionment should be allowed.

In most cases HMRC's focus is on the income of the business, so you are likely to have to prove that the sales income you have declared is correct. Your ability to do this will depend upon the type of business you have. In businesses where cash is an important aspect of the income, you will have to work especially hard to prove the figures.

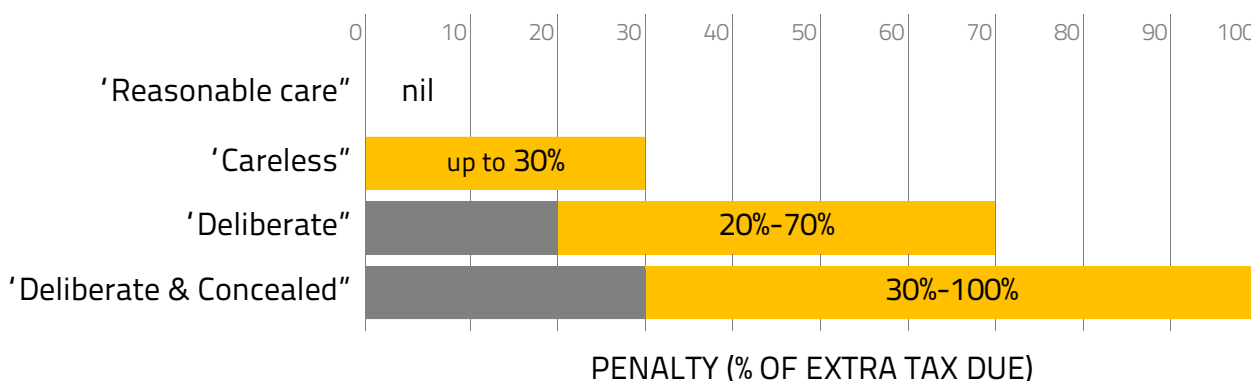
In satisfying themselves that the sales are correct, HMRC will look for unexplained bankings, whether the business has paid out more cash than it has received (including cash paid in), whether the owner is drawing enough to live on, if any till receipts or invoices are missing and whether the gross margins are reasonable for this kind of business.

Getting to know the business may take many exchanges of letters and many months – they may wish to interview you and take notes of what you say or they may wish to examine your personal records and establish if the amount you are drawing from the business is reasonable to cover your personal expenditure. Ultimately, they will form a view on the figures you have declared and either close the enquiry if they are satisfied that the original figures are correct or charge you more tax and penalties if the original figures are wrong.

In proving your innocence, it is vital that you have reliable evidence, including things that are not part of your financial records. It would be wise to keep copies of price lists or contracts. If your computer or till has problems, do not throw away incorrect print-outs, as many documents produced by electronic systems are pre-numbered and HMRC will want to know what happened to those you threw away.

Keep stocktaking records. If you are claiming part of an expense, ensure you keep an explanation of how you calculated that figure e.g. mileage records. If your business is determined by the weather, e.g. a café in a park, record what the weather was like every day. If waste materials can be a problem in your business, record what is destroyed. Take photographs of any big changes.

If they prove that an amount of tax is unpaid, they will assess how much interest and penalties you should pay. The amount of the penalty will depend on your co-operation, the amounts of tax involved, whether your error was deliberate or careless and whether you tried to conceal it. If you did it deliberately and tried to conceal it, the penalty could be as much as 100% of the value of the unpaid tax. The following illustration explains the penalty rates:



Having found errors in the tax for one year, HMRC will review accounts from previous years and they can increase assessments for many years before. In very rare occasions they will prosecute, but in the majority of cases there is a contract settlement, where the taxpayer agrees to pay the tax and HMRC agree not to prosecute.

If you think that the process is unfair, you can ask for another HMRC officer to review the figures or have an independent review from the Tribunal Service. In our experience, every client that has been through an investigation vows that they will never allow it to happen again — they improve their recording systems to prove the figures on their returns.