

CLIENTS, ACCOUNTANTS & THE TAXMAN

First Edition

Martyn F. Arthur

Forensic Accountant, Tax Investigation Specialist

CONTENTS

WHY THE INFORMATION IN THIS BOOK IS SO VERY IMPORTANT	1
A BASIC UNDERSTANDING OF THE SYSTEM	5
Example 1 - Goods for own Use	9
Example 2 - Troncs	13
THE TRADER AND THE SELF ASSESSMENT SYSTEM	15
Practicalities vs. the Complex	15
The Tax Inspectors and the Examination of Traders' Self Assessment Returns	16
ISSUES OF EVIDENCE & PROOF	19
The Responsibility of the Trader to Provide Proof that his Taxation Affairs are in Order	19
Types of Evidence and Proof	20
Firm Incontrovertible Evidence	22
Less Firm Evidence; the Balance of Probabilities	22
Incidental Evidence	23
Contemporaneous Evidence	24
Sworn Affidavits	24
Further Examples of Issues of Proof and Evidence	25
SPECIFIC ISSUES	29
General Considerations	29

Balanced Cash Account	29
Business Money, Cash	30
Business Cash Flow Tests.....	30
Cash Hoards Generally, Capital Introduced & the Potential for the Inappropriate Taxation of Cash Accruals.....	32
An Aside, The Treatment of Cash Within Different Cultures ...	33
Gross Profit Margin.....	35
A General Variation or Year on Year Fluctuations.....	35
Variations and Fluctuations, a Critical Digression	37
The General Treatment of Staff Theft	38
Suggestions of Under Achievement Possibly by Comparison with Trade Statistics	39
Wages Generally.....	40
“Cash” and “Wages” Issues	41
Benefits in Kind.....	43
Goods Purchased for Resale but Used Instead by the Proprietor for Private Consumption	45
Rates & Insurances	45
Accountancy Fees.....	46
Legal Fees	46
Repairs & Renewals – v – Improvements.....	46
Vehicle / Travelling Expenses (the Self Employed and those in Partnerships)	48
General Travel	48

Itinerant Travel	50
Telephone Expenses	51
Loan Interest.....	52
Utility Bills	52
A Distinction between Capital – v - Current Capital Expenditure	52
Current Expenditure	53
Capital Expenditure	53
Pre-trading Expenditure	54
Depreciation & Capital Allowances	54
Depreciation	54
Capital Allowances.....	55
Private use Adjustments.....	56
Extrapolation	58
Interest vs. Capital on Mortgages & Other Forms of Borrowing	60
Tips.....	61
SOME OF THE MEANS BY WHICH THE TAX INSPECTOR CHECKS SELF ASSESSEMENT RETURNS	63
Assumptions, Proof and its Burden	63
Metered Taxi Drivers	64
Driving Instructors	64
A Comparison of Living Style and Funds Taken from a Business	65

A Comparison between Staff Wages and Staff Hours Needed To Run the Business.....	67
The Simplest of Errors on Your Part	70
SOME OTHER TAX SITUATIONS	72
Capital Gains Tax (CGT).....	72
Operating Pay As You Earn (PAYE).....	72
Value Added Tax (VAT)	76
TAX INSPECTORS MINDSET, ISSUES, BEHAVIOUR REGULATION AND COMPLAINTS	79
The Mindset of the Tax Inspector.....	79
Issues and Differences at the Interface between Taxpayers, Accountants and HMRC.....	81
Tax Inspector Behaviour Regulation and Complaints.....	84
BRIEFLY, THE FAIRNESS OR OTHERWISE OF THE SITUATION	88
Upwards & Onwards.....	89
Tax Evasion	89
Tax Avoidance.....	89
Briefly what the Issues within the System are	91
TAX INVESTIGATIONS; IF YOU GET ONE.....	93
Necessary Distinctions.....	93
Interest Charged by Tax Inspectors	94
Penalties	94
Contracts Generally	95
Finally.....	96

EXIT STRATEGIES IF ALL ELSE FAILS	98
APPENDIX I	100
The Typical Trader's Day in Context	100
APPENDIX II	102

WHY THE INFORMATION IN THIS BOOK IS SO VERY IMPORTANT

From the Poll and Fractional taxes of the fourteen hundreds and earlier, through the introduction of Income Tax by William Pitt the Younger a couple of hundred years ago to the modern day, there have been many variations in the nature and method of taxation in the UK. Never before however has the system been as vexed with complexities and anomalies as today! The system of taxation as it stands today is a morass of complex rules and regulations, and unquestioned and total compliance of those rules and regulations is required by the state.

As a forensic accountant, a significant amount of my working time is spent assisting in situations where the individual trader may have quite literally done nothing intentionally wrong. His only failing may be one of not understanding what is required of him by the tax system.

The sole purpose of this book, apart hopefully from yielding me a modest profit, is to assist the trader in avoiding falling foul of the tax system, and getting into some of the horrendous financial situations that I have seen over the years. In this respect you will find that I repeatedly refer to the need to consult your accountant, something for which I offer no apology. Before proceeding further and introducing the role and importance of the accountant let me make clear that I am not in any way touting for trade. I am simply addressing the very real need for the support that businesses need.

The term trader incidentally is the generic term that I have used to describe the self employed, partnerships and company

directors responsible for their own corporate finances. Whilst many of the issues discussed herein can be seen primarily in “smaller” businesses they can, and do, although less often, appear in businesses of any magnitude.

That society should require compliance with the law is of course appropriate, but that requirement is reasonable only if an understanding of what is required is possible. In a court room situation for example, the layperson is not expected to understand and address the legal complexities himself, and legal representation is available to assist with an understanding of the procedures and with what is required. What is required of the individual in terms of compliance with tax law is every bit as complex as those court room procedures and indeed much of what is required derives from the result of issues tested in the court room.

Lamentably, as the reader will soon see, knowledge of what is required of the public is, in many respects, generally unavailable to the ordinary working man in the street! As a consequence individuals who may be guilty of no deliberate or dishonest wrongdoing whatsoever can face swingeing crippling tax liabilities running into tens, or hundreds of thousands of pounds and even more! These liabilities may accrue over numbers of years, without the individual having any idea of what is occurring!

You will soon see from the following examples that a thorough understanding of, and complete and diligent compliance with, business “bookkeeping” requirements in no way ensures that the individual is anywhere near being in compliance with what is required of him by the law. We have then a situation where it is essentially impossible for the trader, on his own, to ensure

that he is in compliance with the law, and thus safe from the kind of consequences to which I have previously alluded.

Her Majesty's Revenue and Customs (HMRC) investigates a significant number of businesses every year, some selected randomly and some for a specific purpose. In my experience the majority of those investigations result in an upward adjustment of liability, which can frequently be **very substantial**. The accountant is, to the trader, what the solicitor is to the defendant in a court case, and is the trader's main defence against potential financial destruction. The only caveat to this is that the accountant must be consulted **before** the event, before an investigation comes about and not afterwards when only a fire fighting defence is possible.

I have absolutely no hesitation in saying the accountant **must be at the very pinnacle of the trader's need to see list**. I am acutely aware of how sweeping a statement this is but please read on, and the judgement of its accuracy will be yours to make. All too often, after the conclusion of an investigation to the trader's disadvantage, I hear the completely inappropriate complaint that he (the accountant) should have told me this, or given me a particular piece of information or advice. The accountant is not blessed with a crystal ball and no matter how good he is he can but respond to specific approaches from his clients. It is impossible, and inappropriate, in the situation where a charge is made for work done, for the accountant to take the initiative and proffer advice on a client.

I have worked on the trader's side of the fence for many years and fully understand and sympathise with the substantial costs generally associated with running a business. Taking advice and guidance simply cannot and must not be skimmed on! The essential relationship between

a trader and the accountant is such that the trader's financial life is discussed fully with him so that he can assist in the planning of the record systems required. The accountant is a trader himself, competing in a very competitive commercial environment. He too has expenses and overheads, and needs to make a living. Any time spent giving advice or considering a question is properly chargeable time for which the trader should expect to pay, and promptly!

A BASIC UNDERSTANDING OF THE SYSTEM

Enough then of my thoughts, opinions and conclusions, read on please and come to your own views. This was a tricky part of the book to progress and I found myself here with something of a chicken and egg situation. On the one hand there are a number of factual matters that we need to consider in order to enable you to understand the system and what is so very dangerous about it. On the other hand I want you to be convinced from the outset how very potentially serious the situation is, otherwise you may just chuck the book out and not proceed. I am therefore kicking off with some examples of how things can, completely unintentionally, go very badly wrong.

One of the factual matters to which I referred in the previous paragraph is that it is the responsibility of the trader to demonstrate that his affairs are in order, not the responsibility of the Tax Inspector to demonstrate that they are not. I ask you to accept that statement at face value, at least for now, and read on.

Here we go then with an example. Could you ever possibly have imagined that winning a largish sum of money could represent your worst ever break? Of course not, so prepare to be dismayed.

One of numbers of types of issues that give rise to problems is the receipt of funds from non trading sources. As mentioned we start from a basic concept that the trader needs to be able to demonstrate that his affairs are in order that the he must be able to demonstrate and prove the source of **all the funds** that come

into his possession, **regardless where they come from, and that they are not even associated with the business!** There is a lot more to this requirement than meets the eye, and again as mentioned previously, it is one of the factual matters addressed later. For now I simply want to demonstrate clearly that the claim I made about how easy it is for the individual to fall foul of the system really is true.

There is a basic “rule” that receipts of money from any source that cannot be specifically and clearly identified are “taxable” regardless whether they derive from business income or not. To put this in context, and for the absolute avoidance of doubt let me quote you an extract from a letter written by the Senior Complaints Team Manager at HMRC:

“The bottom line is that if someone advances an explanation that money has come from a non taxable source then HMRC [the Tax Inspector] would expect to see some contemporaneous [“contemporaneous” is a term discussed later] and independent documentary evidence to support that....”

Did I hear some reference to a police state - just who do they think they are? Read on, please, and be prepared to be shocked!

Imagine perhaps that you decide on an evening’s entertainment on the town and end up in a casino where you indulge in a game of roulette. After a few drinks you may be more adventurous than in normal circumstances, and in a moment of madness (well I would consider it thus) you bet £200 straight on a number. It comes in at odds 35:1 which, with the return of the original stake gives you £7,200. Taking on this occasion, what some might argue as the sensible route you gamble no further and call it a day.

Perhaps you celebrate with a meal out, a night on the town or whatever and the following morning with some £7,000 of cash in hand you deposit the majority of it into your personal bank account. Over time the incident then fades from memory. Imagine then, a couple of years later, a Tax Inspector investigates your business and becomes entitled to view your private bank statements. He notes the deposit and asks you where the £7000 came from. What hope? By this time the incident has faded into the annals of history and you have absolutely no idea where the money came from. Even if you could recall where the money came from how could you possibly prove that it came from a win at the casino, who would believe you could be that lucky?

Unbelievably, as per the quote from the Senior Complaints Team Manager at HMRC above, the Tax Inspector's starting point will be that you must pay income tax on the win. He is "entitled" to assume that the £7000 is undeclared sales and that you must pay tax and national insurance thereon. The responsibility for proving where the money came from and that it does not represent undeclared sales falls entirely to you. If this immediately sets you thinking about stuff that may innocently have gone into your private account you will be far from being alone! As I said at the outset many tax settlements derive not from deliberate wrongdoing but from a lack of understanding

As if paying tax on money that isn't a trading receipt isn't bad enough the Tax Inspector may, having come to the conclusion that he has identified income that is undeclared, charge you tax on it and not content with that you will also have to pay a penalty and interest on the "tax lost".

Even then that isn't the end of it and the triple whammy is that he may also be entitled to assume that similar "under declared sales" have occurred in earlier years, even though the money doesn't represent any form of income, let alone that which is undeclared. He is entitled to make such assumptions going back for ten or even twenty years, dependent on the circumstances of the case, and similarly to charge tax, interest and penalties on nominal sums assumed to have occurred in earlier years. This is all part of the factual matters that I look in detail shortly, but for now please just accept that your "lucky win" could lumber you with an inappropriate liability of £20,000 - £30,000 in hard earned cash, or even more!

I know it all sounds crazy and impossible to believe but please resist the temptation to throw the book in the bin and conclude that I am completely crackers. I am not crackers however as you will see shortly as we go through the underlying logic of things.

There is absolutely no form of melodrama or exaggeration in any of this, it really, truthfully is how the system operates, and it doesn't apply just to a casino win either! It applies to any source of cash coming into a trader's life - loans and gifts from friends and relatives, goods sold at car boot sales - anything! You must account for and be able to prove the source of all funds that come into your life, regardless their source! I have already quoted the Senior Complaints Team Manager at HMRC's words which are clear and unambiguous, and in respect of which I make no apology for repeating:

"The bottom line is that if someone advances an explanation that money has come from a non taxable source then HMRC would expect to see some

contemporaneous and independent documentary evidence to support that....”.

The greatest defence against falling foul of the system is to be aware of the issues within it and hopefully my earlier references to the importance of the role of the accountant are now starting to fit into context. The concept of the accountant being seen as someone who does the books at the end of the year, and who costs money to consult in the interim, simply doesn't fit in with the concept of a successful business. A quick phone call asking what you could do with this lump of cash, and of course following the advice given might well have forestalled the problem.

I have included below two further examples of how easy it is for completely honest individuals, keeping perfect books, to find themselves in crippling financial situations. These examples also demonstrate the extreme diversity of situations that arise, and although they may not relate to your circumstances, they illustrate the principles of how easy it is to get it wrong and also how obscure the system can be. My ongoing recommendation, in the strongest terms is that you consider carefully the specific circumstances of your business, and then discuss them in detail with your accountant.

Example 1 - Goods for own Use

Take the phrase “goods for own use” - what are its implications? With limited exceptions if you run, for example, a retail business, whether it's a substantial wholesaler or just a corner mart, newsagent or DIY shop you must pay for any products that you take from the business stock at full retail value. If you fail to do so those goods become termed goods

for own use and your accounting records must be adjusted to account for the full retail value that you could have achieved.

The calculation of the tax liability of the business must include the profit from those goods effectively sold to you personally. This rule is not restricted to limited companies but applies also if you are in a partnership, or even a sole trader running your own shop. So if you have your own mini market and take food and drink from the business stock without paying for it you could be heading for a very serious problem. Incidentally we will address the question of how Tax Inspectors know about these things later.

In the following instance the cost of simply not understanding how to do things properly gave rise to a liability of some £50,000 and put the proprietor's and his family's entire financial future at risk. The individual in this example was, as far as I know, a completely honest one. He was a long established trader who had never had a single problem with the Tax Inspectors. He ran a mini market and complied with all the rules that he knew of. He kept a proper record book and "put all his takings through the books". At the end of the year he took his books to the accountant and grudgingly paid him a few hundred pounds to "do the tax". He did his own VAT as best he could within the parameters of the time and knowledge available to him.

The products that he bought for resale at cash and carry were pretty much the same as the public generally purchased at the local supermarket and as he himself would have purchased had he not had the shop. His genuine understanding was that he had paid for the product and, as such he was entitled to take some of it for his own use. Ironically had he sought advice and learnt how to do it properly there would almost certainly have been

no problem. It was simply a lack of knowledge and the way in which he organised himself that gave rise to the problem.

He was purchasing both the stock that would eventually be sold at retail, along with the stock that he would later take for himself, as a whole entity, as if it was all for resale, and paying for it all from “business takings”. As such it was classed specifically as business stock and intended specifically for resale at retail value. With a partner and three children however, he took stock with a retail value of the order of five hundred pounds weekly as and when he needed it, from the shop stock without making any further payment for it. His understanding was that he had paid for the stock already at the cash and carry, and what he did with it was a matter for him.

What he should have done however was to have segregated the stock at the cash and carry into business stock intended for resale, and domestic stock for his own use. It could have been done simply by using separate trolleys and paying for the element that he wanted privately from his personal money. He could then have taken it home and stored it separately from his business stock as he would have done had he purchased it from a supermarket and there would almost certainly not have been a problem. He would have been simply purchasing private stock.

Keep everything separate and make life simple! If you see an element of what you do wrong here please do not simply change your shopping habits on the basis of what you have read here. Go and see your accountant, discuss this part of the book with him and seek his advice, pronto!

So, how did such a simple slip end up with a liability of £50,000, after all it was only the profit on a few hundred pounds? Keeping the figures round and simple the calculation

goes as follows. “Extrapolation” and “penalties” are discussed briefly at the foot of the example* and in more detail later.

Average weekly profit on retail goods sales of £500.	£125
Average annual profit (£125 x 52 weeks)	£6500
Tax & National Insurance of profit for one year	£2,200
Backwards and forwards extrapolation 10 years x £2200	<u>£22,000</u>
Tax & National Insurance due	£24,200
Penalties 30%	£7,200
Cumulative Interest, (approx rate base + 3%), say	<u>£18,000</u>
Due	£49,400

*The Tax Inspector, having discovered an under declaration in a particular year is “entitled” to assume that similar under declarations have occurred in previous and subsequent years. He may then be able to project (extrapolate) the tax lost for up to 20 years backwards and even forwards in respect of any self assessment returns submitted since he started considering the case. The Tax Inspectors can charge a fine (penalty) of up to 100% of tax lost. In practice this is reduced (mitigated) for a variety of factors and in a moderately serious case like this where the taxpayer has been “persistently negligent” a net penalty of 25% - 40% would not be exceptional.

Example 2 - Troncs

For my further example I am deliberately using an even more obscure situation to drive home just how vulnerable even an honest well intentioned trader can be, hence “Troncs”, in respect of which I will happily bet my bottom dollar that no more than 1% of readers, if even that many, will even have heard of them. Don't feel too bad though as my bang up to date word processor spell checker hadn't either! A ‘Tronc’ is an arrangement to collect and distribute service charges, tips and gratuities to workers in the hotel and catering trade. Basically there is a general rule that tips are taxable, possibly on the recipient, but the Tronc situation is an exception.

The Tax Inspectors expect that the proprietor of every business within which staff accept tips will know of it, understand it and have evaluated whether their business should be involved in such a scheme! At the time of writing this I have a restaurateur facing a liability of some £60,000. Why? Because he simply assumed that his staff were responsible for their own tips yet, simply because of the method of their distribution, the responsibility had shifted to him and he should therefore have operated a Tronc scheme over time.

How could he have possibly have known that? Ridiculous you may well say, and I agree totally. The Tax Inspectors however will be keen to point out that ignorance is no excuse for breaking the law. A member of the public knows that he shouldn't park on double yellow lines, so a restaurateur should know about Tronc schemes and satisfy himself that he doesn't need to implement one. Absolutely ridiculous I say.

However none of this cursing is going to help the trader who has a £60k liability and faces potential financial ruin. We will doubtless negotiate some compromise settlement with Tax Inspectors but if just one reader is saved from this sort of mess as a result of reading this example, the exercise of writing it will have been worthwhile. The rule is very simple. Consult your accountant, discuss your business with him and seek his advice. And don't begrudge paying him for his time. The relatively small amount it will cost may well pay you back many times over! He really should be at the very top of your "want to pay" list!

This is not a technical book and it may be that the point being made is not readily clear from the example being discussed or the text generally. I have therefore incorporated, where appropriate, a summary of a particular point being made in bold italicised text. The following is an example of just such a summary:

The UK taxation system is extremely complex and it may be virtually impossible for a layperson to avoid unintentionally falling foul of it in some way. Consult your accountant, discuss your business with him and seek his advice, and don't begrudge paying him for his time, the relatively small amount it will cost may well pay you back many times over!

THE TRADER AND THE SELF ASSESSMENT SYSTEM

Practicalities vs. the Complex

The Book deliberately avoids any form of detailed explanation as to the rules and regulations underlying the issues discussed. Rather it looks at the principles applied by the Tax Inspector in conducting his duties. I understand fully that the curious reader may look for deeper explanations and there are numbers of texts that address these.

Further reading is fine from a general reading perspective. If however you are investigating anything relating to your business, as opposed to indulging in a quest for general knowledge then trying to learn about it from a book is not recommended. This is not meant in any way disrespectfully to any author. It s a simple fact, at least as far as tax is concerned, that understanding an element of a situation in no way ensures an adequate understanding of the whole. A little knowledge can be a dangerous thing and this is certainly the case as far as tax applies. There will frequently be ancillary issues that will impinge on an understanding of the whole.

For example, and in no way wishing to sound my own trumpet, I have hopefully afforded a reasonably full explanation of the situation as regards the need to prove the sources of any cash coming into your life. This book is aimed at helping you avoid getting it wrong before the Tax Inspector comes looking. As such I have not addressed in any way how to deal with a situation after the event if someone is being investigated.

As such, there are numbers of measures that can be brought into play after the event which are deliberately not addressed here. If therefore you were the subject of an investigation and looked to this book for “after the event” help you wouldn’t find it even though the subject of investigations is addressed in a number of places. Identical considerations apply to a range of topics and to cover them all in a fashion that a layperson (at whom this book is of course directed) could understand would require at least five volumes of substantially larger books. I’m sorry if I am being boringly repetitive but it all comes back to using your accountant. Even in relation to this book, if when reading it you spot a problem that you think could affect your business, be glad perhaps that the book has made you aware of it. However discuss the detail of how it might affect your specific circumstances with your accountant, **always**.

The Tax Inspectors and the Examination of Traders’ Self Assessment Returns

A very common misconception of laypersons is that once a self assessment return for a particular year has been submitted and it has not, apparently, been queried by a Tax Inspector then it has been accepted as being correct and the matter is closed. This absolutely is not the case however and not at all how the system works! When a self assessment return is submitted then apart from, for example, its receipt being noted within the Tax Inspector’s computer system it is extremely unlikely ever to come before human eyes. A Tax Inspector is under absolutely no obligation to take any action in relation to it at this point in time and may not consider its contents in any way. Remember that it is the specific responsibility of the trader to ensure that his affairs are in order. The general procedures within tax

offices do not provide for any general routine checking of data submitted.

However by not questioning the accuracy of a self assessment return the Tax Inspector very pointedly is **neither agreeing with it nor accepting that it is correct.** He is simply not questioning the information in that particular return at that point in time. It is feasible that an individual may go for many years without ever once having his self assessment return questioned and, indeed, he may never ever have a self assessment return questioned. However, as regards the general trading population this is statistically unlikely. There is a good chance that most traders, who are around for a few years or more, will have a self assessment return investigated.

The circumstances in which Tax Inspectors can decide to question a trader's self assessment return, and the timing surrounding that decision are complex and subject to numerous rules. For our purposes therefore we are going to simplify things by saying that Tax Inspectors can, in the first instance, question only a "recently submitted" return. If however they identify discrepancies with that return the way is then opened to the Tax Inspectors to consider aspects of a trader's life going back 20 years.

There are a number of different ways in which Tax Inspectors may choose to question a trader's tax affairs and, taking the simple approach again, we are going to describe this questioning process simply as an "investigation". The Tax Inspector, incidentally, does not need to give any reason as to why he has decided to launch an investigation.

Although we are not discussing investigations in any sort of detail in this book, it is important, even critical, for the trader to

understand within the context of “bookkeeping” requirements just what kinds of records he needs to keep. He needs to be in a position of strength and security in the event of an investigation into his taxation affairs so that he has not made innocent omissions that could cost him dearly. Good bookkeeping simply isn’t enough and in this context I therefore move on next to issues of proof and evidence.

ISSUES OF EVIDENCE & PROOF

The Responsibility of the Trader to Provide Proof that his Taxation Affairs are in Order

It is the responsibility of the trader to demonstrate that his affairs are in order, not the responsibility of the Tax Inspector to demonstrate that they are not. For you, as a trader, an understanding of this may well be the most important realisation that you have ever had. I make no apologies for repeating the foregoing, that it very specifically is the responsibility of individual traders to demonstrate that their tax affairs are in order. It is very definitely **not** the responsibility of the Tax Inspectors to demonstrate anything to the contrary. This can be described as the negative law of tax and an absolute understanding of exactly what this means is of fundamental importance. The lives of traders are so very, very busy that it's so easy to get into the mental attitude that "you know it's right so it will be ok", but it simply doesn't work like that!

Consider first the "normal" administration of the law. Take for example a situation where an individual assaults someone at a crowded football pitch. There are countless witnesses to the event, the police are called and the assailant who undertook the assault is arrested. Regardless that he can clearly be seen to have been "guilty" there is an ongoing assumption in law of his innocence. The State still has to prove his guilt and the assailant does not have to say a single word in his own defence. If the State fails to prove, beyond all reasonable doubt, that he undertook the assault then he is innocent of the alleged crime.

So whilst in most situations it falls upon the “accuser” to prove guilt, this is not the case with tax disputes. If the Tax Inspector “accuses” a trader by launching an investigation and questioning the accuracy of an aspect of his tax affairs the onus falls fully on that individual, the taxpayer, to demonstrate that his taxation affairs are in order and that they are as they have been portrayed by him. It is completely impossible to emphasise the importance of this! I discuss the nature of these challenges later, but for the moment I am looking from the perspective of “bookkeeping”, just what does a trader need to do to be able to demonstrate that his affairs are in order?

A principle and fundamental rule of the Self Assessment system is that it is the responsibility of the trader to demonstrate that his affairs are in order! It is not the responsibility of the Tax Inspector to demonstrate that they are not!

Types of Evidence and Proof

What is proof? This question may, at face value, seem straightforward. The following is a completely true story relating to a market trader whose takings fluctuated from day to day for no apparent reason. Almost a year after his Self Assessment Return had been submitted he was challenged by the Tax Inspectors that fluctuating takings, for no apparent reason, were suggestive of undeclared sales being taken from the business.

There was a reason of course - the weather. When it rains all day people stay at home and the market is quiet. If it is fine it

might be busy, or of course it might not. The variables are almost infinite. There are of course numerous variations in relation to wind sun and the like. **Bearing in mind that it is the trader's responsibility to demonstrate that his affairs are in order, how can he disprove a suggestion by a Tax Inspector, a year after the event, that the weather caused his sales to be "low"?** "A ridiculous concept" I hear you say, and I agree absolutely, but that is the situation we find ourselves in. The Tax Inspector is entitled to demand proof of just such situations, and I come across such ridiculous demands on a day to day basis. Given the torment that the investigation caused the trader, his book keeping now includes a narrative on the day to day weather. And you thought bookkeeping was about numbers?

Let me give you another example of a trader who opened his till 56 times in a night by pressing the no sale button. He explained that he keeps a pen in there and pulls it out when necessary. What business is that of the Tax Inspectors? The Senior Complaints Team Manager at HMRC contends that it is the trader's responsibility to prove why he opened the till that number of times. What has happened to the law "innocent until proven guilty by the state"? Do we still live in a free country?

Having set out the need for evidence we can now consider the different types. My list is not exhaustive and I must admit that the concept of recording the weather was a new one to me even!

Firm Incontrovertible Evidence

Suppose that £500 has been deposited into your private bank account on a given date, and that this was a gift from a friend who had given you a cheque. You are on good terms with this friend and he is able to obtain the cheque from the bank and let you have a copy so that it can be demonstrated with a very significant degree of certainty that the money came from him.

Nearly as persuasive of certainty is seeing from his bank statement that a cheque for £500 was drawn from and cleared through his account shortly after it was deposited into your account.

Less Firm Evidence; the Balance of Probabilities

In the last couple of paragraphs we discussed how events, for example the source of funds introduced into a business could be demonstrated with a significant degree of certainty, so that there are unlikely to be any issues in relation to it. In the cash from the casino scenario discussed earlier we considered the issue of a non-sales receipt of cash not being recorded in a trader's records. There is however yet another issue to this example, that of the proof of the source of these funds. Even if the trader recorded the win at the time how can he possibly prove that the actual source of the funds was not undeclared sales? In this respect bear in mind the earlier explanation that it is the responsibility of the trader to demonstrate that his affairs are in order. It is not the responsibility of Tax Inspectors to prove that they are not. In the absence of firm evidence

therefore, just what constitutes “acceptable evidence and proof”?

Some of us may be familiar with the concept of the burden of proof in criminal cases being the absolute one that it has to be demonstrated that it is “beyond any reasonable doubt” that what is claimed to have occurred actually did occur. Fortunately tax disputes are almost without exception settled by contractual civil settlements in respect of which the burden of proof is the balance of probabilities that your evidence is persuasive, that what you claim to have happened actually did happen. Expressed figuratively, is the likelihood that your version of events is the correct one 51% or more? There are a number of different ways of going about this. None of the following are 100% proof but it is very difficult to imagine a Tax Inspector successfully arguing against them.

In tax disputes settled by contractual civil settlements (which is all of them almost without exception), the burden of proof is the balance of probabilities that your evidence is persuasive, that what you claim to have happened actually did happen.

Incidental Evidence

This can take many forms, even the weather as we saw earlier. In the case of the casino win for example the trader could ask the cashier for a dated note, on casino headed paper, confirming that he had cashed money chips to the value of the amount. In the event of a loan from a friend a signed dated letter with the friend’s address could serve the same purpose. If

the money had been won on a day out at the races then a note of the winning horses, the odds and the amount won could be made by the trader.

Contemporaneous Evidence

If you are old enough to recall “Dixon of Dock Green” and that policemen used to carry whistles you will doubtless recall the notebook that they carried and into which all the details of an event were recorded at the time when the information was gathered. They didn’t used to do this because they had bad memories, or at least it wasn’t the main reason for doing so. It was in fact done for a very specific reason.

It is I believe reasonably well know that the human memory is fallible and that over time the recollection of events may well change. It is generally accepted that information recorded at the time of an event is likely to be the best possible in terms of accuracy, hence the policeman’s notebook. Information recorded in this manner is described as having been contemporaneously recorded. So if you are the lucky winner in the casino, for example, make a signed dated note of the event and keep it with your records.

Sworn Affidavits

All of this is very well for the future but what about if you are challenged about something that has already happened. An affidavit is a formal sworn statement of fact, signed by the originator, the deponent, and witnessed as to the authenticity of

the deponent's signature by a taker of oaths, such as a notary public or commissioner of oaths. They are very persuasive in situations where absolute evidence is not readily available.

The following is an extract from a letter from an Employer Compliance Team Manager at HMRC, Cherry Court in Hull.

“Although I would have preferred sight of service records and service and repair invoices you have provided the affidavit. The reality of the situation is that Mr H has given evidence that.....and unless I can disprove this or at least seriously discredit his evidence it would be accepted by the tribunal. In view of my observations as above I am now prepared to accept this as the situation..”

The Tax Inspector may frequently require evidence of an event. For example, in relation to the introduction of funds into a business he may “require” to see the bank statements from which he assumes the money was drawn. Evidence can however take many different forms, such as an affidavit and any insistence on the production of absolute evidence should be carefully considered and if appropriate firmly resisted.

Further Examples of Issues of Proof and Evidence

Case 1

Take the case of the public house landlady who accumulated a collection of one pound coins from her personal money, and stored them on the window sill of her bedroom as a means of

saving. When this collection reached seven hundred and fifty pounds she would bank it. Whether this was a sensible thing to do or not has absolutely nothing to do with the issue, but prima facie Tax Inspectors would try and assume that it represented suppressed sales.

When she and her husband went on holidays they employed a relief manager who stayed overnight at the pub and used the landlady's bedroom in her absence. The relief manager was able to attest that she had seen such collections on occasions when she had slept there. Even though there could be no absolute proof of what had occurred, the testimony by the relief manager was instrumental in swinging the balance of probabilities in the taxpayers favour and bringing about a successful conclusion.

Case 2

Take a situation where a taxpayer has borrowed some money in cash, and then spent it in cash on goods, but not maintained appropriate records. When the subject of a tax investigation has been shown to have erred in a particular year Tax Inspectors may be entitled to assume that if the business activity existed in previous and subsequent years then the taxpayer will have erred in those years also.

They will therefore fairly automatically project the adverse tax conclusions backwards and forwards. Say in this example the taxpayer had borrowed £4000 in one year. Then given, typically, a backward extrapolation of six years and forwards extrapolation of two years, the taxpayer is going to be faced with an additional tax and national insurance liability of the order of ten thousand pounds. Add the inevitable interest and penalties into the equation and he faces a debt potentially of the order of twenty thousand pounds!

But what has he actually done wrong? In this case he has done nothing more than borrow some money and failed to keep “proper” records. Typically the Tax Inspectors will require evidence such as sight of the lender’s bank statements to support the loan and equally as typically we realise that the likelihood of these being obtainable is negligible. If the Reader is an accountant he will know the next stage. The Tax Inspector is likely to decide that the evidence is inadequate and the taxpayer has to account for the tax due on what are perceived as being suppressed sales. There is of course the option of an appeal but, in reality how likely is it that the Taxpayer will choose to go to one. The investigation has probably been going on for ages; he has spent a substantial sum on accountancy fees, lost time in work dealing with the paperwork and just wants closure.

So what can be done to save the situation? If the taxpayer’s account of events is genuine then there may well be scope for retrieving the situation in accordance with our old balance of probabilities ally. The following are just a couple of the areas that could be considered, and there may well be others depending on the specific circumstances of the case:

- What was the nature and volume of the personal cash shortly after the loans were received? Are they suggestive of an ability to repay the loan? We might see for example relatively high personal cash taken from the business in the period following the loan. If there was a pattern of this after each loan this would be strongly suggestive to the positive.

- What was the taxpayer's bank balance at the time of the loans - in credit or overdrawn? If overdrawn, was it at the upper limit?
- We have already noted that there is no law requiring that cash funds be banked immediately! Suppose an individual accrues small amounts from personal cash drawn from the business, for example, puts his 20p pieces into a jar and banks them piecemeal. This is the kind of thing that people in self employment do. It may well be unlikely that a Tax Inspector who gets his salary paid directly into his bank account at the end of the month would save in this way.

Regardless that the Tax Inspector demands concrete evidence of a particular situation, in this example of cash transactions, the principle is always the same. Remember that the ultimate test is the balance of probabilities.

There is an almost if not entirely infinite gamut of permutations possible on the theme of verifying cash accumulations. The approach to take is to consider carefully the circumstances of the individual case, and to identify possible forms of evidence that can be used to substantiate a situation.

SPECIFIC ISSUES

General Considerations

We have considered the demands placed on the trader in terms of what the law requires of him. Specifically we have looked at his responsibilities in relation to Self Assessment, aspects of bookkeeping and the more general areas of record keeping. We now move on to a consideration of things from “the other side of the fence”. What may Tax Inspectors look at to consider whether the records genuinely reflect the trading activities of the business? We start this consideration by looking first at a selection of issues that can be questioned by the Tax Inspectors in respect of the Self Assessment Return / Trading and Profit and Loss account.

It is important to be completely clear that it is impossible to address all, or even most, of the eventualities that may arise and the examples should be taken not just de facto but to illustrate specific points.

Balanced Cash Account

There is a huge variety of books and programs available to enable you to maintain your trading records. From experience these vary from shoving all your invoices into a supermarket bag through to maintaining a comprehensive computerised record. This book is about the principles of record keeping not bookkeeping generally and I do not therefore discuss any of the multitudes of different types of records available. There is one point that I really want to drive home - the need to keep a “balanced” book.

Business Money, Cash

I realise that the whole book is about money coming in and going out but please bear with me and things will become clear. Recording the payment of money “paid out”, but which in reality hasn’t actually been paid is one of the most fruitful areas for Tax Inspectors to look.

Business Cash Flow Tests

A Business Cash Flow Test is a procedure commonly used by Tax Inspectors and in the correct context may be appropriate. It considers the running balance of cash income available to the business to meet cash expenditure, and the accruing cash expenditure. If the amount of cash expenditure up to a point in time exceeds the cash available then there is clearly an “overspend”. The business has spent cash that it cannot have without some other explanation. The running balance and cash expenditure are set to zero and the test recommences from that point in time. Any further cash overspends in the period under consideration are identified and the resultant totals demonstrate the amount of cash spent that was not technically available.

A relatively significant negative cash figure in respect of a large business with a formal Bookkeeping System would quite rightly raise questions and would very possibly lead to the identification of serious issues.

In practice however the Tax Inspectors will frequently seek to apply this test to small businesses which are the subject of entirely different procedures and record keeping systems. Take for example the proprietor of a small corner shop who visits his

local cash and carry frequently. The time when he has to pay his VAT bill is upon him, he is short of cash, and so he borrows a thousand pounds from a friend or relative. It happens frequently in this kind of industry, is certainly not restricted to it, and extends into the wider world of cash businesses.

Our trader then repays the money over time out of personal cash taken from the business. Suppose this occurs four times in the year so that he has accrued a negative cash figure of four thousand pounds over the period. The tax and national insurance consequences of this in the year are of the order of, say £1,200.

A very common mistake that traders make is to pay out money which, when the situation is examined closely, is not actually available to be spent. This happens when balanced cash records are not maintained. I return to this theme of balanced cash books on numbers of occasions and the principles really are not just important but crucial. The non technical person may not fully follow this on the first reading but it's really important and I suggest that if you are having a problem with it you come back to it over time until you understand it.

Take a situation where, at some random point, say after the takings have been banked the business has £500 cash in hand as per such records that are available. Over the next three days the business takings are £3,000, giving cash available to be spent for the 3 day period of £3,500. The records indicate that £2,800 was paid into the bank and £1,000 was spent in cash a total of £3,800 but where did the extra £300 (£3,800 - £3,500) come from? A frequent answer in reality is that the trader has under declared sales by £300 or more and then spent the cash and effectively fed it back into the business.

Cash Hoards Generally, Capital Introduced & the Potential for the Inappropriate Taxation of Cash Accruals

Within the general concept of our consideration of the accrual of cash it is important to be aware that, in so far as I am aware, there is no law in the UK that requires an individual, be he a trader or not, to accumulate his capital into a bank account. That being the case he is entitled to retain his funds in cash and to bank them as a capital item at such time as he sees fit.

If a claim to this effect is made it is of course valid for the Tax Inspectors to query the source of those funds and that goes without saying. If an individual has accrued cash funds which he then banks then it is reasonable for the Tax Inspector to be required to be satisfied as to the source of those funds and that requirement is properly inherent in money laundering legislation.

How this is tackled depends on the individual circumstance of the case. It would not be unreasonable at all for the trader to be expected to demonstrate that historically, the funds taken by him as personal cash from the business exceed the amount demonstrably necessary by an amount equivalent to that needed to substantiate his living style.

In a very simplistic example, if personal cash taken from the business were £22,000 annually and lifestyle needs could be demonstrated as £15,000 annually then a claim that he had accrued £21,000 (3 x £7000) in capital over three years might not be unreasonable.

An Aside, the Treatment of Cash within Different Cultures

It is a simple fact of life that the UK is increasingly being populated by a variety of cultures with varied ethnic roots. These can have very different conventions, traits and means of conducting their day to day activities from those of, say, the “traditional” English family (for want of a better description). It is very easy these days to fall into the trap of being accused of racism so, for the absolute avoidance of any doubt, let me be clear that I have absolutely no bias towards or against any culture, ethnic group, religion or gender. I am simply addressing the facts as they present themselves.

Within the traditional English family it would generally be extremely unusual for individual cousins and others loosely related to one another, to make substantial loans to one another in. Even in those circumstances where it did happen appropriate formal documentation would almost inevitably have been prepared, signed and be available as evidence.

In numbers of foreign cultures however, I am widely informed that the practice is very common and is indeed part and parcel of everyday life. I frequently hear of instances where an individual asks his cousin for some cash and it is simply handed over on trust and repaid accordingly. HMRC may well endeavour to attribute the source of those funds to suppressed sales, quoting various precedents in support of the action.

When we look at an exchange of cash without supporting documents in respect of a culture where such an incident is likely, and compare it with an exchange where it is unlikely, culturally, we are looking at two entirely different sets of

probabilities, and hence two entirely different sets of circumstances.

We have already considered that precedents can be properly applied only to situations where the relevant circumstances are identical in both the case under consideration and the case being quoted. We need to think carefully about this however. Clearly individuals resident in the UK are required to adhere to UK laws. The issue here however isn't about adhering to the law but its interpretation.

As noted elsewhere the Senior Complaints Team Manager at HMRC 's view is, "The bottom line is that if someone advances an explanation that money has come from a non-taxable source then HMRC would expect to see some contemporaneous and independent documentary evidence to support that no matter what the ethnicity of the donor or recipient. To seek a lesser or higher degree of evidence because of someone's racial background could, in itself, be an example of racial prejudice".

A precedent is created by reference to the specific circumstances of the particular case in respect of which a judgement is made. If the culture of those involved in the creation of a precedent case is inherently different from that of the case under consideration it must inevitably imply a difference in the circumstances which must then bring into question the applicability of the precedent.

A critical, all important point is that you account for all of the money coming in and going out in a tight balanced fashion!

Gross Profit Margin

These may be subject to attack from a number of different angles of which the following are just two.

A General Variation or Year on Year Fluctuations

We need to be clear that what we are discussing here is not fluctuations in the volume of sales, but the percentage relationship between sales and purchases. Sales volumes fluctuate for many reasons - a shop opening up next door in competition is a common example and there are many more

What we are talking about are relationships between purchases and sales. Assume for example that items such as newspapers achieve a profit of 30% - buy for £1.00, sell for £1.30. The volume of newspaper sales may vary for whatever reason, seasonal fluctuations in a seaside newsagent for example. In the summer purchases may be £10,000 and in the winter just £1,000. The relationship between the purchases and sales will however remain constant. For purchases of £1000 sales will be £1,300 representing a 30% profit. In respect of purchases of £10,000 sales will be £13,000, again representing a profit of 30%. The volume varies but the relationship between the two remains constant.

This is a difficult area and one where the taxpayer can find himself very exposed. The Tax Inspector will suggest generally, that he is entitled to assume that businesses which run on a similar basis year on year, for example a supermarket, will return similar margins year on year. Where the margins

fluctuate annually the Tax Inspector may pick on the year with the highest margin and claim that it is truly representative of the actual business achievement over time. Following on from this it follows he will almost certainly seek to assume that sales in other years have been suppressed, endeavour to increase the charge to tax in those years accordingly, and levy interest and penalties.

Experience has demonstrated however that there may be many valid reasons for these fluctuations and one of those within our experience is described below. There are of course many more and in this respect we return inevitably to the need for a careful examination of all the facts surrounding each case.

Take the greengrocer whose margin had varied year on year, in quite a dramatic fashion. Groceries, whilst having a substantial element of waste, none the less return a fairly substantial profit and the wastage on average will not contribute to the fluctuation. The situation in this case was completely straightforward and related to nothing more than changes in the trading activities whilst the business title remained unchanged.

Having started out as a relatively small village grocer the proprietor extended his activities to include canned product with a significantly lower margin, thus bringing his overall margin down. He then moved towards a more general store incorporating tobacco products and alcohol which further altered the product mix and had the effect of further reducing the margin. Newspapers and magazines were introduced, which attract a significantly higher margin and the percentage was seen to increase.

Latterly, having identified a niche market in alcohol sales relative to his location, groceries were abandoned and he

became affiliated with a well know brand specialising in the large volume retail of alcohol. Volume increased accordingly but the margin again fluctuated.

Variations and Fluctuations, a Critical Digression

Given a trader's almost inevitably busy day a situation frequently exists where he has, to a significant degree, to trust his staff in relation to money taken and stock held. Unfortunately, human nature being what it is, it is not uncommon for staff thefts to occur and these can often involve substantial amounts of money and stock. Theft is not of course restricted to staff and can occur in a variety of different ways and can involve other third parties, shoplifters for example (sometimes with the "consent" of staff) and suppliers.

I dealt with an interesting case involving a fish and chip shop where of course the potatoes contribute significantly to the profit. We checked all the usual areas - for example wastage at the points of peeling, cutting, cooking and end of shift leftovers. We were struggling to find a solution and wondered whether it possibility might be an irregularity in the weight of the sacks of potatoes being supplied.

What transpired was a real surprise. Every sack supplied was underweight by some 4kg! On checking with colleagues in the trade it became apparent that all supplies of potatoes from this supplier to other traders were similarly underweight. What is important here however is that the trader's gross profit margin was below what the Tax Inspector could demonstrate was expected, and the trader knew absolutely nothing about it.

Now then, in the same way in which a Tax Inspector can derive what a gross profit margin should have been after the event, it is relatively straightforward to calculate what the trader should achieve before the event. It is one of the health checks that every business should have, if of course the business is one in respect of which it is appropriate. It provides a bench mark against which the trader can judge the validity of his business receipts.

The check essentially involves constructing a matrix of profit attributable to each element of stock and a measure of the product mix volumes of that stock. Most accountants will be able to do this as a matter of course and we cannot recommend it strongly enough. If your accountant is uncertain just tell him to get in touch with us and we will be pleased to supply a model.

The General Treatment of Staff Theft

The Tax Inspector will take the view that if sales have been received and then stolen, for example from the safe after being recorded in the records, then the business is accountable to tax on those sales.

This however is completely distinct from theft at the point of sale where, for example in a cash orientated business the takings never even reach the till, the counter staff having pocketed them where there are strong arguments to support the contention that a charge to tax does not arise.

Incidentally, in any situation where theft is suspected it is important, for two reasons, to involve the police. In the first

instance of course there is the obvious one of crime detection. The other reason, which is more relevant from the perspective of the book, is that reporting an incident to the police automatically produces a crime report number. This can be used very persuasively in any debate with Tax Inspectors as to the situation with regard to any theft.

Suggestions of Under Achievement Possibly by Comparison with Trade Statistics

The Tax Inspectors may suggest a comparison between the margin achieved by a particular business, and that regarded as “normal” for that particular trade or industry as a means of demonstrating the income potentially achievable by a particular business. He may then go on to suggest that the amount of cash difference between the two percentages is attributable to suppressed sales. This contention should be immediately refuted. It is completely and totally unacceptable that any Tax Inspector should even seek to compare a perceived “norm”, which itself must inevitably be an average, with the actual trading results of a business.

It can be relatively straightforward to establish the margin that a business is, or at least should, be achieving. It involves the analysis of a sample of all product lines, via purchase invoices, over a defined period of time. Again this is the place for consultation with the accountant.

Attempts by Tax Inspectors to attribute the difference between the normal or average achieved by a particular industry and the actual

result achieved by a business as suppressed sales should be immediately refuted.

Wages Generally

There are numbers of different ways in which the figures in the Self Assessment Return can be challenged in relation to this.

- A direct comparison of the accounts figure with any formal PAYE records. This may be associated with one or more visits to the trader's premises by the Tax Inspector. The scope for the trader to unintentionally, and inappropriately, incriminate himself is vast and his adviser should always be present at any such inspection. Such a comparison can be a double edged sword as it enables the Tax Inspector to challenge the PAYE records themselves.
- A comparison may also be made of the percentage relationship between the sale figures and the wages deduction in the accounts having regard to the type of industry. For example a public house turning over a £million and with an annual wage bill of twenty thousand pounds just looks wrong. It potentially isn't viable (an assumption dependent for example on how very hard the proprietor and his family work). On the other hand a consultant charging three hundred pounds an hour for his time might not need much clerical support.
- The Tax Inspector can also consider the actual quantum of the wages paid which can be worked back via hourly

rates to determine how many hours were actually worked. From there it can be deduced whether the deduction claimed for wages paid adequately represents the workforce necessary to run the business. In this respect Tax Inspectors may have covertly observed the business on a particular day or days to get a picture of the number of employees there.

“Cash” and “Wages” Issues

There are many difficult issues associated with the employment of staff and keeping, or even getting, staff in the first place can be an ongoing problem for many businesses particularly (but not limited to) those in the catering and associated industries. Employees will frequently be part time and required to work uneven shifts at anti social hours as may be the case in, for example, restaurants. Finding general staff to serve, clean and the like can be an absolute nightmare. Wage levels generically tend to be low, shift patterns may be unattractive, split perhaps between day and night with a break in between in the afternoon. Employees may tend towards the younger generations, yet the busiest times when they are most needed for work may well be at weekends when they do not want to be serving party goers but want to be out partying themselves

Such employees will frequently have other jobs with little if any loyalty to the part time work and will often want to be paid “off the books”. As if the trader didn’t have enough problems this is yet another and a very serious one. In these circumstances the trader needs to find a source of cash and essentially the only one available is sales which then frequently are under declared.

An incredibly large number of traders fall foul of the system in this respect, often at great financial cost to themselves over time. This is particularly disturbing as it is a situation which can be easily overcome whilst **remaining completely within the parameters of the law**, and avoiding all the consequences that follow from not doing so. What is required is the application of lateral thinking and common sense.

The employee wants to receive a sum of cash in his hand. Take the case of an employee say who wants to receive the full sum of £6.00 hourly cash for his 10 hour casual weekly shift. This sums to £60 weekly. It isn't a huge amount but if there are 4 staff members this goes to £240 weekly. Even this may seem relatively trivial to the trader on a week to week basis, bearing in mind that many, many businesses are run hand to mouth and there may be little scope for significant ongoing thought to the future.

The weekly sum of £240 in our example however sums to £12480 annually and over six years amounts to £75,000. If the trader gets caught after six years he will owe tax interest and penalties of the order of £30,000 - £40,000!

There is however a straightforward alternative which enables the employee to receive the "cash" in hand of £6.00 hourly whilst the employer avoids breaking the law. It simply involves going to the accountant and asking for him to set up a PAYE scheme and "grossing up" the wage so that he can pay the employees the net cash of £6.00 hourly on the books that they want, without storing up future problems for himself. An added bonus is that the trader also gets tax relief on the payments. Without getting into the calculations the approximate gross

equivalent is £7.50 which is the equivalent of £300 weekly for all 4 staff.

But, and it's a very big but, the trader gets tax relief on the wages paid.

- If he is a basic rate taxpayer paying tax at 20% then the weekly tax relief is £60, reducing the cost difference to nothing.
- If however he pays tax at 40% his tax relief is £120 weekly, so he is actually £60 **better off**.
- The employees are happy (or at least as happy as employees ever are in work) and are getting their cash in hand.

Employer's and employees' national insurance payments are not due in this example incidentally because the amounts being paid are below the weekly limit. Unlike tax, NIC is work specific and entirely separate employments achieve separate exemptions of £100 or so.

Benefits in Kind

The question what constitutes a taxable benefit really is a minefield and even an overview of the detailed technical issues associated with it extend well, well beyond the scope of this book. I can however sketch out the issues and point you in the right direction. Basically benefits are goods and services provided to a recipient free or at significantly reduced cost, for tax purposes essentially, as a result of their employment. They can vary in value from a beef burger, the provision of an aeroplane and beyond - the sky being the limit so to speak.

The main issue with them is recognising that you are actually paying them and then determining whether they are taxable. Take, for example, the proprietor of a large and very busy restaurant who had provided accommodation for his head chef, something he had been doing completely innocently for some ten years. It was “necessary” for him to provide accommodation for the chef because it was a condition on which the chef had insisted before he agreed to work for him. The trader had consulted his tax office at the outset when it had been confirmed that if the provision of accommodation was “necessary” by virtue of the nature of the employment then it was not taxable. What the trader had failed to learn was that “necessary” has a clear definition within tax law and provision at the chef’s insistence may be necessary for the trader, but not for tax purposes.

We will never know whether the tax office failed to explain the situation properly or whether the trader failed to understand an explanation properly given. The point is that, even knowing what questions to ask does not in any way ensure that the correct understanding will derive from asking it!

There are many, many examples of benefits and arguments about what constitutes one that is taxable are long, varied and ongoing. You supply a jeep for example to someone who may be called out at night and need to use that specific vehicle. You specify that he can drive it to and from home but not use it in any other way privately. Yes he has the benefit of a free vehicle for home to work transport, but he needs the jeep to be able to do his work. Is the provision taxable, what’s the answer, you see the problem? If therefore you supply any form of non-monetary items to members of staff, make a list of them and

ask the accountant what the situation with regard to each of them is.

Goods Purchased for Resale but Used Instead by the Proprietor for Private Consumption

We have addressed a detailed example of this issue earlier and it is not repeated here. If you need to refresh your memory this may be a good time so to do. An almost inevitable question is how can the Tax Inspector find out about this, and anyway how can he demonstrate it? It's simple enough. He may decide simply to sit anonymously outside in a car and observe events, and discreetly take some photographs of food being taken and no cash being put in the till.

Rates & Insurances

It is not uncommon for the private and business elements of these not to be clearly distinguishable. In these circumstances, for example where the business and private items may be shared, respective costs may be paid as one item. It is therefore essential that the accountant knows just which element of an expense claimed is private and which is business.

Traders may sometimes be tempted to describe elements of private expenditure as relating to business but it is simply a no go area. Any experienced Tax Inspectors will rapidly spot an exaggerated claim from a number of factors within his experience. These include but are not restricted to his

knowledge of the business, the size of the business and the size of the amount claimed.

Accountancy Fees

These are generally deducted in full if they are business related. There is an exception however in that accountancy fees associated with a tax investigation can be set against tax only if the trader demonstrates that he has not erred and the Tax Investigation is closed without any adjustment being made by Tax Inspectors to the trader's tax liability.

Legal Fees

The rule here, as elsewhere of course is that expenses incurred running a business are deductible. Costs of recovering debts and the like are generally deductible, but one area where I have seen a number of slips is in the acquisition and renewal of leases. If you acquire a property and then start trading you are acquiring it in order to be able to trade, not in the process of trading. As such the legal fees incurred in relation to the acquisition are **not** tax deductible. If however you are already trading and you acquire a property in order to continue trading the legal costs are tax deductible. Please be aware that the foregoing is not restricted to legal fees and can apply in relation to other costs.

Repairs & Renewals – v – Improvements

It is unfortunately a very common misconception that if money is being spent “repairing” a business premises then this will automatically qualify for tax relief, but this is not necessarily

the case. The reason for this is that what the trader may regard as a “repair” may be classed as an improvement by the Tax Inspector for whom the definition of repair has a very clear meaning for tax purposes, and is one that is completely distinct from its day to day usage.

In this respect I can comfortably quote from the tax office’s inspectors’ own instructions to its staff,
 (<http://www.hmrc.gov.uk/manuals/bimmanual/BIM46900.htm>)
 :

“
BIM46900 - Specific deductions: repairs & renewals: contents

... 'repair' means the restoration of an asset by replacing subsidiary parts of the whole. No significant improvement of the asset beyond its original condition can result or there will no longer be a repair

The cost of a repair is normally revenue expenditure but the cost of replacing the asset or of making a significant improvement to the asset as a whole will be capital expenditure [and will not qualify for tax relief].
 ”

I am including a couple of examples, but they are illustrative only and even if you have a situation which you perceive as identical to one of them check it with your accountant first.

- In the case of a high street shop:

Replacing what is already a “shop front” window that has been badly damaged with another shop front window of the same specification is classed as a repair.

Replacing it with a similar window of a higher classification may be classed both as a repair and an improvement and only the part of the cost relating to the equivalent would be allowed.

Repairing by replacing an “ordinary” house window with a shop front window may well be considered improvement.

- In the case of a badly damaged slate roof being repaired by renewing it with a tiled roof the situation may not be clear. Slate may be more expensive, but tiles may be regarded as more durable.
- Replacing a section of a damaged wall with a door may be an improvement, but if the cost thereof is less expensive than repairing the wall it may be allowable.

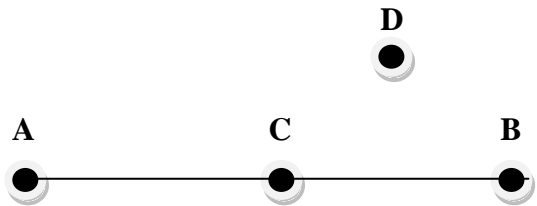
Vehicle / Travelling Expenses (the Self Employed and those in Partnerships)

General Travel

The starting point to this seems very straight forward but it hides a vast area of potential stress, confrontation and cost. The basic rule is that if you need to travel in the course of your business you can claim tax relief. This is a summary of a more complex form of words which I am not repeating, because even the words themselves have a myriad of interpretations.

Take the simple case of a trader who lives at point A, has a lock up newsagent's shop at B and uses the cash and carry warehouse at C which is en route to the shop. There is another cash and carry that he sometimes uses at D, a little off his main route to the shop. This is shown diagrammatically at Diagram [a]. Let's have a bit of a quiz, if you get all the answers right you are on fairly safe ground as regards this topic. Which of the following trips qualify for tax relief?

Diagram [a]



1. A \rightarrow B Going to the shop in the morning.
2. A \rightarrow B via C to collect goods for the shop
3. A \rightarrow B Going back to work in the afternoon after taking the kids to school
4. B \rightarrow A via C specifically to return some unwanted stock on the way home.

Well? The answer is none!

1. This is simply driving to work in the morning.
2. This is simply something that he is doing en route to work
3. This is simply driving back to work
4. This is simply something that he is doing en route home.

In respect of 2 and 3 although there is a business aspect from the proprietors perspective, from Tax Inspectors' perspective that is incidental to the main purpose of getting to and from work, something done on the way, en route.

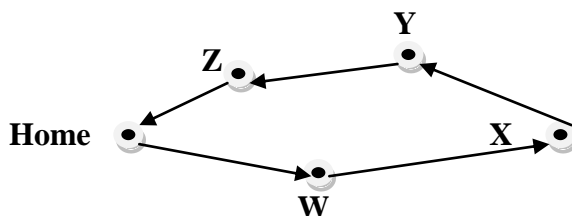
If he had travelled from A → B and then done a trip from B (back to) → C and back to collect stock then B → C would qualify because it was business specific and there was no private intention.

Likewise had he travelled from A → B **via** D specifically to collect stock then that leg of the trip that incorporated the extra distance to D would have been business specific. As such the additional mileage (note, **only** the **additional** mileage) between B and D and back would qualify for tax relief.

Itinerant Travel

An itinerant trader is one who travels from home to a number of different locations for the purely temporary purpose of completing a job there, at the conclusion of which they attend at a different location. A typical example would be a jobbing builder (see <http://www.hmrc.gov.uk/MANUALS/bimmanual/BIM37620.htm> for more information).

The principle here, again, is that home to work travel is **not** allowable so that the trip to the first site and the one from the last site home is not allowable. There is however an exception in that if “home” is the official base of the business it may be possible to claim for the whole trip. The trick of course is getting home defined as the base, or even arranging things legally so that it becomes the “base”. This again is shown diagrammatically at Diagram [b].

Diagram [b]

No more quizzes I'm afraid. The trip from home to W and the final trip from Z home is not tax deductible. So now you have to keep a record not only of the mileage travelled, but the routes taken and the order in which they were taken, bearing in mind the eternal need to be able to prove whatever it is that you state. Our bookkeeping chore becomes one bit more demanding - perhaps we should attach a video camera to the vehicle to keep record of journeys! This comment is not to be taken literally, I think?

Telephone Expenses

There are frequently situations, usually in smaller businesses, where there is no specific business telephone and one line serves both domestic and business purposes. It is perfectly acceptable for tax relief to be claimed on the business element. Consult your accountant as to the best way of working this out.

I come across cases sometimes where traders haven't claimed a proportion of the cost of the telephone bill because it's a "private line" and not a business phone. It makes absolutely no difference what your arrangements with the service provider

are; it is the use to which the telephone is put that determines whether tax relief is due.

Loan Interest

Similarly to the foregoing, who supplies the loan and the terms of the loan are generally irrelevant and it is the use to which the funds are put that is the determinant. Similar conditions apply even to private credit cards, if they are used for business purposes then that proportion of any charges and interest incurred are available to offset against profits..

Utility Bills

There is little if anything to be said here. If you pay them in the course of a business then they are tax deductible.

A Distinction between Capital – v - Current Capital Expenditure

“Capital” in monetary terms may well be thought of as a sum of money deposited, for example, in a savings account. For tax purposes the term capital expenditure roughly describes the nature of the item on which the money is spent. Even then there are some contradictions but the following addresses the

main issues that I wish to clarify and your accountant will be able to explain any distinctions that need to be made.

Current Expenditure

First off then, current expenditure is money that is spent on the day to day running of the business - vehicle expenses, staff wages and insurance to mention just a few. It is money that is spent specifically in the day to day running of the business. There are technical terms but I am studiously avoiding getting into them. Current expenditure that qualifies for tax relief is generally set against tax in its entirety in the year in which it is spent. So, if you incur current expenditure of £10,000 in year X and you are otherwise liable to tax at 20%, your tax bill for year X will be reduced by £2,000 (£10,000 x 20%).

Capital Expenditure

“Capital” in monetary terms may well be thought of as a sum of money deposited, for example, in a savings account. For tax purposes the term “capital expenditure” relates to the purchase of a fixed asset. It isn’t a straight forward concept to explain accurately because there are many exceptions and contradictions. Think of it as expenditure on substantial items that are not resold.

Pre-trading Expenditure

By pre-trading expenditure I mean expenditure incurred in setting the business up. A common situation is one where the taxpayer believes that having spent a substantial amount of money setting up a business he will not be called upon to pay any tax until the expenditure has all been offset against income subsequently received. Unfortunately he is in for something of a shock as “pre-trading” expenditure is not generally tax deductible although there are, as is frequently the case, exceptions.

Depreciation & Capital Allowances

As previously noted depreciation is an item proper to both the Profit and Loss Account and the Balance Sheet. It isn't relevant to the calculation of tax as such but I need to touch on it to explain why not and it is discussed here in association with Capital Allowances.

Depreciation

Depreciation can be described as the decrease in the value of an asset due to obsolescence and / or use. In relation to accountancy the calculation of depreciation has a function to play in relation to “larger” businesses where keeping a record of the “wearing out” of plant machinery and vehicles is very relevant to the business itself. Take a haulage company for example with a need to retain an ongoing fleet of say 200

useable vehicles. Working out the residual value of the fleet plays an important ongoing part in making financial provision in its planning for the replacement of those vehicles as necessary.

In the case of relatively small businesses, say a shop, the value of the fixtures and fittings is pretty much irrelevant, they are there and there they are going to stay. It is however part and parcel of accountancy practice and is used by accountants as a matter of course, even though there are no tax implications flowing from it.

Tax relief may nonetheless be available in respect of capital expenditure on vehicles, fixtures and fittings and similar items purchased for use in the business but the medium of calculating this is via capital allowances to which we now come.

Capital Allowances

The best way of kicking this section off is by reference to an example. Take a situation where a business proprietor purchases a piece of equipment costing £10,000 which is to be used exclusively for the business. We have already considered that depreciation is a paper keeping exercise that does not provide for tax relief so how does the trader get the tax relief in respect of his outlay. He obtains the relief by means of Capital Allowances which give relief on a year on year reducing balance. The following example is intended to illustrate **only** the principle underlying how this is worked out. It should not be applied by the reader to any real life situation because there will be circumstances where this method may apply, and circumstances where different principles will apply:

Day 1 of Year 1 trader purchases a qualifying capital item	£10,000
Tax Relief Year 1 (25% of cost (in this example))	£ <u>2,500</u>
Carried Forward to year 2	£ 7,500
Tax Relief Year 2 (25% of remaining cost (in this example))	£ <u>1,875</u>

The point to be clear about is that all day to day qualifying expenditure is available to reduce the tax liability in the year in which it is spent. In relation to qualifying expenditure on “one off” capital items the tax relief may be spread over a number of years. This can have very important implications for a number of considerations including, for example, cash flow planning! Do NOT assume automatically that everything you spend will be available to offset against tax and reduce your liability in the year in which it is spent!

Private use Adjustments

The foregoing brings us conveniently onto the subject of private use adjustments. These are very common and easy areas of attack for Tax Inspectors and upwards adjustments of profits are commonly sought. It is not uncommon for business assets which have been purchased through the business to be used privately by the proprietor and family members. Cars, telephones and computers are just three examples of the kind of assets involved.

If a business asset is being used partially privately then not all of the expenditure on it is tax deductible. Take for example a publican, who purchases a car for use in the business. This may typically be used to collect non-delivered products from the cash and carry or whatever. The car may also be used to take the daily takings to the bank, attend business meetings and the like. If the car was only ever used for business purchases then the total cost could be written off to tax.

More typically however the vehicle will be used for shared business and domestic purposes in which case there is an element of private use and the expenditure that relates to private use is added back in what is called the tax computation. A tax computation is a separate calculation prepared by the accountant, and it does not need further discussion, particularly as we must not lose sight of the private use issue.

Until now the typical trader reading this book would have left it to the accountant to do the best he can in estimating how much private use the trader and his family make of the shared assets. It's an impossible task and typically the accountant will add back a nominal sum of, say, 25%. This is done because if he asks the trader how much private mileage he does the almost inevitable response from the trader is that he doesn't know, he hasn't got time to work it out and the accountant should calculate the figure! I know. I've been there countless times.

It isn't a satisfactory situation but it is one that we accountants have learned to live with over many years. For the Tax Inspector it is of course a potential bean feast, and I have heard it said that if he wants to look at earlier years but can't find anything wrong with the accounts he will certainly be able to

find something in the private use adjustments. I personally would not of course dream of making any such suggestion!

Private use adjustments aren't restricted to vehicles of course and are applied to any expenditure that is shared between the business and private sides. This could refer to power, insurance - literally anything that can be shared. There is little more to be said about this other than to repeat the now much repeated statement about proof and the fact that the trader has to prove that the adjustments made have been correct, not the other way around.

Extrapolation

In relation to Tax Inspectors extrapolation means the extension backwards, forwards or both of additional revenues that are estimated to be due in respect of additional years. The extrapolated figures are based generally on the calculated figure of liability for the year of the Tax Dispute, adjusted in line with one or other of the various inflationary indicators that have appeared over time. With the exception of those cases where defalcations can be demonstrated as having been a one off event Tax Inspectors will inevitably seek to impose the extrapolation of additional liabilities, these days for increasingly extended periods.

This method of addressing earlier and subsequent years is not in any way set in legislation as the only way of addressing other years and is definitely not mandatory on the taxpayer. It is the Tax Inspector's shortcut solution to ending Tax Disputes quickly. Backwards extrapolation in particular can be a significantly expensive part of a Tax Dispute because of the interest charges that will have accrued over time. In severe

cases where the extrapolation goes back for extended periods the interest charge may even exceed the tax due!

Proposals by Tax Inspectors to extrapolate duties should never be accepted without first checking that they are appropriate. There are two angles to consider in considering this check.

1. Has the taxpayer erred in other years at all?
2. If the defalcations stem numbers of years, are the actual amounts in respect of those years likely to exceed or be less than the proposed extrapolated figures.

If the answer to 1 above is no then the approach is simple enough, review the year before and the year after to encapsulate the Tax Dispute year and provide closure. If the answer to 1 is yes then we default to 2 and consider the extent of the review necessary having regard to likely differences and the potential cost to the client of so doing. Each case must be considered on its individual merits.

The method of review is straightforward enough. To conduct a full review of the whole of the activities of an alternative year or years would be expensive. It would also become increasingly difficult the further back we go, as the availability of records and accurate data inevitably reduces with time. The method generally that we recommend is to carry out a comparison only of those issues that have featured in the determination of the additional liability. Tax Inspectors may disagree and seek a wider exercise. The solution to this is that the proposed extrapolation itself relates to specific areas and that it is both inappropriate and inequitable to extend matters further. If the Tax Inspector continues to object one way of proceeding is of inviting the Tax Inspector to undertake the

review himself. That he will continue his objection is unlikely and I have never known it to happen. Be aware though that we have no means of preventing him from so doing.

Interest vs. Capital on Mortgages & Other Forms of Borrowing

Although technically it should be obvious that there is a clear distinction between interest payments and the repayment of capital we reside in a real world and not a technical one. Many business people and potential entrepreneurs are ordinary men in the street who are prepared to take a risk but may simply not have a technical understanding of things. Alternatively, in the “real” world it is very, very easy for individuals to get swept away with what they see as the potential for a big financial killing and to lose sight of reality.

It is not uncommon for individuals who, for example, understand clearly the distinction between the repayment of capital on a mortgage and the payment of interest on the outstanding balance, yet too easily lose sight of that distinction in relation to tax. It is not uncommon to hear someone say, in relation to a property that they are renting out, my rent coming in is £10,000 and my mortgage going out is £10,000 so I am not making any profit to pay tax on.

So, for example, take a situation where an individual borrows £100,000 on 100% mortgage to purchase a buy to let property. The loan is to be repaid over a relatively short period with annual repayments of £14,000 in respect of which £5,000 is interest, and £9000 is capital. The rent for the property in this example is £14,000 and it is so very common for the trader to have based his assumption of £14,000 going out, £14,000

coming in, tax to pay = £0. Neglecting any other expenses for the purpose of the example, there is in fact an annual tax liability of £1,800 on the part of the repayment which is capital. If there is just one property in question this may (or indeed may not) be a mistake which can be lived with. If however the trader has purchased ten properties and this figure thus becomes £18,000 this may present a very different situation.

Now frequently (not always) the businessman's perspective is that he is paying, say, £4000 out annually "for" his property which equates to the amount of income obtained and that he is therefore not going to have a tax liability. I have dealt with numbers of cases, the numbers of which increased sharply in years leading up to the "credit crunch" of 2009 where individuals have purchased large numbers of properties on just this basis.

Tips

Tips are a very vexed subject worldwide. In Florida for example tipping is pretty much compulsory, so much so that in some industries an individual's income is derived solely from the tips that he receives. The government makes an automatic assumption that the individual has received them and taxes them automatically. I was made aware of this very forcibly the first time I took delivery of a takeaway meal, paid for it and thanked the guy who delivered it and closed the door. He hammered on the door until I reopened it and made it clear in absolutely no uncertain terms that he wanted to be "paid" his tip and that he would take the meal back and a piece of me with it if I didn't pay him.

The situation in the UK isn't that bad but Tax Inspectors certainly make assumptions that individuals working in an industry where tips are traditionally paid will have received at least some tips. If an individual hasn't received them it is then down to that individual to prove that he hadn't received any tips, a tall order to say the least!

So tips are definitely taxable income, and the question of who pays the tax is one for the trader (and his staff if he consults them) to decide. Where the liability lies is determined substantially by how the tips are collected and we touched on this early on in relation to Troncs. It's the usual situation of needing to take advice from your accountant and get a system set up that you know is appropriate for your circumstances.

Tips attract a tax liability. If yours is an industry where tipping is traditional you may feel it best to arrange that tips are collected individually by staff members in cash. This is however not a straightforward situation and advice from your accountant is essential.

SOME OF THE MEANS BY WHICH THE TAX INSPECTOR CHECKS SELF ASSESSEMENT RETURNS

Assumptions, Proof and its Burden

I made a point at the outset of emphasising the negativity of Taxation Laws, and the fact that the onus rests with the trader to demonstrate the accuracy of his tax returns and that they are in order. There is in fact a fairly serious exception to this general rule but I did not allude to it at the outset because I neither wished to detract from its importance, nor confuse the issue. An explanation of this exception is however now very contextually relevant. As I explained at the outset the onus is on the taxpayer to demonstrate that his records are accurate, but at what point has he complied with that responsibility?

I haven't lost sight of the fact that this book has been written for the layperson, but this issue is extremely important and it is essential that the situation is understood as clearly as possible. Tax disputes can result in settlements of tens or hundreds of thousands of pounds or even more and it is essential that the trader understand the context of things! The following represent just a few of the "tools" available to the Tax Inspector. If I were to set one rule before all else to be considered it would be that it simply isn't worth fiddling your tax. As discussed elsewhere by all means look for legitimate means of reducing your liability. Properly planned there are still numbers of these around but, as you have seen, the system

is simply too tight and harsh for you to risk the consequences of abusing it!

Metered Taxi Drivers

A not uncommon situation may be where the taxi driver claims more fuel costs than have actually been incurred. Possibly friends or relatives are supplying him with their receipts or he may claim for cash expenditure for which he doesn't have receipts. The idea is that the greater his expenses the less apparent profit in respect of which he will be called upon to pay tax. These overstated fuel purchases can actually have the opposite effect, and suggest clearly that sales have been under recorded.

Here there are a number of known relevant facts. The average mileage per litre of the car in question can be reasonably estimated, the cost of fuel is known and from that the Tax Inspector can multiply the two together and come up with an estimated, but reasoned, calculation of the number of miles likely to have been driven in the period in question. The private mileage can be derived from the tax computation submitted by the accountant. From this the Tax Inspector can to a reasonable degree calculate the likely business mileage driven and multiplying this by the mileage rate (which may also vary with the time of day etc) he can suggest a likely figure of sales at variance with that declared by the trader.

Driving Instructors

The issues in principle here are similar to metered taxis and relate to fuel expenses. They revolve around the cost claimed

for fuel and the length of the journey to collect and drop off the pupil, distances covered in the tuition and the like and the distance of private mileage disallowed.

A Comparison of Living Style and Funds Taken from a Business

I mentioned previously the issue that the interaction with the Tax Inspector is a battle, with an unequal balance of power. The Tax Inspector can attack you for having “too much” cash, and we will now consider the alternative, how you can be criticised for “not having enough” cash. Understand please first of all that in the case of a limited company funds will generally be drawn by the proprietor in the form of wages, benefits and dividends. Where the proprietor is self employed or in a partnership they are simply classed as personal cash taken from the business. For our purposes here we aren’t concerned by which “legitimate” method the funds are taken from the business, simply the amount of funds that there are.

An examination of the amount of money taken from a business, along with other sources of money available to the proprietor, is a method frequently used by Tax Inspectors to consider whether sales have been under declared. It considers not the level of sales themselves, but the availability of funds available to sustain the proprietor’s lifestyle.

In the first instance the Tax Inspectors will obtain the taxpayers personal records, bank statements and any other details about what the taxpayer pays for outside of the business. He will draw up a matrix of the taxpayer and his family’s personal expenditure through the bank, mortgage, loan payments, credit card payments and the like. Let us assume that this sums to

£20,000. The Tax Inspector will then consider what cash the taxpayer spends - perhaps on newspapers, going out for a drink and the like. Let us assume that this sums to £12,000.

A comparison is then made between the total expenditure of £32,000 (£20,000 + £12,000) and the total funds available to him generally, as drawn from the business, and from other sources such as, say, Social Security benefits and his partner's income. Let us assume that this amounts to £24,000. The Tax Inspector is entitled to assume, even though there is no evidence of under declared sales, that sales have been under declared by the difference £8,000 (£32,000 - £24,000) and the taxpayer can be required to account for the tax thereon.

During the course of the dispute he may well ask you to complete a detailed schedule of your outgoings, which is your opportunity to present a reasoned picture of a situation. Be very careful how you fill this in. Specifically do NOT understate anything simply because you think "he" may not believe you.

There may be even deeper probing. Did I hear some reference from you to a Police State? Take one situation where the personal cash taken from the business was adequate for all the expenditure recorded. Looking further the Tax Inspector perceived that there was no apparent expenditure on household food, Tesco bills and the like. His conclusion therefore was that cash of £200 weekly from under declared sales had been used to fund the family's "domestic" life.

The taxpayer was adamant that everything was properly declared. He gave his wife, who was not involved with the business and wanted to know nothing about it, the household money and she looked after the bills. I had never met with or spoken to the taxpayer's wife. The situation was dire! There

was no apparent explanation and he was facing an overall liability over time approaching £100,000. It was only in chance casual conversation that he mentioned that it was the second anniversary of his mother-in-law's death and that his wife was particularly upset as she had lived with them for some time prior to her death.

The dispute related to a period some three years previous and there of course was the answer! The taxpayer's mother-in-law had shared the household expenses and helped fund them from her state pension and that of her late husband along with her personal savings. There was no immediate evidence of the source of cash and it was necessary to ask the taxpayer to rake through her late mothers records to establish this. Such was the depth on big brother's intrusion into the family's life. Is this appropriate?

A Comparison between Staff Wages and Staff Hours Needed To Run the Business

Another common one this and again it really is nothing to do with bookkeeping but as you will see after the example it is a situation where given the negativity of tax laws it is so very easy for a business to be in an extremely adverse situation. Take a situation where we have a staffing need of four people daily. It's a hairdressing salon open 9.00am to 5.00pm five days weekly. The weekly wages shown are £700. The Tax Inspector will seek to reconcile the wage bill with the number of staff hours worked in a particular period. The calculations undertaken by the Tax Inspector will be as follows:

Opening hours	8 hours
Days of opening	5 days
Weekly hours worked per person (8 x 5)	40 hours
Labour force	4 people
Total paid hours worked weekly (40 x 4)	160 hours
Tax Inspector assumes the Minimum Hourly Rate, say	£6.00
Wage bill “inevitably” needed to staff the salon (160 x 6)	£960
Weekly difference (£960 - £700)	£260

By “demonstrating” that the trader must have paid more staff than he claimed to have paid the Tax Inspector is in effect making a statement that the trader has under declared his sales revenue and used that money to pay additional “cash” wages. The Tax Inspector’s inevitable conclusion would be that the trader is under-declaring his sales, in respect of wages alone, by £260 weekly and he would call upon the trader either to demonstrate that his assertion was incorrect or to pay the tax on the additional undeclared sales revenue.

The Tax Inspector is making an assumption that all the employees are being paid at at least the level of the minimum wage and his conclusion is based on that. It is an assumption however that he is simply not entitled to make and the “conclusion” drawn from it is untenable. We will always return to the concept that his job is to make an objective judgement

about the facts in front of him. The moment he puts himself in a situation where he makes an assertion “I assume that the minimum level of wage is in payment” then he must be called upon to substantiate it, and demonstrate that what he has said is likely on the balance of probabilities to be true. But what evidence does he have to persuade an appeal tribunal. Nothing per se, it is a pure assumption without any basis whatsoever.

The moment the Tax Inspector puts himself in a situation where he makes an assertion such as “I assume that the minimum level of wage is in payment” then he must be called upon to substantiate it, and demonstrate that what he has said is likely on the balance of probabilities to be true.

Additionally he is making a further assumption that everyone working at the salon is a paid employee. He is also making the assumption that everyone working at the salon is actually an employee of the salon. What about family, friends, models and trainees? I had a case of a fish and chip shop where, on a Friday night when the Tax Inspector came (covertly actually, sitting secretly in a car with a colleague), there were 5 people behind the counter. Of these 5 the proprietor, experienced in the ways of Tax Inspectors and therefore with adequate sustainable records, was able to demonstrate beyond doubt that three of the “employees” were unpaid relatives. The phrase “egg on face” comes readily to mind and this I suspect is very much a situation where the taxmen will not cometh again for quite a while.

Another common ploy, in circumstances where the taxpayer didn’t realise that he “had” to keep records of people who weren’t employed, as well as people who were employed, is to

produce a sheet of paper and ask the tax payer to list the current employee situation so that he can compare the current actuality of the workforce with a historical situation. There will be situations where this kind of exercise is both acceptable and useful, for example where records have been lost or destroyed and we are trying to reconstruct a data situation by reference to the best means available. To do it in a situation such as this where the trader is being asked to justify his factual records, in a situation where a Tax Inspector is fishing for some hypothetical bookkeeping issue that may or may not exist is nothing short of ridiculous.

The Simplest of Errors on Your Part

The subject in this case was a combined fish and chips and kebab outlet. Tax Inspectors had conducted a business economics exercise and come up with suppressed sales resulting in additional liabilities of forty thousand pounds in respect of the year of Tax Dispute. The shop had been established for many years and with extrapolation the total settlement sought was of the order of a quarter of a million pounds. The proprietor was distraught, desperate and adamant that he had done nothing wrong. My initial thought was one of staff theft. Incidentally staff theft issues are a frequent solution to suppressed sales matters, but they are not discussed in this book as they are not directly relevant to its subject.

A thorough examination of the records revealed a straightforward solution. The menu described kebabs as being sold with salad or chips but there were minimal purchases of salad items. A brief discussion with the proprietor revealed that most kebabs were sold with chips, which were supplied with the meal at no additional charge.

The Tax Inspector had calculated the volume of chips sold as being sold as single product items all of which were sold at unit cost. It was now clear that virtually every sale of kebab represented a portion of chips given away without generating any sales revenue. In the business economics exercise this factor had been completely overlooked. A cross reference to the volume of kebabs sold confirmed that this fully accounted for the discrepancy. The tax dispute was closed without any adjustment and a bonus for the client was that we had identified a “loss” of income which he now had an opportunity of rectifying if he wished.

SOME OTHER TAX SITUATIONS

Capital Gains Tax (CGT)

There are many books that offer a detailed consideration of CGT, but there are a number of aspects that I feel you really need to be aware of!

First off you make a capital gain when you sell or “dispose of” an asset which “may occur” when you cease to own it. This may happen in the following circumstances:

- You sell it
- You give it away as a gift
- You transfer it to someone else
- You exchange it for something else
- You receive compensation for it - e.g. you receive an insurance payout when an asset's been destroyed.

The Tax Inspectors’ explanatory leaflet on this subject is available at the following web site:

<http://www.hmrc.gov.uk/cgt/intro/basics.htm>.

I mention this leaflet for guidance only. CGT is extremely complicated and has changed significantly over the years. Go it alone at your peril!

Operating Pay As You Earn (PAYE)

Whilst I have opted out of some “detailed” considerations, PAYE plays such a potentially fundamental role in a trader’s activities that the principles at least must be addressed. In

circumstances where a trader employs someone he immediately becomes responsible for ensuring that he meets his (significant) responsibilities as an employer and in this respect we have already touched on the implications of not understanding the “Tronc” scheme. There is a very significant responsibility placed on the employer by PAYE and he will be faced with a very significant amount of paperwork.

Expressed in very simple terms the trader has a responsibility for running and “policing” his system and ensuring that the correct amount of tax and national insurance is deducted from each and every employee. The trader also becomes responsible for operating various other elements of the overall PAYE, Statutory Sick Pay (SSP) and Statutory Maternity Pay (SMP) being just two of them. What follows in this respect is very specifically NOT intended to be a comprehensive schedule of duties. It is simply intended to make the reader broadly aware of his main responsibilities, and the stages that he needs to go through with each employee and also in respect of record keeping and payment of monies due.

- First and foremost, and before he can proceed further, the trader needs to set up a PAYE scheme and to do this he needs to get in touch with Tax Inspectors and request the paperwork. At the time of writing the web address was

<http://www.hmrc.gov.uk/pay/payroll/year-end/annual-return.htm>

- Having set up his PAYE scheme and taken on a new employee, the trader needs to establish what his previous status was. He might have been a student, unemployed, a newly employed immigrant or whatever

and the course of action required depends on this status.

- There may be certain circumstances where the trader needs to do nothing more than establish the employee's status but they are few and far between and we shall assume here that it is necessary for the trader to implement the PAYE scheme and make deductions of tax and possibly National Insurance Contributions (NIC).
- Essentially the trader has to establish a record for each employee and deduct tax and national insurance, as appropriate in respect of each employee.
- I am not even going to try and summarise the procedures here and anyone new to the PAYE concept can anticipate a good few hours of study ahead of him. Read on and you will come to understand why the terms "unpaid tax collector", or "unpaid government administrator", may become frequently used!
- What I will emphasise is the need to maintain very good records of the employees details, go through all the procedures, record their national insurance numbers and get passports and such other documents as are required from time to time. If you employ someone in good faith and it turns out that they aren't who they claim to be (and this happens surprisingly frequently) it will be the trader who has to sort out the mess - something which could be very costly. If your records are pristine you have a reasonable chance of avoiding any serious hassle.

- So, having set the system up, made it operational and worked out how much the employee has to pay you it would be very unwise to assume that this is the end of your responsibility because it isn't. As a reward for creating a job for someone you now find yourself liable (dependent on the level of the employee's income) to both calculate and pay an employer's tax, described as Employer's National Insurance Contributions, and at some 13% it's a very hefty rate of tax.

The temptation to get into the politics of this is almost overwhelming but I am resisting the temptation valiantly. I am however going to permit myself the observation that if you flourish and are successful with numbers of employees you may be further able to support the economy by employing someone at your cost to operate your complex PAYE system. And in respect of this fortunate individual not only will you have to pay him a wage from your profit (if any remains) but you will also be able to make a further additional payment of employer's NIC in respect of him.

- Ok, moving on then, we have our PAYE system in operation and are making the necessary deductions from wages being paid. But what if that individual becomes unwell or even pregnant - what then? Well as an employer operating a PAYE tax and NIC deduction scheme you now become the administrator and paymaster of SSP and SMP schemes to name just two of them.
- Not only now do you have to reward your employees for the work that they do for you but if they are unwell

and unable to do that work you have to employ a replacement and you also have to continue to pay the one on the sick. I remember the days when the social used to do that!

Did I describe this as a summary at the outset? I did, but I really do think it necessary that the reader has a full understanding of the serious ramifications of becoming an employer. I am not going to flog this example any further save to say that all of this is just part of the system that you are called upon to operate.

There are significant volumes of records to be maintained. Tax and the like collected has to be remitted to Tax Inspectors on a regular basis and there is the inevitable end of year documentation to be completed. Penalties may apply if things aren't done correctly and/or on time, and increasingly there is a requirement for data to be processed by computer online.

The trader has a responsibility for running and “policing” his system and ensuring that the correct amount of tax and national insurance is deducted from each and every employee.

Value Added Tax (VAT)

Vat in essence is relatively straightforward, either you should be registered or not depending on the circumstances of your business. If you should be registered (and this can include a voluntary registration because you are entitled to reclaim vat and not pay it) there may be various different schemes that you may need to consider.

The particular point that I need to talk about here is the ridiculous way in which the registration threshold is set at a particular point so that you either have to register or not, with no sliding scale in the interim. This is the area in which many vat issues arise. Assume a registration threshold of £70,000 pa, so that if your turnover is £70,000 you do not need to register and if it is £70,001 pa you must register.

Then take one of the various personal service intensive trades such as a hairdresser and disregard for the moment the small quantity of goods, hair sprays and the like. With a vat rate of 15% the moment his turnover goes to £70,001 pa he becomes liable to pay vat on all his takings and goes from being relatively profitable to having to hand over £9,000 pa vat. It is absolutely ludicrous and easy to understand why numbers of traders artificially suppress their sales to “stay” below the threshold.

I see it time and again. What happens is that the Tax Inspector sits down the street in a car observing who goes in and out of the salon. He may do this a few times to get an average and if he can demonstrate, by means of a headcount and the cost of a haircut, that the annual takings exceed the threshold then the trader is “caught” and the only question then is for how much? So what’s the solution? There isn’t one other than to deliberately structure the business by reference to opening hours and numbers of staff employed so that the turnover is actually kept below the threshold. The government by virtue of its regulations is essentially restricting the ability of your business to grow.

I am no expert on human rights but does this situation not breach human rights legislation somewhere? Are there any

lawyers out there reading this, who may be up for the challenge?

TAX INSPECTORS MINDSET, ISSUES, BEHAVIOUR REGULATION AND COMPLAINTS

The Mindset of the Tax Inspector

Tax Inspectors of HMRC represent the administrative arm of the Civil Service that is responsible for the assessment of a significant number of taxes levied by the Government within the UK.

What follows below is an extract from the training section of the Tax Inspector's occupational profile (http://www.prospects.ac.uk/p/types_of_job/print/tax_inspector.jsp), which describes in part the training process that they receive:

“
The [training] programme starts with a six-week core module, followed by modules covering technical tax issues and communication. It is a mixture of practical work experience in teams, formal study days, tutor-led sessions, self-study, exams and practical assessments with regular reviews and appraisals. Trainees are allocated mentors as well as supervisors. The programme leads to an internal qualification...
”

Note that there is absolutely no reference to interaction with or experience of the reality of industry in the big outside world of

the trader. Whilst the financial rewards for the Tax Inspector from his employment may be regarded by some as substantial, his working life is far from glamorous. It is primarily desk bound with no "real" contact with or experience of the outside commercial world. Life within the Tax Inspector's working environment is compartmentalised and follows a cyclical daily process of working through an allocated caseload. He typically has little if any experience, and thus hardly even a rudimentary concept, of the day to day types of traumas to which the self employed are subject to on an ongoing basis.

In considering the entity that is HMRC it is useful to look more closely at the concept of the individual Tax Inspector functioning within the System. Remembering always that we are talking **not** about the individual in the context of his private life and how he performs socially. Whilst, in reality, a Tax Inspector's power in real life is limited, this is not necessarily how he or others may perceive the situation. I frequently hear the phrase (about HMRC staff) that "they wouldn't last five minutes in the real world", but what exactly does this mean? On the self employed side of the fence - be we shopkeepers, company directors, accountants or whatever - we do not have the HMRC System to support us. We cannot be absorbed into it and have it support and assist us. We survive or fail pretty much entirely as a result of our own endeavours. Conversely, the System that is HMRC carefully looks after and supports and nurtures its employees, and makes available a huge variety of resources to help those employees.

The Tax Inspector doesn't deal with people as individuals as such. He is a case worker, in an office environment, working a selection of cases allocated to him. Apart from technical ones he may make no distinction between human beings, and non

living legal persons in the form of limited companies. He does not interact, at a personal level as such, with the subject of Tax Investigations and has neither a need nor a means of relating to the personal consequences of the individual or what he does. He may pay lip service (a term not meant unkindly) to the fact that there are very real individual consequences of what he does, but this is nothing more than common courtesy.

It is for the foregoing reason that I take such offence at the use by HMRC of the term “customers” or “clients”. Regardless the strict dictionary definition of the terms, in reality our customers and clients are people with whom we interact and with whom there is, between them and us, a mutual ongoing interdependency on one another. Within HMRC taxpayers aren’t customers at all, they are simply cases to be worked.

Accountants, for example, by virtue of the very thing they do, are closely involved with people. They often work for the same individuals over a period of time and develop understandings of their circumstances. In particular they understand the consequences of the Tax Investigation on the individual client.

Issues and Differences at the Interface between Taxpayers, Accountants and HMRC

It is here, at the interface between different perspectives and approaches that the roots of adversity lie and where the cause of many of the adverse interactions between Tax Inspectors and the self employed originate. Right and fair minded members of society must inevitably disapprove of theft, which of course is what tax fraud is. The tax man isn’t fair game as was the perception of many historically, and money misappropriated from the treasury simply impinges on the well

being of the remainder of the general public who have to pay more tax as a consequence. It is generally recognised that all members of society should pay their share of tax - the amount properly due - and that those in arrears with their tax liabilities must “catch up”.

The situation however is not black and white and is FAR from being straightforward. I have come across many situations where, had it not been for specialist intervention (an observation not intended vainly) the taxpayer might have paid substantially more than he was liable to pay, not because he had defrauded the System, but because he was unable to prove that he had not done so. In such circumstances the perception of the “truth” is not necessarily what occurred but what can be demonstrated as having occurred.

Additionally we live in a humanitarian society. Yes, people have to pay their dues, but in this respect also the situation is again far from straightforward. The consequences for individuals and their families of catching up with arrears (regardless the reasons why they arose in the first place) can be devastating. The rights and wrongs of the System could well be the fruitful subject of a large and totally separate book and I do not dwell on them here. At this point I am simply looking briefly at the interface between the Tax Inspector’s perspective and that of others.

The lifestyle of many of the self employed revolves, inevitably and to a very great extent, around work related concepts. The need to get new work in and keep existing customers happy and loyal, getting paid for work done and the like is fundamental to their lives. They are subject to significant pressures which derive directly from a need to survive financially. The success of what they do is fundamental to their

lifestyle and how much money (if any, literally) is available to spend.

The Tax Inspector's situation however is entirely different. Having been accepted into the HMRC fold and having served some sort of probationary period he becomes established in his work situation and, unless he does something way off the planet he is pretty much guaranteed a job for life. Furthermore not only does the Tax Inspector potentially have a job for life but he also has a guaranteed income, albeit that the amount of that income may vary in accordance with his work performance. Whilst the finite amount of that income is not guaranteed, it is certainly going to be there long term subject again only to the caveat that he must not step significantly out of line. In the background, for the future, the inevitable prospect of a substantial public sector pension is always there.

Of course by the same token life out here in the real competitive world is equally an unknown factor to the Tax Inspector. He has absolutely no experience of the kinds of pressures - financial and otherwise - to which we are subject, nor is he able even to come close to appreciating them. The following example comes to mind which, whilst I suspect it will bring a wry grin to the reader's face nonetheless emphasises how significant the lack of experience of reality is, in considering the actualities of situations.

Consider the case of a small corner shop type business where the Tax Inspector was "concerned" about the relationship between wages and turnover, the former being somewhat lower than might be expected by reference to the size of the latter. The shop was open from 8.00 am to 10.00 pm seven days weekly – a total of 98 hours. The staff worked a limited number of hours weekly leaving the proprietor working the

bulk of the time, fitting in also cash and carry visits, trips to the bank and the various other necessary tasks.

Lead wholly by his theoretical training the Tax Inspector “found it difficult to believe” that a proprietor would work such long hours. The Tax Inspector’s assertion was that it was inevitable that the proprietor had employed other staff, who were being paid in cash from suppressed sales, and who were not being the subject of PAYE deductions. The proprietor was challenged to prove that this was not occurring.

We of course know the alternative reality of the situation faced by the proprietor. The business, like many similar ones, was struggling and in the harsh reality of life the proprietor was required to put in the hours or face closing down. But how can anyone prove a “negative” situation such as this?

Tax Inspector Behaviour Regulation and Complaints

In relation to HMRC we need first to make a clear distinction between events that are statutory and appealable through an appeals procedure and actions taken at the volition of individuals, and for which they are responsible. In considering complaints we are looking specifically at the latter, the manner in which Tax Inspectors conduct themselves personally in the performance of their day to day duties. As we have noted previously the use of discretionary measures delegated to Tax Inspectors can have real financial consequences, such as the timing of penalties.

I am no longer a party animal but many years ago, in my early working life things were different. There was a long established tradition within the culture of office workers

generally that the last working day before Christmas was a day for winding down. Work stopped about midday to give way to the inevitable activities associated with alcohol and pub and the much anticipated Christmas party.

I remember one particular such last working day when, like everyone else, I was looking forward to the forthcoming activities when the District Inspector (DI) summoned me to his office. It was with a feeling of foreboding that I attended the summons where he expressed his extreme regret that I would need to miss the festivities. A “Member of Parliament” (MP) complaint had been received in respect of HMRC’s treatment of a member of the public. As a complaint this required immediate attention. The processing and action had to be started on that day so that the rigid timescale allocated for such issues could be adhered to. How does that compare with the lie of the land these days?

Over time there have been very significant changes of management styles and structures generally, not just in HMRC but in the Civil Service generally and indeed throughout the UK and globally. Structures have become less regimented and complaints systems generally have increasingly tended to look inwards to deal with complaints internally. If the issues I raised here were to derive from complaints stemming from me alone it might well be considered that I am a discontented individual with some axe to grind, but they do not derive from me alone!

I frequently deal with cases which have been passed to me by other accountants who are not content with the actions of particular Tax Inspectors. I have worked on those cases and in respect of some of them encountered similar problems to the previous accountant. Over the years I have raised significant numbers of complaints over a wide range of issues, and those

issues have frequently been such that other professionals too have been concerned about them.

Yet not on one single occasion has a complaint been upheld or, as far as I can establish from responses received, resulted in action being taken to rectify the future situation. There appear to be only two possible conclusions to this scenario. The first is that I along with all the other professionals who have been discontent with situations got it wrong on every occasion, whilst HMRC got it right every single time. Alternatively there is something inherently wrong with the complaints procedure. At one point I had managed to convince myself that the fault must inevitably lie with me, but I have since recovered from that depressed situation.

Regardless whether the complaints were justified or not, what further avenue, if any, is available to me in order to have the matter further considered if I disagree with the outcome?

- There is certainly the option of a further review, or perhaps reviews within HMRC at another tier, but is there any reason to assume that the response to that will be any different? We have already considered that those administering the training system have themselves gone through the same in-house training procedure. Inevitably therefore, the same will apply to those administering the complaints process and many if not all of those, will have been similarly trained. It must follow therefore that those administering the complaints procedure will have perspectives and outlooks in relation to the performance of work that will be similar to those individuals whose actions have been the subject of complaint.

- If the foregoing does not produce a satisfactory response there is the potential to complain to the Adjudicator's Office. Experience has shown that the processing by the ombudsman can take a disproportionately long time. The following is a quote from that letter. "We are currently working through a backlog and are unable to respond to written or telephone requests for updates." The letter is dated some eighteen months ago and, my understanding from its recipient, is that a reply has still not been received from that office!

There are a couple of exceptions to the foregoing internal complaints procedure but these relate to separate matters which are potentially criminal, and which may be considered by the Independent Police Complaints Commission (IPCC).

BRIEFLY, THE FAIRNESS OR OTHERWISE OF THE SITUATION

It should by now have become pretty clear that essentially, whatever set of books you keep, what we have in reality is a battle, and a battle with a significantly unfair balance of power to one side - that side not being ours on this side of the fence. The Tax Inspector knows nothing about day to day working life as we know it. He occupies a world of theory. As we have seen courtesy of the Senior Complaints Team Manager at HMRC, the business proprietor has no private life as far as money is concerned, and all receipts received by someone running a business must be provable even if that means the need to infringe the donor's personal rights to privacy.

The Tax Inspector knows nothing about day to day working life as we know it. He occupies a world of theory.

It must also be clear that I am not the Tax Inspector's greatest fan, but I have tried to strike a reasoned balance between criticism, satire and making you aware of how very serious and important this all is! On the basis that the reader is concerned, reasonably, about getting his own affairs into order and not hearing about my political views I do not discuss this further.

You must remember always and never lose sight of the fact that the trader is responsible for demonstrating that his affairs are in order. The Tax Inspector does not have to prove that they are not in order.

Upwards & Onwards

I now move on to address a number of specific issues which you might previously have been horrified even to have to think about. These too may not be part of the day to day record keeping requirements placed on you technically, but I believe it critical that every trader should know about these also.

Tax Evasion

Tax evasion constitutes a general term used for the non payment of tax by illegal means. It is a criminal offence with which I will have no truck and it is not addressed further.

Tax Avoidance

Tax avoidance on the other hand occurs where a trader, acting within the parameters of the law, arranges his affairs in order to minimise his tax liability. There are various complex overseas schemes and the like which tend to be somewhat specialist in nature, and sometimes questionable.

There is however absolutely nothing wrong with arranging your affairs so as to legally pay as little tax as you possibly can. I prefer the term Tax Planning.

There is absolutely nothing wrong with arranging your affairs so as to legally pay as little tax as you possibly can.

We have already mentioned one example when I referred, under itinerant travel to “*The trick of course is getting home defined as the base, or even arranging things legally so that it becomes the ‘base’*”. There is absolutely nothing wrong with a trader **legitimately** arranging his affairs in such a way that his home actually is his base specifically so that he can benefit from the maximum tax relief in respect of necessary travel.

Where the problems **may** start will be if he claims his home as the base, but keeps “the lorries” and a small office somewhere else. It may be that this is a perfectly acceptable arrangement, yet equally as well it may not be. Each case depends on its individual merits, and at the risk of repeating myself again it is absolutely essential to get advice and set it up properly from the outset. If you are already in that, or a similar, situation don’t sit there and do nothing because it will catch up with you somewhere along the line - get it sorted!

Take for example a situation where a trader has been claiming for the past three years for his home as a base and he becomes aware that it almost certainly doesn’t qualify. There are essentially two course of action - do nothing and worry until caught or get it sorted. If a trader had come to me in such a circumstance when I was in practice I would have approached the Tax Inspectors along the following lines.

“Mr X has become aware that he has been claiming for his home as a base and that it potentially should not have been treated as such. In this case the taxpayer has clearly been honest in coming forward, the matter has not been tested, and the cost of testing it might be a disproportionately expensive one to the public purse. In the circumstances I suggest that we disallow the relief for the current year, and that the previous

years be left undisturbed. In 95% of cases, subject maybe to a little argument I would expect the Tax Inspectors to take that route!

Briefly what the Issues within the System are

Take as a starting point a comparison between the responsibilities of the police forces that investigate crime and bring accusations, and the court system, the judicial arm of the law system that follows on and administers justice. I am not going to go into any minutia of the comparison. The comparison is completely straight forward and in essence there can be no intermingling of their respective responsibilities. There may be some exceptions to this statement but essentially they are completely separate.

As the reader doubtless guessed, the next step is to compare the combined functionality of those two organisations (the police forces and the court system) with the functionality of Tax Inspectors. The comparison and the conclusion are clear - Tax Inspectors perform both the dispute function and also the administration. In itself, whilst questionable and open to significant debate, this dual functionality in the context in which it exists is not necessarily inappropriate:

1. Tax Inspectors are charged with the responsibility of “arbitration”, ensuring that the taxpayer pays the correct amount of tax, not too little, but not too much either.
2. Tax Inspectors are charged with the responsibility of conducting a pragmatic review of a case having regard to the all the facts.

3. In an appeal situation the Tax Inspector's role is completely reversed from that of being an arbitrator to being charged with the responsibility of presenting the case on behalf of the Crown.

Tax Inspectors are ordinary human beings subject to the same frailties as all of us. Which is the starting point in relation to any particular case? At which point does an individual Tax Inspector switch from being an "independent" arbitrator to a prosecutor?

TAX INVESTIGATIONS; IF YOU GET ONE

Necessary Distinctions

As mentioned before, the UK system is one of Self Assessment where taxpayers are trusted to complete accurate tax returns and pay the correct amount of tax. It is a system that is not restricted to the UK and can be found in other countries throughout the world. There can be no disputing the fact that some sort of checks need to be carried out and I have absolutely no issues with that in principle. You will by now have a good understanding of just how very complex the system is and how easy it is to get things wrong, although this book will hopefully have driven you a long way to understanding and avoiding the multitude of pitfalls.

The main way in which a Tax Inspector carries out his checks is by way of an investigation and if you are subject to one of these it is not a pleasant experience believe me. I do not discuss the actual investigations here and they are fully discussed in the sister book to this one - "The Taxpayer Strikes Back". Human nature being what it is the unknown can be very frightening and the majority of traders that I meet are basically scared of dealing with a Tax Inspector. What I do want to do here is simply to describe the nature of the individual so that if you do have to attend a meeting with one of them you will at least understand their underlying situation.

Fortunately the general understanding of the authority/power situation as regards the Tax Inspector, as frequently expressed to me by taxpayers and accountants alike, is a complete misconception which I am pleased to be able to correct here.

1. Tax men are salaried civil servants, administrators occupying junior management positions within Her Majesty's Revenue and Customs (HMRC).
2. The Tax Inspectors' job is essentially to assist in examining business records in a pragmatic manner with a view to coming to a conclusion as to their accuracy.
3. Tax Inspectors specifically do not have any personal powers; they are representatives of the system that is HMRC.
4. Tax Inspectors have a certain amount of delegated responsibility to implement certain procedures such as the levy of penalties.

Interest Charged by Tax Inspectors

There is little to be said here about the principles of interest being charged by Tax Inspectors as the provision to be able to do so is pretty much mandatorily provided for in statute. However, be mindful always of situations where Tax Inspectors have occasioned delays! Any delay occasioned by Tax Inspectors can cause an inappropriate loading of interest chargeable. In such cases calculate the excess charge cumulatively over time and seek to have it offset against the overall settlement as part of the negotiation procedure.

Penalties

The situation regarding the method of calculating penalties is in a state of change, and is in any event technical and not

discussed here. However before accepting any penalty proposal conduct your own calculation of the amount you consider should be due, and compare this with the Tax Inspector's proposal, which you should always await before you consider disclosing yours.

If the figure the Tax Inspector presents is less than yours, clearly there is no point in disputing it, and it can be accepted by default. If however their proposal is higher than yours, require sight of the details of their calculations. Consider disputing them on the basis that you have already, separately, calculated your lesser figure. Remember that the inevitable desire of the taxpayer to achieve closure is likely to be mirrored by the Tax Inspector who, very often, will be disinclined to put up a strong argument to a reasonable reduction.

The Tax Inspector will, very often, be disinclined to put up a strong argument to a reasonable reduction.

Contracts Generally

Bear in mind always that the negotiations leading to a "Settlement" are in fact negotiations leading to the drawing up of a Contractual Civil Settlement. The Tax Inspectors may know little about contract law and may make statements which he regards as being simply glib, off the cuff ones.

In English and Welsh Law, with certain exceptions such as contracts relating to land, (the law in Scotland may be different) the terms of a contract can be written, spoken or even inferred. Getting onto a bus involves entering into an inferred contract with the bus company that as the passenger you will

pay the required fare, and that the bus company will deliver the passenger to the stated destination. Just as a general point, and clearly depending on many factors, be aware that any statement made by a Tax Inspector may just be one that can be deemed to form part of the Contractual settlement, to the taxpayer's advantage. The odds of it being so are not high, but there is always the possibility. It comes back always to looking at all aspects of every case and to keep reviewing everything about it.

Finally

There is just one more thing that I wish to say about investigations and that is simply that under no circumstances should you permit yourself to be interviewed by the Tax Inspector without your accountant being present.

This is also a good place to repeat a general point about tax fraud, tax fiddles, call it what you will, and that is that **it simply isn't worth it under any circumstances**. You will be caught one way or another. The misery, stress and financial consequences are unimaginable to the ordinary inspector in the street and this is one of the problems. Traders frequently go through life pretty much on a day to day basis, with lives that may be so busy that there is limited scope for forward thought.

Please therefore just take my word for it and don't do it! If you find yourself in a position where you "need" to fiddle because you don't have enough cash to go around then the problem lies with the fact that your activity isn't profitable enough, so direct your energies towards increasing profitability. I'm sorry if this sounds harsh but if you had seen as many situations as I have

you would fully understand the point I am driving at! As you haven't seen those situations please just take my word for it.

Tax fraud simply isn't worth it under any circumstances. You will be caught one way or another.

EXIT STRATEGIES IF ALL ELSE FAILS

Human nature being what it is there must inevitably be occasions when traders fall foul of the system and where substantial settlements of tax interest and penalties come about and the trader may find himself in the following situation:

- Regardless whether arrangements are made to make payments by instalments he has to find the resources to fund the settlement.
- Additionally he has to find resources to fund the activities, the shortage of which may have driven him to need to avoid paying the appropriate taxes in the first place.
- Associated with the previous point, he is now denied the additional cash derived from underpaying tax.

It is inevitable that in numbers of these cases the trader will simply be unable to meet the financial demands of any settlement, regardless any relatively beneficial terms that it has been possible to negotiate. If this potentially is going to be the situation then the time to consider an exit strategy, in the form of a personal bankruptcy properly conducted within the parameters of the law, is at the outset of the investigation when you still have numbers of choices and options open to you.

This area will not normally be the domain of the accountant whose task is to deal with the investigation itself and it will require you to take a realistic view of the situation, seeking the

accountant's advice as to the likely outcome of the investigation. If you anticipate having problems then the first port of call has to be professional advice. I am not able to discuss the fine detail which would need to be raised with a licensed insolvency practitioner. My understanding of the insolvency scenario is limited but at the very least there are a couple of important points that must be noted. First and foremost any exit strategy planning must be undertaken under the auspices and strict guidance of a licensed Insolvency Practitioner. Additionally there are at least four golden rules that must be observed by the taxpayer, and which must never, under any circumstances, be broken.

1. In absolutely no circumstances should anything be done that is, or could in any way be considered to be dishonest in relation to obtaining finance.
2. Prior to bankruptcy an individual is entitled to dispose of assets but he must not give them away, as it may be possible for any such gifts to be overturned.
3. An individual may sell his assets, even to a connected party such as his wife. Any such sale however must reflect the full market value of the asset and must not be disposed of "undervalue".
4. Hiding activities from the Official Receiver, or failing to disclose assets to him is a serious criminal offence.

APPENDIX I

The Typical Trader's Day in Context

Having been self employed myself I fully understand the issues of running businesses and the time pressures and stresses involved. I was having a conversation with the proprietor of a restaurant, at 10.00 am on the morning of my typing this. We were discussing the day to day, hour by hour activities of running his business, which went as follows. The proprietor incidentally is aged 66 years and has been working in this vein since 1988, over twenty years.

1.00 am - (earlier this morning), closed the restaurant and headed home.

2.00 am - retired to bed.

7.30 am - breakfast and the like.

8.30 am - leaves home for this morning's meeting with the accountant.

9.00 am - this morning's meeting.

10.00 am - leaves meeting and heads off to:

1. Cash and carry and the like to collect fresh produce and items that cannot be delivered. Can this be delegated to staff? Maybe, but the problem is that staff cannot be relied upon to adequately ensure the best possible produce. Why not? It's a relatively small restaurant with no dedicated management staff apart from the proprietor. Therefore a casual member of staff may be the only one who could be available to do the shopping.

2. If time permits he needs to bank accumulated cash and cheque takings. Whilst in cash and carry he may have “overspent” on his intended cash “purchases” and borrowed from funds already recorded as cash banked. In the haste of the activities that follow this may be completely, yet innocently, forgotten about, thus giving rise to bookkeeping errors that Tax Inspectors may attribute to negligence.

11.00 am - this is the target time for a return to the restaurant itself. These days, by the purchase of pre-prepared products the need for time to be spent on food preparation and similar activities has been substantially reduced by comparison with historic “norms”. There is a plethora of tasks awaiting attention, wages and record book completion being just two.

12.01 pm - sees the start of the afternoon’s trading activities which are likely to persist through to 3.00 pm or so, the afternoon shift being a short one. Given the short duration of the shift, staff (disinclined to turn up for work and disrupt the day for a “few” pounds) will almost inevitably have been difficult to find. This may result in a doubling up of the proprietor’s duties, serving as well as cooking for example.

5.00 pm, having had a 2 hour break from 3.00pm the evening shift resumes.

APPENDIX II

The UK taxation system is extremely complex and it may be virtually impossible for a layperson to avoid unintentionally falling foul of it in some way. Consult your accountant, discuss your business with him and seek his advice, and don't begrudge paying him for his time, the relatively small amount it will cost may well pay you back many times over!

A principle and fundamental rule of the Self Assessment system is that it is the responsibility of the trader to demonstrate that his affairs are in order! It is not the responsibility of the Tax Inspector to demonstrate that they are not!

In tax disputes settled by contractual civil settlements (which is all of them almost without exception), the burden of proof is the balance of probabilities that your evidence is persuasive, that what you claim to have happened actually did happen.

The Tax Inspector may frequently require evidence of an event. For example, in relation to the introduction of funds into a business he may "require" to see the bank statements from which he assumes the money was drawn. Evidence can however take many different forms, such as an affidavit and any insistence on the production of

absolute evidence should be carefully considered and if appropriate firmly resisted.

There is an almost if not entirely infinite gamut of permutations possible on the theme of verifying cash accumulations. The approach to take is to consider carefully the circumstances of the individual case, and to identify possible forms of evidence that can be used to substantiate a situation.

A critical, all important point is that you account for all of the money coming in and going out in a tight balanced fashion!

Attempts by Tax Inspectors to attribute the difference between the normal or average achieved by a particular industry and the actual result achieved by a business as suppressed sales should be immediately refuted.

The point to be clear about is that all day to day qualifying expenditure is available to reduce the tax liability in the year in which it is spent. In relation to qualifying expenditure of “one off” items the tax relief may be spread over a number of years. This can have very important implications for a number of considerations including, for example, cash flow planning! Do NOT assume automatically that everything you spend will be available to offset against tax and reduce your liability in the year in which it is spent!

Tips attract a tax liability. If yours is an industry where tipping is traditional you may feel it best to arrange that tips are collected individually by staff members in cash. This is however not a straightforward situation and advice from your accountant is essential.

The moment the Tax Inspector puts himself in a situation where he makes an assertion such as “I assume that the minimum level of wage is in payment” then he must be called upon to substantiate it, and demonstrate that what he has said is likely on the balance of probabilities to be true.

The trader has a responsibility for running and “policing” his system and ensuring that the correct amount of tax and national insurance is deducted from each and every employee.

The Tax Inspector knows nothing about day to day working life as we know it. He occupies a world of theory.

You must remember always and never lose sight of the fact that the trader is responsible for demonstrating that his affairs are in order. The Tax Inspector does not have to prove that they are not in order.

There is absolutely nothing wrong with arranging your affairs so as to legally pay as little tax as you possibly can.

The Tax Inspector will, very often, be disinclined to put up a strong argument to a reasonable reduction.

Tax fraud simply isn't worth it under any circumstances. You will be caught one way or another.