

How to Master a Tax Investigation

By James Bailey



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Contents

About James Bailey.....	1
About This Guide	1
1 What Exactly Is A Tax Investigation?	2
1.1 Compliance Check	2
1.2 Aspect Enquiry.....	2
1.3 Full Enquiry.....	2
2 Why The Taxman Starts Investigations And What He Is Looking For	2
3 If You Have Poorly Kept Accounts Are You More Likely To Be Investigated?.....	3
4 Anybody Is At Risk From An Investigation	3
5 The Different Types Of Full Enquiry.....	4
5.1 Local Investigation.....	4
5.2 SCI Investigations.....	4
6 How HMRC Notifies You That You Are Going To Be Investigated	4
7 What You Should NOT Do If You Receive An Enquiry Notice	4
8 What You Should Do If You Receive An Enquiry Notice	5
9 How Long Will A Typical Local Investigation Last?	6
10 What Happens If You Can't Agree On The Figures With The Taxman?	7
11 Deeper Waters – The “COP 9” Investigation	8
12 Is It Ever Likely That A Local Investigation Would Turn Into A COP 9?	8
13 Paying More Tax To HMRC	9
14 Understanding These Is Important!.....	9
15 Will The Taxman Forgive Me?.....	10
16 How Does The Taxman Catch People Who Have Been Cheating?	11
17 The Best Defence Against An Investigation	12

About James Bailey



James Bailey is the Tax Partner at Robinson Reed Layton, a well-known firm of Chartered Accountants and Chartered Tax Advisers in Cornwall. He advises family businesses and their owners, and other wealthy individuals. He provides advice on tax planning together with help in dealing with tax investigations.

He began his career as an Inspector of Taxes with HMRC, latterly as the Deputy District Inspector of a large London tax district. He ran investigations into the tax affairs of individuals and companies, ranging from local businesses to national companies and a few well-known media figures!

After leaving HMRC, he worked with two of the “Big 4” accounting firms, specialising in tax planning for family companies and wealthy individuals. He advised such businesses on how to minimise their tax liabilities, and their owners on how to reduce or eliminate the capital gains tax due when the business was sold. He also helped the owners of family businesses to pass them on to the next generation without any inheritance tax becoming due. As an ex-Inspector of Taxes, he also dealt with HMRC tax investigations, both at local level and with more serious cases involving HMRC’s Special Compliance Office.

James has appeared on TV and radio to comment on taxation issues, and written articles on tax planning for various professional journals.

He is also the author of:

- 27 Ways to Beat the Taxman
- Tax Secrets for Entrepreneurs and Family Businesses
- How to Successfully Plan for Inheritance Tax

All these titles are available from www.taxinsider.co.uk.

About This Guide

This special report tells you everything you need to know about a dreaded **Tax Investigation**. Former Tax Inspector James Bailey identifies the challenges faced during an investigation and how to master them.

1 What Exactly Is A Tax Investigation?

A tax investigation is triggered when HMRC uses its statutory powers to look at your tax return and/or the accounts for your business in order to satisfy themselves that they are correct.

Most tax returns and business accounts that are sent to HMRC are simply filed into the system so that the amounts of tax that you owe can be calculated and the Statements of Account can be sent out. Most tax returns are never actually looked at or checked for accuracy.

However a small percentage of these tax returns will be investigated further by HMRC.

A tax investigation by a local tax office can take several forms:

1.1 Compliance Check

These are becoming a more important part of HMRC's enforcement policy. They involve visiting a business (which HMRC have the legal power to do, if necessary without your consent) to make sure that proper books and records are being kept, or that PAYE is being operated properly on the wages paid to employees. Other examples are checks on VAT or in the case of the building trade, the Construction Industry Scheme.

1.2 Aspect Enquiry

The first is an "aspect enquiry", where the inspector simply asks one or two questions to satisfy himself that a particular point in the tax return is correct; a common example is a check that a capital gain in your tax return has been correctly calculated.

These are not particularly serious and are usually dealt with in a matter of weeks. However, what most people mean when they refer to a tax investigation is what is referred to as a 'Full enquiry'.

1.3 Full Enquiry

A full enquiry is when HMRC goes right through your tax return to make sure that the personal information and business accounts that you have filed are correct. This can be a very thorough and stressful process. The rest of this report concentrates on this type of investigation.

2 Why The Taxman Starts Investigations And What He Is Looking For

In short the taxman starts investigations because he can! HMRC has power under the tax legislation to inquire into any tax return.

They do not have to have a reason and in fact they actually do look at quite a number of tax returns every year on a purely random basis.

A 'Tax Investigation' can thus be similar to a lottery - if your number comes up they will open an enquiry on you.

Other investigations are started because HMRC has specific information about your business. They may have received information from an informer, or they may have picked something up while investigating someone else's tax affairs.

An investigation can also be triggered if they are aware of any particular risks in your business. A good example might be a Pub which is primarily a cash business so it is comparatively easy to conceal some of the takings.

HMRC also has software which interrogates their databases and the figures which have been submitted.

The software can identify anomalies where, for example, the relationship between the purchases and the sales appears to be out of kilter with the relationship that you'd expect for that particular kind of business.

To summarize there can be three key reasons for an investigation:

1. You are randomly selected
2. HMRC has specific information on your business (e.g. via an informer)
3. Your accounts look odd compared to the accounts of other similar businesses.

There is no particular bias towards newer or older businesses, though it might well be the case that a newly started business that was particularly unusual could be selected for an investigation, almost as a fact-finding exercise.

3 If You Have Poorly Kept Accounts Are You More Likely To Be Investigated?

It is not so much a case of having poorly kept accounts as of having something unusual in the figures. Don't forget that the inspector doesn't normally see the accounts; all he sees are the figures that are entered in the various boxes on the tax return. Don't forget, however, that he also has the power to visit your business premises to check that you are keeping proper records, and that there is a fine of up to £3,000 for poorly kept records!

It is only if he decides to open an enquiry that he will look at the actual paper accounts.

A typical test that my ex-colleagues and I used to use a lot when I was a tax inspector involved taxi drivers. I would look at the amount of fuel that they claimed as an expense and then I would look at the fares that they had taken. If there seemed to be too much fuel compared to the fares taken I would consider investigating them.

Another typical test is to compare the cost of food purchased by a restaurant with the sales of meals.

One of my ex-colleagues once investigated a greengrocer on the basis of comparing his expenditure on brown paper bags with his sales of vegetables!

4 Anybody Is At Risk From An Investigation

Because a certain proportion of investigations are entirely random, anybody can be investigated.

Nobody is safe from being investigated.

Those who submit a tax return where their business has a turnover of less than £70,000 a year (for 2010/11, likely to be £73,000 for 2011/12) are probably less likely to be investigated. Such people only have to fill in the short three line income/expense/profit "self employed" pages of the tax return. However HMRC does have a policy of investigating a certain number of these businesses as well just to keep everyone honest. They are particularly likely to do so if the expenses are high in relation to the turnover.

Because some investigations are randomly selected it is important to realise that being selected for investigation does not necessarily mean that HMRC know or even suspect that there is something wrong with your return.

Some of these random investigations can be opened and closed in a matter of weeks.

5 The Different Types Of Full Enquiry

Leaving aside the aspect inquiries which are not very serious and which are usually dealt with very quickly there are basically two types of investigation:

5.1 Local Investigation

This is where the local tax office to which you send your return opens the investigation.

5.2 SCI Investigations

These investigations are opened by the Special Civil Investigations unit (SCI) which is a Head Office department of HMRC. These investigations are much more serious and are discussed later in this report.

The vast majority of investigations are local tax office investigations.

6 How HMRC Notifies You That You Are Going To Be Investigated

The important point to remember is that HMRC **does** have to notify you that they are going to investigate you.

They are required to give you written notice of their enquiries, and they will enclose a leaflet with that letter explaining the ground rules and how the investigation works.

They will usually also enclose a list of questions about your business accounts.

It should never be the case that they are investigating you and you do not know about it, but beware of the current trend for “informal” investigations. This is where you receive a letter, or possibly a phone call asking questions about your tax return or your accounts. If you have a tax adviser, you should refer them to him. If you do not, you should seriously consider consulting one. Some “informal” enquiries are simply genuine attempts by HMRC to resolve a simple point about your accounts, but all too often I have seen them used to launch a full scale enquiry. The problem with an “informal” enquiry is twofold:

- In a formal enquiry, HMRC can only ask for information they “reasonably require” in order to establish your tax liability, so (for example) if they want to see the private bank accounts of the directors of a company, they need to be able to explain why there are “reasonably required” to establish the company’s tax liability. No such rules apply to an “informal” enquiry
- At the end of a formal enquiry, there will either be a “settlement” (see later in this guide) or the inspector will issue a “closure notice” saying he is now satisfied with the accounts, and unless new evidence turns up, he cannot revisit the accounts for that year or years. You have no such protection in the case of an “informal” enquiry.

7 What You Should NOT Do If You Receive An Enquiry Notice

The first thing is don’t panic and don’t ignore it.

I have known a number of cases where people have received these letters and a bit like the credit card statement or the bank statement you know contains bad news, they have just put it in the back of a drawer and hoped it will go away.

You need to respond quickly and positively if you get an enquiry notice because if you don't HMRC may interpret this as a lack of co-operation, which can have financial consequences later in the investigation – as we shall see, the amount you have to pay if errors are found will be directly influenced by how co-operative you have been.

It may also be tempting to telephone the inspector immediately in the belief that you can sort the whole thing out with a quick chat on the phone. This is not a good idea – having notified you that he is investigating your tax affairs, the inspector is not going to be put off by your assurances that there is nothing wrong.

If you already use the services of an accountant, the first thing to do is to discuss the situation with him – he should have been sent a copy of the notice opening the enquiry in any case.

If you do not have an accountant, you should consider taking advice from a professional tax adviser who specialises in tax investigation work. In a simple case, you may be able to deal with the enquiry yourself, but only after you have had the benefit of a professional view of the situation. In more complicated or serious cases, you really need to be professionally represented.

A tax professional who is used to dealing with tax investigations can often tell a lot from the initial letter that you have received from the inspector. Many of these letters are basically just a formal notice to say you are under enquiry, but where there are questions included with the letter then it can be obvious to the tax specialist exactly what the nature of the enquiry is going to be.

I was consulted about a case recently and it was clear to me from the questions asked that the inspector had received specific information that something was wrong with the accounts.

In another case it may be fairly obvious to the adviser that it is just a “fishing expedition”. You are unlikely to be able to spot the difference if you are not a tax specialist.

If HMRC do have some sort of information and you just ring them up and say “what’s all this about”, the danger is that you’ll get into a conversation where you’ll say things that you later regret saying. Don’t forget that the inspector will be making notes of what you say.

I hope I have made it clear how important it is to get proper advice and to think carefully what your response to the notice will be. If you feel you must respond immediately in some way, then simply send a short letter to the inspector saying: *“Thank you for your letter. I am seeking professional advice and I will be in touch with you again in the near future”*.

8 What You Should Do If You Receive An Enquiry Notice

As I have already said, you should contact your accountant if you already have one, or if not, an independent tax adviser.

You should also consider whether you are going to ask your own accountant/adviser to deal with the enquiry or whether you are going to get a specialist independent adviser involved.

There is much to be said for having an independent investigation specialist to help you deal with the case – indeed, several of my clients are firms of accountants who ask me to deal with all their tax investigation work. This is because the independent adviser will be looking at the case with fresh eyes and he is likely to have more experience than your accountant in dealing with HMRC enquiries. An independent adviser will not feel personally

involved whereas some accountants see it as almost a personal insult that HMRC have decided to investigate one of their clients or investigate accounts that they have prepared.

9 How Long Will A Typical Local Investigation Last?

A local investigation will typically involve the accounts of a local family business.

The initial letter will normally ask to see the business records or will have a list of questions about the business.

HMRC has the power to compel you to let them see the business records so there is no point in arguing about that.

Once you send in the business records or you have answered the various questions the next stage, which will typically follow a month or so after you have sent your reply, will be for the inspector to ask for a meeting.

Inspectors like to give the impression that it is compulsory to attend these meetings. However it is not, and they have no power to force you to go to a meeting with them.

If you have nothing to hide or if you have found some mistakes and you want to disclose them to HMRC a meeting is often the best way to do it – though it is absolutely essential that you have a professional adviser with you when you go to the meeting.

It may seem expensive to pay an adviser's hourly rate to accompany you to a meeting with the inspector, but it will usually be money well spent. Your adviser will try to ensure that your side of the matter is properly put before the inspector, and he should protect you from some of the questions you are likely to be asked.

Under the stress of a meeting like this, you will probably feel that you want to appear as helpful as possible to the inspector, and all too often I have seen cases where this led to people making up the answers to questions when the truth was that they didn't know the correct answer.

Here are a few examples, together with their hidden traps:

Q: How much cash do you normally have in your possession, in your pocket or in the house? What is the largest amount you have had, and when did you have it? Don't get this wrong – you may later be confronted with a "cash test" (more on this below).

Q: Who takes the kids to school? Would that be you, in the van that you "only use for business"?

Q: What do you do in your spare time? If you try to give the impression that you stay in every night, you may look rather foolish when your subscription to the yacht club shows up in your cheque stubs! In one of my cases, I found payments for a number of flying lessons in the bank account of a man who "had no hobbies" and "never went out".

Q: Do you bank all the cash you receive? This leads back to the cash test referred to already.

After the meeting the inspector will send you his notes of the meeting. He will invite you to sign them to confirm you agree with them.

Most advisers including myself say that you should not agree to sign the notes because once you have done so it is difficult to argue later that there are mistakes in them. The inspector will try to find discrepancies between what you have said and what is in the records.

There is also a certain tendency amongst inspectors to record what they wish had been said rather than what actually was said. It is very important to read those notes through carefully and to challenge immediately anything that you consider to be inaccurate.

In some cases I advise people not to go to a meeting at all. This is typically where I don't think that the client would show up very well at the meeting, perhaps because he is somewhat paranoid and nervous, or perhaps because I can't trust him to keep his temper!

It is perfectly possible to insist on dealing with things through correspondence with the inspector, though the problem with this approach is that it takes a lot longer and potentially it is more expensive for the client in terms of the adviser's time.

Provided that you and your adviser agree on this approach and it isn't going to be to your disadvantage, then go to the meeting.

After the meeting as well as the notes the inspector will possibly come up with more questions or he may actually make a proposal as to how to settle the matter. He may even agree to settle without any alterations to the figures but more typically he will propose some additions to the profits.

Your tax adviser will then negotiate with the inspector, which can last some time before finally the investigation is closed. A good adviser will balance the desire to fight every point with the need to settle things in a cost-effective manner.

Once it has been agreed:

- Either there are no changes needed to the accounts, or
- what those changes are,

The time has come for making a settlement with HMRC and paying any of the additional tax that is due.

I would be amazed if this type of investigation lasted less than six months; I would also be amazed if it lasted longer than two years.

In fact in most cases an investigation lasting longer than two years would suggest to me that the adviser isn't doing his job properly. A good adviser should be able to put pressure on the inspector to negotiate in a constructive manner – in the last resort, where the inspector has found little of significance but won't let go, the taxpayer can appeal to the First Tier Tribunal – see below – to force the inspector to close his enquiry down.

10 What Happens If You Can't Agree On The Figures With The Taxman?

In a case where the inspector is proposing that a certain amount be added to the profits and you cannot agree, or where the inspector simply keeps digging despite having found nothing, you have a right to go to the First Tier Tribunal, which is an independent body of arbitrators.

Both you and the inspector will put your case to them and they will make a decision. Their decision is usually final, except where it involves a complex point of law rather than a question of fact such as "were all the takings included in the accounts?"

HMRC are reluctant to go to the Tribunal because the result is so uncertain, although they will quite often use the threat of doing so to put pressure on you to agree with their view of things.

Before going to the Tribunal, it is also possible to ask HMRC to conduct an independent review of the case. This is supposed to be done by an official who has not been involved in the investigation and who has been specially trained to be as unbiased as possible. This is a new arrangement which started in April 2009, and in my limited experience of it, it works quite well – or to put it another way, I have got the right result from the few occasions I have used it so far!

Again, I strongly recommend that you should be represented professionally by an experienced tax adviser when you attend a Tribunal. This may seem expensive, but there is an old saying among lawyers – “the litigant who represents himself has a fool for a client”. Presenting a case to the Tribunal is a skill that can only be learned by experience.

11 Deeper Waters – The “COP 9” Investigation

Earlier I mentioned the Special Civil Investigations unit. (SCI). They only deal with cases that are very serious – typically, cases where there might be a prosecution for tax fraud.

C-O-P stands for ‘Code of Practice’ and Code of Practice 9 is effectively an offer from HMRC saying that *“we know you have committed fraud, but if you confess to it and give us the full details we will not prosecute you. Instead we will just take the tax, interest on the tax, and financial penalties from you”*.

If you get a letter from HMRC which includes the leaflet COP 9 – ‘Code of Practice 9’ - then the situation is very serious and you absolutely must get professional advice.

I have known clients to take the alternative course, which is to flee the country, but I obviously cannot recommend this!

A COP 9 letter means that HMRC consider that they can probably prove that you have committed tax fraud.

Most of what I have said previously about conventional local investigations does not apply to a COP 9 enquiry. It really is a completely different matter, and let’s hope you never get one. If you do, then you should go straight to a specialist in tax investigations – or if you already have an accountant, ask him to recommend a specialist in tax investigations. Accountants in general practice will (or should) agree that they simply do not have either the time or the expertise to deal with a COP 9 enquiry.

12 Is It Ever Likely That A Local Investigation Would Turn Into A COP 9?

This can happen, but it is very unusual. I had one case where the local tax office originally asked a fairly simple question involving the accounts for a business. However, when I talked to the client he admitted to me that he had actually been engaged in very serious international tax fraud.

In such a situation the only thing to do was to ring up the Special Compliance Office (as it was then called) and explain that the client had responded to the local enquiry by telling me that he had been involved in major tax fraud.

I got the SCO to agree to meet him and formally hand him COP 9, because the point about COP 9 is that it protects you from prosecution - provided you are honest in your disclosure to HMRC and you give them the full facts of what you have been doing.

It is very rare for a local investigation to develop into a COP 9 and I have only had three cases in my career where this has happened.

13 Paying More Tax To HMRC

If you negotiate a settlement with HMRC they will expect you to pay the additional tax, and interest on that tax from the dates when it should originally have been paid.

In cases where they discover that the enquiry year's returns are wrong they are then entitled to go back to previous years. In law, they can go back up to twenty years, but in a local investigation it is very unusual for them to go back more than six years. Generally, they will use a "broad brush" approach for these earlier years, and again this is something that an experienced adviser can help to negotiate for you.

In addition to the tax and the interest on that tax, they will consider whether to charge penalties. Penalties can only be charged if you have been "fraudulent or negligent", and we will look more closely at what this means later.

The penalty is based on the amount of tax that was underpaid. If you have underpaid £1,000 tax, the maximum penalty for this would be £1,000. In practice, the penalty is almost always reduced from this maximum by looking at the nature of the errors.

There is a procedure HMRC follow in determining the appropriate penalty, which is expressed as a percentage of the tax involved in the errors.

The first question is whether you disclosed the errors before you were asked about them – though once an investigation has started it is too late to make an "unprompted" disclosure to HMRC. Penalties for "unprompted" disclosure are lower than those for a "prompted" disclosure. For example, in the case of an error due to carelessness (with no deliberate concealment of the correct figures), the minimum penalty for a "prompted" disclosure is 15%, whereas the minimum for an "unprompted" disclosure is 0% - no penalty at all.

The full range of penalties is set out below:

	Mistake despite reasonable care	Careless Error	Deliberate understatement	Deliberate understatement with concealment
Prompted disclosure				
Maximum	0%	30%	70%	100%
Minimum	0%	15%	35%	50%
Unprompted disclosure				
Maximum	0%	30%	70%	100%
Minimum	0%	0%	20%	30%

14 Understanding These Is Important!

Reasonable Care means being careful to get your return or accounts correct, and if necessary taking the appropriate advice from a suitably qualified accountant or tax adviser. You cannot simply rely on your accountant to get things right – you must be able to show that you have made every effort to check that the accounts and

return are correct. This is why it is important to have a record of the checks you performed before signing your return and accounts, in the form of a meeting note or an exchange of correspondence with your accountant. Of course, in some cases there will be technical points of tax law where you need to rely on your accountant, but even here, you need to make the effort to try to understand the basics of what he has done and why.

As you might expect, HMRC have a very limited view of what is “reasonable care” as we shall see later on!

A **“careless error”** is, of course, the result of not taking “reasonable care”, and would include such things as not keeping proper records, losing bank statements and guessing at the numbers rather than getting copies from the bank, and claiming expenses that are not allowable as a deduction.

A **“deliberate understatement”** involves using figures you know to be incorrect. For example, in cash trades like a pub or a taxi, there is always a temptation to “skim” a few pounds each week from the takings, and not to record the full amount as income. This would be a “deliberate understatement”, as would be overestimating your out of pocket expenses.

“Concealment” is when you either tell lies or produce false documents to try to cover up your “deliberate understatement” – for example, producing fake invoices to justify the inflated claim you made for expenses. Typically, “concealment” occurs during the early stages of the tax investigation, when awkward questions are asked by the inspector, but I have known examples where it took place before this – perhaps when putting together the business records to give to your accountant for him to prepare the accounts.

You will note that for each type of understatement referred to in the tables above, there is a maximum and a minimum penalty. For example, the maximum penalty for a deliberate understatement without concealment (if you did not make an “unprompted” disclosure) is 70% of the tax, and the minimum is 35%. The difference between these two extremes depends on how you behave during the investigation. Having worked out the amount of penalty involved, it is then reduced by percentages for “Telling”, “Helping” and “Giving Access”.

For example, if there was deliberate understatement of income on which the tax was £10,000, the maximum penalty would be £7,000, and the minimum £3,500. The difference between these two is £3,500.

The level of reduction is determined by applying the following percentages to that £3,500:

Up to 30% for “telling” – that is, admitting to what has been done and explaining how it happened. The reduction here could be up to £1,050 (30% of £3,500).

Up to 40% for “helping” – by answering all HMRCs questions and providing all the necessary information to quantify the tax lost. This could reduce the penalty by a further £1,400.

Up to 30% for “access” – such as getting copies of bank statements from the bank if necessary, allowing HMRC to see any documentation, and so on. This is worth up to £1,050 in the example we are looking at.

The key point is that you will significantly increase the penalties if you are obstructive or refuse to admit anything is wrong until the last moment.

15 Will The Taxman Forgive Me?

It is important to realize that HMRC will not forgive the tax or the interest on it, but it is possible that they will accept that there was a genuine mistake or a genuine misunderstanding.

This is most unusual, because a very high standard of care is expected when you prepare your tax return.

“I lost the till rolls for that week, so I had to make an estimate of the takings” – it was careless of you to lose the till rolls, wasn't it?

“My accountant said it was all right” – he should have known better – that's a matter between you and him.

“I was told by a man at the golf club that it wasn't taxable” - if you'd asked a tax adviser he would have told you it was taxable.

“I rang up the tax office and they told me it was OK” - we have no record of that phone call. (If you ever do ask advice from the tax office, get it confirmed in writing).

16 How Does The Taxman Catch People Who Have Been Cheating?

In some cases it is just by luck. This is because as mentioned at the outset of this report HMRC opens some inquiries at random.

However, more often they will have some reason to suspect that there is something wrong and rather than the return being investigated at random they will have actually flagged it up as one that they are going to investigate. Essentially they look for certain triggers.

I have already mentioned that HMRC's software will spot anomalies in accounts – such as where the purchases and sales are not what you would expect for that sort of business.

HMRC are very fond of what they refer to as **gross profit rates (GPR)**. The GPR of a business is the percentage of profit made from the purchases and sales, before taking into account the overheads such as staff costs, rent, advertising and so on (which vary much more from business to business). They have access to extensive statistics about the likely GPRs for various types of business in their local area and nationally, and are likely to investigate accounts which show different figures.

They also look for unexpected evidence of wealth. For example if you declare income which seems just enough to support you and your family and suddenly you start declaring an amount of interest from a bank account that suggests a substantial deposit in that bank account, then they might investigate to find out where you got the cash to open the bank account.

Of course there might be a perfectly genuine reason such as an inheritance but HMRC might well investigate your return to find out where the money came from.

Also, I am afraid that quite often investigations are opened as a result of informers. When I worked as a tax inspector we used to get a lot of informers and I am sure that this is still the case.

I suppose the most likely informers are disgruntled employees. We used to get a number of people who had left or been sacked or had had a disagreement with their employer, who got their own back by telling us about tax irregularities they knew or suspected were going on.

Next are spouses and girlfriends or boyfriends.

I think I can say that if you are fiddling your taxes, for goodness' sake be good to your employees and don't fall out with your wife or your husband because they really are one of the most common sources of information!

On one occasion my informer was someone who was negotiating to buy a business and the proprietor of the business had been stupid enough to show him two sets of books – one he used for HMRC and the other one he claimed to be the real set, showing a much higher profit. The purchaser came straight round to the tax office and told me about it.

The above instances highlight the fact that HMRC do not carry out all their investigations at random by any means.

In many cases they either have specific information about tax irregularities, or the accounts look strange compared to others for similar businesses.

17 The Best Defence Against An Investigation

Because some investigations happen at random, there is no absolute defence against getting investigated in the first place, so what we should really talk about is the best defence when you do get investigated.

The best defence is to have proper and carefully kept business records, and to make sure that the accounts are prepared in accordance with those records.

Now this may sound easy but in practice most of us are sometimes a bit lazy about it and it is very important to keep proper detailed records. If you have any doubts about what records you should be keeping, ask an accountant.

The first job of an inspector running an investigation is to “break the records” – that is, to demonstrate that they cannot be relied on as a basis for the accounts. Once they have done this they have a justification for substituting their own estimates of what they think the profits should have been.

I cannot emphasise enough the importance of keeping meticulous records. All tax advisers – and tax inspectors – are well aware of a real case where HMRC were able to prove that one specific sale from a shop had not been recorded or declared in the accounts – the customer had become suspicious when she was asked to make out her cheque to a name different from the name of the shop, and had reported this to HMRC. This case went to court, and the Court agreed that the proof of this single deliberate omission was enough to “break the records” and allow HMRC to substitute their estimate of what the profits should have been.

One of the classic ways that HMRC try to “break” your records is what they call a **cash test**. They will start with the amount of cash that you had at a certain date and they will then go through all of the cash that came in and went out in the next few days or weeks.

They look only at actual physical coins and banknotes received and spent, not cheques. If at any point you go negative in your cash balance, then this shows that the business records are wrong, because it is impossible to have a negative amount of cash in your pocket or in your cash box.

As I mentioned earlier, you are likely to be asked at the meeting with the inspector what is the largest amount of cash you have ever had in your possession.

This is a terribly dangerous question because the answer will be used as part of the Cash Test. Unless you are absolutely sure you know the correct answer, you should be truthful and say you do not know.

Too often people at meetings with inspectors want to be helpful so they will provide an answer to the inspector even if they are just guessing. The problem is that this will come back and bite them later when the inspector lays out his conclusions based on what he has been told.

So the first best defence is keeping good records and making sure your accounts are accurate.

The next best defence is to respond to the inspector's enquiries and to answer his questions as honestly as you can; in many cases investigations will be settled quickly, for example if you have been investigated because there is a sudden new source of income in your return such as bank deposit interest or rent from a house – and if you have a reasonable explanation for this and the evidence to back it up.

Finally, the other most important defence is to have expert professional advice!

Congratulations!

You have reached the end of this special report: 'How to Master a Tax Investigation'.



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