

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



Response from
The Institute of Chartered Accountants of Scotland
to
HM Revenue & Customs
Business Records Checks

28 February 2011

Introduction

We support sensible steps by HM Revenue & Customs to encourage improved business record keeping by SMEs which are not already maintaining adequate records. This should create greater fairness for the large majority of businesses that comply with their accounting and tax obligations.

Unfortunately the bases on which these proposals have been presented seem deeply flawed. Assumptions made by HMRC regarding the incidence of inadequate business records are unsubstantiated by any detail, and estimated costs of the scheme are massively understated. It was not long ago that HMRC were assuring the Administrative Burdens Advisory Board that interventions would be well targeted to reduce red tape for compliant taxpayers, and we fail to understand why this policy has been changed. Importantly, reducing red tape and Government departments' requirements was recommended in the Hampton and Macrory reports and recommendations.

HMRC's basic assertion that poor business record keeping is responsible for a loss of tax in up to 2 million SME cases annually seems to be a sweeping generalisation with little credible evidence provided to back it up. We would like to see evidence as to how this statistic has been arrived at, as the validity of the entire consultation document is based on it. Without such evidence, the proposals might appear burdensome and unjustified.

Experience of our members in practice suggests that poor record keeping (where it arises) does not necessarily equate with loss of tax – it can sometimes result in their clients paying too much tax. This comes about because good practitioners take a prudent line in preparing accounts. Where records are inadequate, it is not uncommon for an inadvertent cash difference to arise. In such circumstances, it is standard practice that any 'cash over' is assumed to be unrecorded sales and brought into turnover, while any 'cash under' is treated as non-business expenditure or drawings and therefore not claimed as deductible. This approach undoubtedly flexes the end result (i.e. the tax payable) in favour of HMRC.

We would take issue with HMRC's basic assumption that SMEs with poor records have chosen to have poor records. This is a misconception. Those with the courage and tenacity to embark on new business ventures are forced to battle from the outset against a mass of Government regulation and red tape. Typically they don't go into business because of their record keeping skills. Their ability to deal with all the necessary administration improves as they gain knowledge and understanding of book-keeping, accounting and tax. It is sometimes a while before they realise the value of seeking professional advice on such matters, but when they do so they are generally receptive and quick to learn how to keep better records or eager to engage help in maintaining these.

If the Government is to create an environment in which new businesses are nurtured and encouraged, it is essential that HMRC should adopt a stance which will assist businesses in learning how to meet their record keeping obligations. For businesses that choose not to be represented professionally, we believe HMRC has an obligation to provide appropriate training and education so that these business proprietors can learn what is required of them. For those who have already sought advice from professionally qualified agents, HMRC should use existing links with agent representative bodies to ensure that the standards of record keeping their members promote are adequate to meet HMRC's requirements.

We are concerned by the impact assessment where it states: “It is estimated that £600m of extra revenue will be collected over 4 years assuming 50,000 BRCs annually.” It has not escaped our notice that the average extra revenue per business is expected to be £3,000, equating precisely with the maximum penalty exigible for failure to keep proper business records. This leads us to question whether HMRC have any intention of helping and educating businesses, or whether their key objective is to generate high penalties through prompted disclosures. For this reason we would ask that HMRC publish, in advance, the tax and penalty components of its £600m target as separate totals. Furthermore, we would ask that HMRC should publish annually the actual costs incurred on and actual benefits arising from the programme of business records checks.

HMRC should be looking for positive ways of encouraging taxpayers to maintain adequate records, rather than embarking on a campaign based on punishment. Since there is no ‘one size fits all’ and different businesses will learn their record keeping skills in different ways, HMRC should allow the first business records check of each business to take place without penalties – and on that occasion they should provide only practical advice or a warning if appropriate. This has been long established practice for late submission of VAT returns, and has proved that most traders who are late once get a sufficient shock from the surcharge liability notice that they improve dramatically. Taking a similar line by issuing no more than a warning on a first business records check would demonstrate that HMRC were genuinely attempting to help and educate – not simply trying to maximise revenues from penalties. In cases where a penalty is considered to be appropriate, we recommend consideration of whether that penalty should be capable of suspension. A suspended penalty regime might encourage better record keeping and produce a better outcome.

We note that HMRC are willing to regard a box of invoices and receipts, to be sorted out later, as adequate business records. Typically, where this method is adopted, the box is delivered to the tax agent some time after the year end. The agent then sorts out the contents, tabulates and analyses the various items of income and expenditure, and prepares a set of accounts for the year – which sometimes involves adjusting for a cash difference that may have arisen inadvertently, giving HMRC the benefit of the doubt in doing so. The resulting accounts are usually reviewed by the agent and client together, relying on their knowledge of the business (and the agent’s knowledge of the client) to ensure that the accounts appear to be correct and complete. We do not believe that an HMRC representative, acting alone, could arrive at any valid or useful conclusion on examining such a box of invoices and receipts part way through an accounting year.

Anecdotal evidence has caused our members to question the skills and professional judgement of some HMRC representatives checking the business records of their clients. We understand that many of these members of staff have no significant accountancy or tax training. This can cause them to be on the defensive, and in these circumstances it is not unknown for them to adopt intransigent attitudes. More importantly, anecdotal evidence suggests that HMRC officers try to impose standards of record keeping that are impractical and burdensome, in some cases unrelated and inappropriate to the business needs.

As the consultation document acknowledges, business proprietors with no technical competence in book-keeping are capable of maintaining unsophisticated business records which can be turned into correct and complete returns of taxable business profits. However, this is not to say that an under-trained and intransigent HMRC officer is capable of applying professional judgement in assessing whether or not those records are adequate, nor that such an officer would be able to engage in useful and productive

discussion with the business proprietor regarding those records. We would therefore envisage that represented clients would wish to have their agent present throughout any business records check, and we believe that any prudent tax agent would encourage them to do so.

We are concerned that the real costs to businesses may have been understated significantly. The impact assessment estimates the total annual costs to businesses at £2.7m, based on 50,000 business records checks taking half a day (say 3½ hours) each. This assumes that the cost to each business, presumably in terms of interruption to their earning capacity, averages only £15.40 per hour for 3½ hours. This might be realistic in the case of an established business willing to delegate an accounts assistant to show the records to the HMRC representative, but wholly unrealistic for a small business where, if the work of the proprietor was disrupted for half a day, the whole business might grind to a halt and lose substantial earnings. In the latter case a fairer measure of the cost could easily be (say) £100 an hour or substantially more.

Given their fear of getting things wrong and the threat of penalties, many businesses, however confident they are with their record keeping would wish to have a representative from their accountant or tax agent present for a preparatory meeting of at least an hour and throughout the HMRC visit, adding an extra hour to the process and at least a further £50 if not £100 per hour on cost. On a revised and still modest estimate of the average interruption to the business as 4½ hours, the opportunity cost of the proprietor's or employees' time as (say) £50 per hour and the added professional costs at (say) £75 per hour, the overall annual costs to businesses would increase to more than 10 times those set out in the impact assessment – from £2.7m to £28.1m.

We are also surprised to note that the programme would involve “no extra costs to HMRC as this will be absorbed by ongoing resource costs.” If (as suggested) checks were to take an average of ½ a day each, the programme would occupy 25,000 person-days per annum, requiring in total the equivalent of 100 members of staff for 4 years. We would have expected the impact assessment to have recognised the very considerable opportunity costs of deploying this number of HMRC staff on the proposed business records checks, at a time when the quality of HMRC's services in other areas appears to be inadequate. HMRC is responsible for considerable yet unnecessary costs because of their delays, difficulty in communication and unacceptable levels of error.

We have another point arising from the impact assessment, where it states: “It is estimated that £600m of extra revenue will be collected over 4 years assuming 50,000 BRCs annually. A risk is that BRCs might focus on cases with adequate records; but through the application (*sic*) of ‘risk assessment’ we expect the initial incidence of poor record keeping in the BRC population to be around 60%, increasing as BRCs progress.”

We are concerned by this statement that the incidence of poor record keeping is expected to increase as business records checks progress. By contrast, we think that a well advertised and professionally run campaign by HMRC should have exactly the opposite effect, reducing the incidence of poor record keeping by persuading all SMEs that it is imperative to maintain adequate records because of the risks of failing to do so. If the Government really think that the level of poor record keeping would increase, then it is time to redesign these proposals from scratch.

Responses to Consultation Questions

We set out below the specific questions from the consultation document and our answers to them:

Question 1. The record keeping requirements - Do we need to go further than what is available from the factsheet and the evaluation tool; and if so, what else is needed?

The ‘evaluation tool’ is not explained in the consultative document, but we assume that it refers to the interactive tool on the Business Link website. We think that the HMRC factsheets and Business Link evaluation tool provide useful guidance, and we think there is probably no need to go much further than what is already available from these.

Question 2. Categories of failure and responses - Are the categories and responses at 4.11 above the right categories and the right responses? If not, what should the categories and/or responses be?

We think the categories are broadly acceptable.

For reasons stated above, we think that the award of a penalty on a first business records check would be inappropriate. A warning along the lines of a VAT surcharge liability notice would be a fairer response, and just as effective in improving business records.

If a penalty is to be imposed, a mechanism to suspend that penalty if the taxpayer improves the record keeping to a satisfactory level might achieve a better outcome.

Question 3. Significant failures – Is the outline proposition at 4.13 above a reasonable basis for drawing up guidelines as to what should constitute significant record keeping failure? And if not:

Why not? And

What alternative basis would be reasonable or drawing up guidelines as to what should constitute significant record keeping failure?

The proposition at paragraph 4.13 is much too brief to enable us to comment on it in detail. We would suggest that the definition of ‘significant’ and needs to be considered carefully, and that a ‘*de minimis*’ level below which discrepancies can be ignored should also be defined.

It is unclear to us what allowances are to be made for genuine, inadvertent errors, which all human beings are prone to making. The guidelines should aim to forgive these, while identifying record keeping failures that are both significant and persistent. This would be in line with decisions by the Courts (e.g. in TC00669 Stephen Ho) that some human error is to be expected and such defects in record keeping need not be significant.

On a similar basis we feel that businesses should not be penalised automatically for failing to record amounts of business ‘money out’, except where it is discovered that these are part of a wider series of discrepancies resulting in an understatement of taxable profits. In many cases an inadvertent failure to record money out would merely result in an overstatement of profit (or understatement of loss) posing no threat to the Exchequer, and we recommend that isolated errors of this kind should not be penalised.

Question 4. Penalty tariff - What amount of penalty is needed at a minimum to encourage those with significantly poor records to bring their record keeping up to standard, and to deter a potential 'for £X its worth it' mentality?

As already stated, we think that a warning would be adequate when shortcomings in record keeping first become apparent. Beyond that point, the minimum level of penalty that would act as a deterrent will vary according to the size of the business. Where a penalty cannot be avoided, we think it should be based on a small proportion of turnover or gross profit rather than any specific minimum.

We recommend that a penalty suspension mechanism be considered to encourage improvement in record keeping.

Question 5. Penalty tariff - Should the penalty tariff for significant record keeping failures be the same for all? If not, on what criteria might a workable penalty differential [within the statutory maximum of £3,000] be based?

As stated above, we would favour a workable penalty differential between large and small businesses, and for this purpose we think that the penalty in every case could be based on a small proportion of turnover or gross profit, subject of course to the statutory maximum (and the possibility of suspension).

Question 6. How can the interaction between the penalties for the very separate offences of failure to maintain statutory records, and making an inaccurate return best be managed and articulated?

If the return is inaccurate as a result of the failure to maintain statutory records, then there is a single transgression and these penalties should be assessed as one.

Question 7. Leverage - Does this seem a good way to encourage the desired change in behaviour, and if not why not?

The Courts have confirmed that HMRC have the discretion to target particular sectors. This needs to be handled carefully as it might be counterproductive if certain business sectors perceived HMRC's actions as unfair.

Question 8. Leverage - Are there any other or better ways to encourage the desired change in behaviour?

The business records checks programme, if properly communicated in a positive manner to taxpayers, should achieve the desired change in behaviour in cases where this is needed. All businesses should be treated in the same way. It would be grossly unfair to do otherwise.

Question 9. Time to adjust - What will constitute a reasonable period of time to allow those whose record keeping is sub-standard to make the necessary changes to their record keeping?

The emphasis in paragraph 4.39 is on those with agents and those who seek to engage agents. There is no compulsion to seek professional advice, and those who choose to remain unrepresented are likely to require even longer to make the necessary changes to their record keeping, so this should be factored in.

We recommend that a reasonable period of time would be not less than one year.

On this basis there should be an absolute ban on any business receiving a business records check less than one year after the previous such check.

Question 10. Time to adjust – Would it be useful to begin BRCs on this ‘test and learn’ basis?

We see no objections to HMRC beginning business records checks on the suggested ‘test and learn’ basis. However, it would be unfair to impose this on businesses during the trial phase, so we recommend that they should be allowed to opt out if they wish.

The suggestion here is that the checks should begin, but without penalties being imposed during the trial period. As you will appreciate, we recommend that on a continuing basis no penalties should be charged on a first check.

Question 11. Publicity and awareness - How might HMRC best work with agents in bringing details of these changes to their clients?

Tax agents come in many different shapes and sizes. HMRC should adopt a flexible approach in working with agent representative bodies and with different firms of agents to ensure that details of the changes reach their clients.

Question 12. Publicity and awareness - How might HMRC best bring details of these changes to the wider audience, especially unrepresented SMEs?

We recommend that details of the new regime should be sent to all SMEs known to be in business in the UK. In addition, we envisage that HMRC might bring the details to the attention of the public at large by means of an effective advertising campaign – using the Internet, Facebook, TV, radio and the Press.

Question 13. Other issues - Are there issues other than those referred to above that ought to be taken into account, and if so, what are they?

We are particularly concerned about the cost implications for all SMEs who will find themselves subject to business records checks, and the costs and disruption likely to be imposed on very small (and especially one-person) businesses. These run contrary to the Government’s stated aims of reducing administrative burdens on business and encouraging economic growth.

Question 14. Impact assessment - Do you have any comments on the assessment of compliance costs?

We think the compliance costs would be huge. The autocratic attitude of HMRC in instigating such checks, particularly where many businesses are paying for sound professional advice on their record keeping obligations, would be a major disincentive for many to stay in business or set up in business for themselves. This could decimate the Government’s plans to encourage business growth and new employment as catalysts to economic recovery.