

Taxman's tactics - what contractors should look out for when an IR35 investigation looms

Contractors trying to take on the might of HMRC single-handed in an [IR35](#) investigation need to be aware of the risks, warns former tax inspector Carl Whittaker of [Qdos Consulting](#).

No one can know what the distant future will bring following the [Law Commissions'](#) recent consultation paper asking how a system of redress can be created for individuals who have suffered loss as a result of seriously substandard administrative action from public sector agencies.

But one thing is certain: the taxman's tough approach to investigating the tax affairs of contractors will continue for the foreseeable future as likely changes to UK rules governing public bodies will undergo endless consultation before changes can be made.

And that's why contractors should think seriously before attempting to defend an HMRC investigation without professional assistance, says Whittaker.

HMRC can track-down contractors with ease

"An experienced HMRC inspector can glance at the profit and loss account of a large business, like an engineering firm, oil company or bank, and immediately spot unusually high bills in professional services. That means the firm probably uses a lot of contractors, which will be of immediate interest to the inspector."

Then they only have to identify the contractors from their invoices in the firm's accounting records, and for the inspectors it has suddenly become a target rich environment – with contractors firmly in their sights.

The investigation starts when the inspector reviews the contractor's accounts. There are a number of giveaways that the contractor might fall within [IR35](#) and merit an inspection:

- o No employees, other than directors
- o The directors pay themselves [minimum wage as salary](#)
- o The directors, possibly husband and wife, take most of the cash out of the business as [dividends](#)
- o There are no materials charged through the business.

"All these factors point to a personal service company which will almost certainly result in an inspection," says Whittaker.

"Warning bells should ring the day a contractor receives a letter from the HMRC informing them of an Employer Compliance Review," continues Whittaker. "This means the early stages of a status inspection has begun and the inspector will be out to prove the contractor falls within IR35 – classic HMRC tactics."

Frightening powers of investigation

The common law tradition in the UK is underpinned by the fundamental assumption that someone is innocent until proven guilty by the relevant authorities.

But beware – that's not the case if a tax investigation of a contractor is underway – the burden of proof lies with the contractor, not HMRC. Simply put, you are guilty until you prove your innocence.

That presumed guilt, if accepted by the contractor without a fight, could result in back taxes and substantial interest and penalties, potentially resulting in professional and personal ruin, from which a contractor may never recover. And that's not to mention the stress and impact on the contractor's family.

But taking on HMRC alone is not a trivial undertaking. And Whittaker explains why.

HMRC tactics - be careful what you say

"HMRC will start the investigation before they even arrive at a contractor's premises. They will have already considered the main issues and great care needs to be taken at the initial meeting," says Whittaker. "That's when an expert needs to be present.

"I attended an investigation at a client's offices. The client used a number of sub-contractors, not employees. However the first question the inspector asked when the meeting began was 'So, Mr Smith, how exactly do you control your employees?'"

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Two key tests were satisfied in that statement; employment status and [control](#). Whittaker told ContractorCalculator that had he not intervened at that point and halted the meeting, the client not understanding the issues would have responded to the inspectors question as he was invited to do. The inspector would have written in the notes of the investigation: 'When we arrived, Mr Smith explained to us how he controlled his employees'.

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And, says Whittaker, this statement would have become a conclusive piece of evidence throughout the case, alongside the HMRC inspectors' account of the meeting, during which they would have used similar questioning.

What goes on record?

At the start of the investigation, HMRC could spend an entire day with the contractor. The inspectors will spend the morning asking questions about how the business is organised and in the afternoon they will go through all the company records.

The notes of the meeting will reflect the inspectors view and great care should be taken when asked to countersign the notes of the meeting. Indeed it is common practice for these notes not to be signed by the advisor or client. Any discrepancies should however be pointed out. The notes may express the inspector's interpretation but not necessarily the contractors.

You don't have to go it alone

A veteran of many run-ins with HMRC investigations, Whittaker advises contractors to consider the costs of an investigation and take pre-emptive measures: "[IR35 tax investigation insurance](#) can cover the costs of having an experienced professional adviser from day one.

"It is also vital that the contractor is aware of HMRC's tactics and listens to his professional adviser's advice when responding to any questions. Even a simple response to a seemingly friendly and innocent question can prove costly to a contractor; in many cases very costly indeed."

Law commission correction

ContractorCalculator recently reported that the Law Commission has criticised public sector bodies in a recent consultation paper. The editor acknowledges that this is incorrect.

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