

Minimising the risk of an HMRC investigation

Contractors are always at risk of being investigated by HMRC, but there are simple measures they can take to reduce the risk and avoid the stressful and potentially expensive investigation process.

"I genuinely don't believe that truly random tax investigations exist anymore," says **James Abbott**, owner and head of tax at contractor accountant **Abbott Moore**. "HMRC has neither the inclination nor the resources to stick a pin in a list of names to identify targets.

"The taxman has hugely sophisticated and effective tools that can be used not only to target contractors exhibiting risky behaviour, but also to identify those who are likely to deliver a good yield to HMRC as a result of its compliance activity."

HMRC has adopted a new approach to compliance, in which it is trying to cover more ground but with less depth. The days of contractors being targeted for inspection simply as a result of being in business for a long time are also over, believes Abbott.

No one knows HMRC's risk criteria

According to Abbott, HMRC has developed highly detailed and effective risk criteria that it uses to target taxpayers for investigation. But no one knows what the risk criteria are: "If we knew what criteria HMRC used to profile and target taxpayers, we'd know what to avoid," says Abbott.

Although HMRC keeps its risk criteria a closely guarded secret, Abbott stresses that there are undoubtedly taxpayer behaviours that increase the chances of being investigated by the taxman.

"Contractors and their tax and accountancy advisers can secure hints about HMRC's profiling processes from the compliance campaigns it runs. Contractors can learn from these what behaviours are least likely to attract attention."

In the case of **IR35**, the now defunct business entity tests (**BETs**) that were abolished in April 2015 provide useful insights into what behaviours HMRC believes are 'risky'.

Limited company contractors are not simple and straightforward

When he first joined the profession, Abbott says that most agents considered one person limited companies to be fairly straightforward, as did HMRC. But this approach has changed, as **limited company contractors** are actually anything but simple.

"The scope for limited company contractors to get things wrong is considerable," he says. "Contractors can make errors to one, all or some of corporation tax, income tax, National Insurance Contributions (NICs), payroll, expenses and VAT. And any error provides the taxman with a reason to investigate."

HMRC can apply IR35 and argue that the **high dividend, low salary strategy** simply disguises that the contractor is drawing a salary, so all of their income could be reclassified, leading to a potentially huge tax yield for HMRC if the contractor is a high earner.

And Abbott believes that the days of high street general practitioners supporting contractors are long over: "Accountants really need to understand their clients' sectors. Best practice for regular small businesses is just not the same for limited company contractors."

HMRC will start with what it knows

The first place HMRC will look when considering an investigation is what it knows – this means tax returns. And if a contractor is filing tax paperwork late and/or with errors, a tax inspector will assume that the contractor is also making errors with the amount of tax they should be paying. And to a taxman, that means 'yield'.

Abbott warns: "HMRC is interested in two groups: those telling lies and those making mistakes," says Abbott. "It makes no secret of the fact that it views you as 'risky' if returns come in late or they have errors."

The taxman also knows that some areas of business are particularly prone to non-compliance, which is why HMRC runs so many compliance campaigns based on sectors and locations.

"Contractors with good accountants who file accurate and timely tax paperwork are highly unlikely to be investigated," he adds.

HMRC's Connect software

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Abbott warns that HMRC also has powerful and sophisticated software, called Connect. This can analyse all public sector databases alongside other data in the public domain and online, including social media.

"If a contractor has filed a corporation tax return reporting poor performance and profits, but is boasting about how well they are doing on their Facebook page, an inspector will pick this up and initiate an investigation," continues Abbott. "Many of the connections made are automated, and Connect can search over 4bn items of data.

"There is now more chance than ever that HMRC will spot your mistakes and draw your attention to them. And if you have been telling lies, you will almost certainly be found out, because HMRC will use software to identify inconsistencies."

Business record checks (BRC)

HMRC's business record checks (BRC) campaigns don't look at the forms that have been filed but focus on what is happening in the business in real time.

"BRCs are designed to determine whether a business has the processes in place to create and maintain sufficiently high quality business records on which accurate tax returns can be based," says Abbott.

Contracting businesses failing to maintain adequate records face steep penalties. So contractors should ensure they create and maintain high quality records and keep them in a form ready for immediate and convenient inspection, if asked.

How to avoid an inspection

Abbott's checklist for contractors to reduce the risk of being targeted for an inspection is straightforward:

File accurate tax returns on time

Pay tax owed in time

Don't get involved with aggressive tax solutions

Keep high quality accurate records

Use an accountant.

"Of course you would expect a tax professional to process your tax returns with a high degree of quality, but they are also vital as another set of eyes, and are more likely to spot any mistakes," suggests Abbott.

"Take what your accountant files on your behalf seriously. Although you are paying an accountant to complete the forms you need to critically review them, as ultimately HMRC will hold you responsible."

The reassurance of insurance

Abbott urges contractors to get [tax investigation insurance](#): "Most accountants and many membership organisations offer low cost tax investigation insurance. Contractors can and do lose tax cases simply because they run out of money to pay their professional advisers before the case is resolved."



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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. [Read Full Profile...](#)

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Insurance will also cover the costs of an 'aspect enquiry'. This is when HMRC queries a specific aspect of a contractor's tax affairs relating to, for example, income tax or corporation tax. Abbott's experience is that a professional tax adviser responding promptly to an aspect investigation can often stop the investigation in its tracks.

Abbott concludes: "For the sake of less than the cost a round of drinks a month, tax investigation insurance removes much of the stress and cost of an HMRC investigation."

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