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Chartered Accountants

## Taxpayers as Terrorists - Draconian New Powers for Tax Inspectors



When my erstwhile employers, the Inland Revenue, merged with HM Customs and Excise in 2005 to create HM Revenue and Customs, the government gave assurances that the merger of the organisations would not mean that the Inland Revenue side would get the same powers as had been enjoyed by HM Customs for many years.

This was important, because the two organisations had totally different traditions and values. While the Inland Revenue's "Surveyors" (as the early tax inspectors were called) were responsible for taxing landowners on the "annual value" of their property, the "Preventive Officers" (the early Customs Officers), spent their time shooting smugglers and sinking their ships.

As I suppose was to be expected, those assurances have lasted less than three years because the current Finance Bill combined with a statutory instrument in February which brought into effect certain provisions of the Serious Crime Act 2007, mean that HMRC now has a fearsome array of new powers.

Customs Officers, due to their responsibility to crack down on drug and gun smugglers, have long had the power to bug phones and intercept mail and email, but now this power has been extended to HMRC when investigating direct tax matters.

Given the appallingly incompetent way Customs have used their powers in the past, leading to the collapse of several prosecutions due to what Mr Justice Crane described in 2005 as "muddle, incompetence, and lack of frankness", it seems strange that

the solution chosen has been to extend rather than to limit those powers.

In addition to being given bugs to play with, HMRC now has the power to enter business premises in order to inspect business records - something that VAT inspectors have always had, but which tax inspectors could only do if they obtained a search warrant in the most serious cases of tax fraud.

This power means that if you run your business from home (as I used to do, and as many self-employed people do) HMRC could turn up on your doorstep and demand to come in to inspect your records. Thankfully, given that they can do this without a search warrant, they have no power to force entry (so, presumably, if they try, you can use "reasonable force" to resist them). If you do refuse to let them in, however, they can then impose penalties on you for refusing to allow your records to be inspected.

It has long been a legal requirement to keep business records, with penalties for not doing so, but in practice I have never known HMRC to try to enforce this, mainly, I suspect, because there was no definition of exactly what "business records" were. Under the new legislation in the Finance Bill, HMRC can define (by statutory instrument) what records must be kept, and then you can be fined if you do not keep them. Many tax inspectors display a wholly unrealistic view of what are appropriate records for a small business to keep, so it will be interesting to see how burdensome the record-keeping requirements will be when the statutory instrument defines what is required. I would not be surprised if within a few years computer based records

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were made compulsory, given how much easier it is for HMRC to use software to interrogate such records.

"Doublethink" is typical of all totalitarian regimes, as George Orwell pointed out, and the new rules on record inspections are a beautiful example of doublethink. The new legislation restricts the inspection powers to statutory records (the ones the law requires to be kept, such as the VAT account book, and not other records such as your appointments diary). This has been highlighted by apologists for the new rules, but there is also a power to compel the taxpayer (and anyone else) to provide supplementary information to establish the correct tax position.

In other words, HMRC have no power to inspect records other than statutory ones, unless they think they are relevant to the tax payable. Or to put it another way, they can't inspect them unless they want to!

It is easy to get hot under the collar about these proposed invasions of our civil liberties on general principles (I have a Labrador called "Liberty", which tells you where I stand on the matter) but I think there is another much more serious aspect to these powers, and one which may have far-reaching consequences for the way we do business with HMRC.

Until now, relations between tax advisers and HMRC have been reasonably cordial. We can sometimes be a bit abrasive with each other, but in general we cooperate with each other to get things done. The new powers of entry, arrest, and search will (I fervently hope) not be used in the typical local tax enquiry, but the fact that they exist and could be used may well bring about a change in the way we represent our clients.

Tax advisers will need to be familiar with the extent of these new powers in order to protect their clients from attempts by HMRC to abuse them - and attempts there will be, if the past record of HM Customs is anything to go by. We will be less like business negotiators, and more like criminal defence lawyers, alert to attempts to coerce our clients or to infringe their civil liberties. Meetings with tax inspectors will become more formal, and this will do no favours to either side.

I was talking recently to a tax inspector who said that all the good staff have either left HMRC or are in the process of looking for other jobs, as he would have been were he not so close to retirement. He said he felt "ashamed" of the quality of work his colleagues were producing, and that they seemed to have no concept of applying the law in an even-handed way, but instead simply demanded tax wherever possible, leaving the tax advisers (for those taxpayers who could afford them) to argue that the tax was not due.

If you have lost your best staff, is it really a good idea to solve the problem by giving those who remain new powers that are so easy to abuse?

# Tax Tips

## Do your employees have to work late (after 9pm) sometimes?

As long as it isn't a regular thing, and it doesn't happen more often than 60 times a year, if it isn't "reasonable" for them to use public transport you can pay for a taxi home without any taxable benefit arising

## Catching the bus!

If you have several employees and your business location is hard to get to, you could consider providing a "works bus" to take them to work. This is also exempt from tax, provided a number of conditions are fulfilled - broadly, the bus must be used to take employees to and from work, or to the shops at lunchtime, and it must be available to (but not necessarily used by) all employees.

## Do you have two properties that could be your main residence?

If you have two properties that could be your main residence (such as a cottage in the country and a flat in town) it is always a good idea to nominate one of them as your main residence within two years of acquiring the second property - this will give you the flexibility to vary the nomination later.

**Or are you self employed as well as employed?** Check your PAYE codes carefully - it makes sense to have your tax

allowances set against the better paid job, and in addition you may be due a refund of NIC if you have paid more than the annual maximum.

## Have you received a tax repayment from HMRC?

Was it too much? If you receive a larger repayment than you are entitled to, you MUST tell HMRC about it and repay the amount overpaid. Not doing this is an offence under the Theft Act

**The filing date for your 2007/08 Self Assessment return** is now 31 October 2008 if you file a paper version, and 31 January 2009 if you file online. If you submit a paper return after 31 October, you may be liable to a penalty for late filing - and you cannot retrieve the situation by switching to filing online!

## Are you a "contractor" in the "Construction Industry Scheme"?

Apparently a number of contractors have incurred late filing penalties (and thus, in some cases, the loss of their "gross payment" registration. According to HMRC, in many cases the problem has been that they have put the wrong postage stamp on the envelope containing their monthly return - it's a "large letter" in Post Office language, and needs a 48p stamp, not a 34P one.

# Q&A

**Q1.** How much can private landlord charge per week before having to pay tax on the income?

**A1.** Tax is charged on the profit you make from letting and there is no minimum amount of rent. The only exception to this is the "rent a room" allowance, which applies to letting a room to a lodger in your own home. In this case, rent of up to £4,250 per tax year is tax free.

**Q2.** My wife and I have a property that has been let out for about five years. The property is currently in my wife's name and we are about to sell it. Would it be possible /simple to transfer the property into joint names prior to selling it in order to take advantage of both capital gains tax allowances?

**A2.** Provided that your wife has not yet agreed the sale with a buyer, a solicitor can draw up a deed of gift for you for a modest fee, but beware if there is a mortgage on the property, as there could be a liability to stamp duty land tax. Bear in mind that the saving in tax will only be about £1,700.

**Q3.** In what manner should I claim tax relief for travel to and from my property, which is

350 miles away, to undertake maintenance? Actual cost of petrol or at a mileage rate of 40p/mile (AA rate)? Maintenance was the sole reason for my trip and I stayed in the property, which, at that time, was furnished and unoccupied.

**A3.** The strict rules would say that you should calculate the business proportion of your mileage for the tax year and claim that proportion of the total running costs of your car, but provided your rental income is less than the VAT threshold (£67K), HMRC should not object to 40p per mile.

**Q4.** My daughter bought a property which she lets out. It is making a loss after accounting for interest on the buy to let mortgage used for buying the property. She does, however, have deposits in saving accounts. Can she offset the loss on property against the interest she is receiving from the savings accounts?

**A4.** No - the only rental losses that can be deducted from other types of income are losses on letting "furnished holiday accommodation". Your daughter's losses are carried forward and can be set against any future profits from letting the property concerned, or any other property.

## A Breath of Sanity - New PAYE Regulations from 6 April 2008



On 20th March, HMRC announced a change to the PAYE regulations that has brought a welcome return to sanity and fairness in the way the income tax is dealt with in cases where a worker is reclassified as being an employee rather than self-employed.

In order to appreciate the solution, we must first understand the problem. Many businesses use the services of individuals who are treated as self-employed. They also have employees. The key difference is that in the case of an employee, the business is responsible for operating the Pay As You Earn (PAYE) system to deduct tax and national insurance contributions from the wages paid to the employee. The employer also has to pay employer's national insurance contributions. The amounts deducted are paid over to HMRC on a monthly basis, on the 19th day of the following month, so for the April 2008 tax month (which, confusingly, ends on 5 May 2008), the tax and national insurance have to be paid over by 19 May 2008.

In the case of self-employed individuals, the position is much simpler. The individual presents his invoice for work done and this is paid with no deductions for tax. The individual is responsible for declaring his income and paying tax (and national insurance) on it through the self-assessment system of annual tax returns.

The problem comes when an individual has been treated as self-employed when he should have been paid under deduction of tax as an employee. This can happen for a number of more or less respectable reasons, ranging from the "employer" trying

to dodge his responsibilities under employment legislation to a genuine misunderstanding of the situation.

In most cases, this comes to light during an "Employer Compliance Review" by HMRC, and the usual policy is to expect the employer to make good the tax and NIC that should have been deducted from the payments made, typically for the last six years if the individual has been "employed" for that long.

It gets worse. Because tax should have been deducted from the payments made to the individual concerned, HMRC take the view that the amounts paid to him were net of income tax (for the sake of clarity, we will ignore the NIC situation for the rest of this article, as the important change relates to income tax).

This means that for every £100 paid to an individual liable to income tax at the basic rate, the tax due is not £22 (being the 2007/08 basic rate of 22% on £100). Instead, it is £28, because £100 net of basic rate tax is equivalent to £128 gross. £128 times 22% is £28.

In the case of an individual paying tax at 40%, the tax due on a net payment of £100 after this "grossing-up" procedure is a stonking £67.

Of course, the missing piece of the jigsaw is the tax the individual has already paid through his self assessment returns. In the past, provided the "employee" agreed, this tax could be informally offset against the PAYE tax due from the employer. This would

not cover the whole liability, of course, precisely because the individual concerned was paying tax on the net sum received (£100 in our example, so £22 or £40 depending on the rate of tax he paid), but it did go some way towards softening the blow for the employer.

Then came the case of *Demibourne v Revenue and Customs Commissioners*, which highlighted the fact that HMRC did not in fact have the power to do this offsetting. Instead, the employer had to pay the tax in full, and the "employee" got a nice hefty repayment of all the tax he had paid under self assessment for the same period. Apart from being unfair, particularly in cases where both sides had been perfectly happy with the "self-employed" arrangement, this also provided a very strong incentive for those workers whose status was being reviewed by HMRC to agree that they were in fact employees.

The PAYE regulations have now been amended so that in cases where settlements are being agreed after 5th April 2008, including those involving earlier years, HMRC now do have the power to offset the "self-employed" tax paid by the individual against the employer's liability.

This is good news for employers, though it does not mean they can relax about the question of whether a particular worker is self-employed or an employee. A PAYE settlement will still be an expensive experience, for the reasons described above, even though the new regulations mean that at least some of the tax will have already been paid by the employee.

## Employee Expenses Made Simple

Employees often incur expenses when doing their jobs and it is reasonable for these to be reimbursed by their employer. The process of claiming and reimbursing expenses can be frustrating for all concerned. Employees often mislay receipts and may not get round to submitting claims for some time. Employers may spend a considerable amount of time dealing with claims and reporting payments to HMRC. Consequently, anything that streamlines the process and makes life easier all round is worthy of consideration.

One option is to reimburse certain expenses by reference to scale rates rather than repaying the actual amounts incurred. This has a number of benefits. Employees will know in advance the level of reimbursement that they will receive and this may have the added benefit of controlling costs. Reimbursing by reference to scale rates also removes the need to keep receipts to support expenses claims, greatly simplifying matters.

From a tax perspective, there are various issues to be aware of. If the scale payment does no more than reimburse the expenses actually incurred, HMRC do not regard it as a round sum allowance. This is important as it means the employer does not have to operate PAYE when the payment is made to the employee. However, before this approach can be adopted, HMRC need to be satisfied that the rates used are not excessive. This means that it is necessary either to obtain HMRC's consent or to use benchmark rates published by HMRC, where these are appropriate.

The fact that the employer does not need to operate PAYE does not mean that tax and National Insurance can be forgotten. In the absence of a dispensation, the employer will need to return the expense payments made to HMRC on form P11D or P9D, as appropriate. The employee will then need to claim an associated deduction if the expenses are incurred wholly, necessarily or exclusively in the performance of the duties.

In the event that the expenses covered by the scale rate are fully deductible, it makes sense to seek a dispensation. This will allow the scale rate payments to be ignored for tax purposes. The employer will not need to report them on the P11D or P9D and the employee will not need to make an associated claim for relief.

However, before granting a dispensation,

HMRC need to be satisfied that the scale rates are set at a rate that broadly represents the employees' actual spending. Where possible, employers should submit receipts and other evidence in support of the rates.

Where the claim relates to subsistence expenses, it may not be practicable for the employer to obtain evidence of actual spending from all employees in support of the claim. In this scenario, HMRC will accept claims based on a sample, provided that the sampling exercise adheres to certain conditions. The sample must be a random sample based on ten per cent of eligible employees for one month (Employment Income Manual EIM05210). Once the sample has been selected, only the chosen employees need keep expense records and receipts. Further, they only need to do this for the month for which the sampling exercise is being carried out. However, HMRC need to be convinced that the sample is truly random and not contrived to support higher scale rate payments. Samples based on, say, every tenth employee from an alphabetical list, would be regarded as acceptable.

### Setting the Rates

Scale rate payments are not suitable for all types of expense payment and, indeed, HMRC will only accept scale rate payments may simply cover the actual expenditure incurred and should not be set at a rate that will cover the highest amount that the employee may spend. Rates that provide the employee with a profit will not find favour with HMRC!

Further, the payment must only be made if the employee actually incurs the associated expense. The fact that an employer pays subsistence at a scale rate does not mean that the employee can automatically claim the payment if he is away on business unless he has actually spent his or her own money on subsistence expenses whilst working away. If the payments are made regardless of whether the associated expense has been incurred, the payment will be treated as a payment of a round sum allowance and consequently subject to deduction of tax under PAYE.

If the employee uses his or her own car for work, any mileage payments made should be paid in accordance with the approved mileage allowance scheme.

### Bench Mark Rates

HMRC acknowledge that agreeing scale rates where employees travel abroad on business can be difficult. The sampling approach outlined above may not be appropriate as the employer is unlikely to have sufficient internationally mobile employees for a meaningful sample to be obtained. Consequently, HMRC have published tables of benchmark scale rates that employers can use to pay accommodation and subsistence expenses to employees whose duties require them to travel abroad.

Where the benchmark rates are used, the employee does not need to keep receipts or other evidence of actual expenditure. Further, provided payments for accommodation and subsistence are made at or below the scale rates to employees who travel abroad, tax and National Insurance are not due and the employer is relieved of the need to report the payments on the employee's P11D.

Now, unlike the mileage allowance scheme, if the employer pays scale rates which are less than the benchmark rates, the employee is not automatically entitled to tax relief. However, tax relief will be forthcoming if the employee's actual expenses, supported by receipts (referred to in the HMRC guidance as 'vouched expenses'), exceed the amount reimbursed by the employer. In such cases, relief will be available for the unreimbursed expenses.

Different benchmark rates apply for different countries. Tables of rates, which cover the payment of accommodation and subsistence to employees travelling outside the UK, are published in HMRC's Employment Income Manual at EIM05290ff. The tables are arranged alphabetically by country. Guidance on using the tables can be found at EIM 05250ff.

### Final Thoughts

Although agreeing scale rates with HMRC can be time consuming, it is probably an exercise worth doing where employees regularly incur similar expenses, as using scale rates will greatly simplify matters for both employees and employers. If employees travel abroad on business, the benchmark rates can again make life easier. However, the employer may first wish to check that HMRC's rates are in line with the spending actually incurred by their employees.

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