

TaxZone Newthwire

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Editorial Note

Most practising accountants are overworked and workaholics. When they have dealt with their clients' affairs there is one further job to be done - their own accounts and tax returns. Because this job is likely to be left until last, the accountant, particularly if he is a sole practitioner or in a smaller practice, is likely to be vulnerable in a number of ways. I shall seek to explore some of these in this wire



Regards

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Disclaimer

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Regulation

First of all one must mention regulation. This has increased dramatically over recent years, and for a small accountancy firm is a real deterrent to entrepreneurial activity.

If the accountant is a member of a professional institute, he or she will be bound by the code of ethics of that body, and may have to obtain and pay for a practising certificate. The members' handbook of the particular body is likely to be quite extensive. Failure to observe basic rules will result in disciplinary proceedings by the investigation body of the particular institute or association.

One universal obligation is to take out professional indemnity insurance against possible financial claims by disgruntled clients.

There are also strict regulations imposed by the FSA if the accountant engages in advice regarding pensions, insurance and investments. These are beyond the scope of this wire. Similar regulations apply to those who specialise in liquidations and receivership, charities work and/or management consultancy.

Other disincentives to practice include employment law, health and safety regulations and the Data Protection Act.

However, having mentioned all these issues, I want to focus on the accounts and taxation affairs of the practising accountant.

Money laundering

I only want to touch on the subject of money laundering, as I have already had my say in Newthwire No 38, and the 'nuts and bolts' of this subject are dealt with on the site very ably by David Winch.

Nevertheless this subject has had an immense effect on the profession. All new clients must be 'vetted' and asked for embarrassing identification. The accountant or a member of his staff must be appointed Money Laundering Reporting officer, and every client transaction involving funds comes under potential suspicion.

This situation is exacerbated when the accountant has some part in a client's financial transaction, either in the form of advice or actual financial participation. The use of a clients' bank account, already subject to strict regulation, has the potential to lead the accountant into trouble. Enough said, but this aspect will remain a very important one until the draconian laws and regulations are changed. The salutary tale of former solicitor Jonathan Duff, who was imprisoned for six months under the money laundering law and regulations, is sufficient warning for us all to comply at present or cease practice.

Accounts

Larger firms of accountants are likely to have an administration partner who, inter alia, will be responsible for the books and accounts of the firm. Smaller firms are likely to rely on a bookkeeper for routine transactions, while a partner or sole practitioner prepares the final figures. In some cases the practitioner himself will do all the work.

One hardly needs to remind practising accountants of the need to keep proper books of account and to comply with section 12B, Taxes Management Act 1970, but the possibility exists, however faint, of a full random audit under the self-assessment provisions, meaning that the books and accounts will be actually examined by the Inland Revenue. The tax fine for not keeping proper books of account is a mitigable amount up to 3,000 pounds.

PAYE matters

In a small firm the payment of salaries and the administration of PAYE is likely to be dealt with either by the practitioner himself, or someone outside the firm. It could be the wife or partner of the practitioner. It should be remembered that any firm may receive notice of a PAYE Audit, purely on a random basis. Any errors or defaults found could be reported to the Schedule D inspector and lead to a general self-assessment enquiry.

Accountancy firms of all sizes may use either agency staff or subcontractors in connection with technical work. Where subcontractors are treated as self-employed, it is essential that the contract and facts stand up to Revenue scrutiny. If not, any PAYE Audit or Schedule E Compliance Visit could lead to an attack by the local status inspector.

In a smaller practice, the spouse or partner of the practitioner(s) may be involved in the practice to one extent or another. If treated as an employee, it is important that PAYE is operated correctly. Payment should actually be made, and the salary agreed be commensurate with the responsibilities undertaken and number of hours worked. Unusually, the wife or partner could be self-employed (i.e. if providing computer services), in which case the usual contract and self-employment criteria should be considered.

Accounts items

I shall now turn to items in the accounts and tax returns that may be controversial, or invite the attention of the Inland Revenue.

Work in progress

Traditionally, work in progress for a smaller firm of accountants has always been valued on the basis of the cost of employee time and overheads, including administration. Partner's and principals' time has always been excluded. Obviously, the basis of calculation at the accounts year end should stand up to scrutiny.

There has been a recent controversy about an amendment to Financial Reporting Standard 5 (FRS 5). Some commentators believe that, in the future, work in progress will have to be valued at full market value, inclusive of partners' and principals' time. Others do not believe that FRS 5 has any application to unincorporated businesses. The debate continues, but it does seem that the Inland Revenue favour the view of Robert Maas, who considers that nothing has changed.

Corporate hospitality

Many accountancy firms now use corporate hospitality as a valuable marketing tool. It is important that such items are recorded correctly in the accounts, and only claims for tax purposes valid under law are made.

Motor vehicles

Partners and perhaps staff will use motor vehicles in connection with the work of the practice. In the case of staff, the practice must make a decision as to whether the firm will supply a motor vehicle, in which case the employee will suffer a benefit in kind imposition. Alternatively, if the employee owns the vehicle, reimbursement can be made at the agreed tax rates on a mileage basis.

In the case of the principal or partners, different criteria will apply. They may own their own vehicles personally, and charge the practice based on mileage records. What they have preached to clients about keeping a mileage record will apply to them.

In other instances the practice will own the motor vehicle, and the total expenses will be debited in the accounts, with an 'add back' in the tax computation. The percentage add back must be based on evidence of business and non-business mileage, and will be recorded in the Standard Accounts Information section of the tax return, as well as the tax computation. This is an example of the Revenue giving tacit agreement to 'duality of purpose'.

Use of home

Another dual purpose claim may involve use of the home for business purposes by the practitioner. Unusually, he or she may be based at home. In other instances, some of the work of the practice will be performed there, perhaps to preserve privacy and the need to eliminate office distractions.

A claim may then be included in the accounts for use of home, based on the usual criteria. Despite recent Revenue statements, I still submit that it is possible to make a reasonable claim and retain CGT exemption.

Technical issues

The concept of adherence to accountancy principles has become much more widespread and is recognised by Revenue inspectors. Some transactions will be judged on this criterion. For instance

in the case of the well-known solicitors, Herbert Smith, a claim was made for a deduction for a provision against future rents in connection with a property that the firm was vacating. The firm won their case in connection with this deduction in the High Court (see *Herbert Smith (a firm) v Honour* [1999] STC 173).

Susceptibility to investigation

We now turn to the question of the susceptibility of the accountant to Revenue Enquiry and investigation. It is ironic that, despite the fact that accountants spend much of their time preventing clients from being investigated or helping them when they undergo an enquiry, an accountant is equally susceptible to investigation. The following are some of the triggers for investigation.

Type of client

If an unusual number of clients of the practice are investigated by the Revenue, the attention of the Revenue may turn to the accountant himself. In extreme cases, it may transpire that the accountant has committed a tax default personally in connection with client matters.

The Revenue then has the power to impose a tax penalty of up to 3,000 pounds under section 99, Taxes Management Act 1970. Almost certainly this will be followed by a section 20 notice to examine all client files.

It should be noted that section 99 is not limited to the principal or partners of the firm concerned. It could apply equally to a tax manager, a junior tax clerk or someone in the accounts department of the firm concerned.

In less serious cases, the Revenue may consider an alternative to imposing a section 99 penalty. They may 'do a deal' to the effect that no further action will be taken if, either the accountant ceases in practice immediately, or he makes immediate plans to sell the practice. This is entirely up to the Revenue inspector involved.

In serious cases the Revenue may even consider prosecution of the accountant, and it should be noted that a section 99 penalty may only be imposed by SCO following reference to the Revenue's Standards Office.

There are extremely serious professional consequences to the imposition of a section 99 penalty. First, clients may sue for professional negligence and the PII insurers must be notified at an early stage. If the accountant (or clients) are covered under a professional fee protection policy (see below), this will be another area where negotiation must take place. In theory, cover could be withdrawn in all cases because of the facts.

The imposition of a section 99 penalty will also come to the ears of the professional institute involved. In consequence the accountant will face disciplinary proceedings under the rules of the body, and could:

- Lose his or her practising certificate.
- Be suspended from practice for a period; and
- Suffer a fine from the institute.
- Be excluded as a member of the institute.

Random audit

Accountants are just as likely to undergo a 'random' self- assessment enquiry as anyone else. I know two well-known people in the tax world who have suffered enquiries already. The suspicion exists that their standing and public views may have had some bearing on the Revenue's decision to investigate, but that is pure conjecture.

However, every accountant must accept that an enquiry could take place. This could be purely an 'aspect' enquiry, or full investigation, either random or due to some item in accounts or returns that has come to the attention of the tax inspector.

Delay

Most accountants in professional practice are under time pressure, particularly at key times of the year involving self- assessment, the Budget, and Tax Credit claims.

This is of particular relevance to sole practitioners and smaller accountancy firms, and situations may develop that produce delays in submitting the practitioner(s) own accounts and tax returns to the Inland Revenue. The impact of personal ill health could also affect the accounts and tax returns of a sole practitioner, even though he or she may have arranged 'peer group' assistance for such an eventuality.

Failure to file accounts and tax returns on time will produce a fixed penalty fine, but could also be a trigger for an enquiry into the accountant's affairs.

Tax planning

The use of sophisticated tax avoidance and tax planning schemes on behalf of clients that go to the very edge of the law will bring an accountant to the attention of the Inland Revenue. One is not referring to tax evasion in this context, but legal tax avoidance.

Unfortunately, in the perception of the general public, Inland Revenue and government, tax evasion and tax avoidance now appear to be indistinguishable, and this perception has spread to the courts of law. The niceties of tax law and practice will be alien to lawyers and judges in the criminal courts, who will deal with any perceived negligence or fraud on the basis of criminal law criteria. This subject is referred to in Newthwire No. 48 on Fraud, Prosecution and Searches.

As illustrated in that wire, regular use of legal avoidance schemes could make the accountant personally liable to enquiry and investigation. In some instances such schemes may be challenged by Special Compliance Office and the actual involvement of the accountant may come under scrutiny.

In extreme cases, the involvement of the accountant in a scheme could lead to criminal prosecution by the Revenue, and practitioners need to be extremely careful of their involvement in schemes at the edge of the law. This was illustrated dramatically in the case of *R v Cunningham, Charlton, Wheeler and Kitchen* [1996] STC 1418, where three accountants and a barrister were involved in a tax planning scheme that 'went wrong'. Following criminal prosecution all, including a chartered accountant and the barrister, received custodial sentences.

This particular case has caused considerable controversy in professional circles, but is a clear warning to the accountancy profession. The performance of defending criminal counsel in the court may be as important as tax law and facts. Ken Dodd demonstrated this aptly when defending himself some years ago, and has continued to bait the Revenue about this in his one-man shows.

Matters have now moved even further forward as the provisions of the 2004 Budget include a requirement for taxpayers and their agents to notify proposed 'tax avoidance' schemes to the Inland Revenue, and, in effect, gain clearance before matters proceed.

It is far from clear how these requirements will actually work in practice, but they are an illustration of the current Inland Revenue and political climate.

VAT defaults

There is now official co-operation between Customs and Excise and the Inland Revenue, and this will increase further as the Departments merge. Any defaults picked up by Customs investigators during a routine visit will be notified to the Inland Revenue, who will then mount their own enquiry. The converse also applies.

Technical issues

Technical arguments over the basis of entries in the accounts and returns of an accountant will lead to an 'aspect' enquiry. Indeed it is the only way that the Revenue now has of challenging accounts and returns.

Business status

Many accountancy practices now trade as limited liability partnerships (LLPs). In other instances all or part of the non- auditing function may be carried out by a limited company. Issues such as IR35 and section 660A, Taxes Act 1988 could be in point. At the very least the use of these business media or the change to them will add to tax complications, and accordingly to the vulnerability of the practice to enquiry and investigation.

Means test

One trusts that accountants are trading profitably, but this is not always the case. The classic investigation criteria of means and profitability could apply in some cases.

Is the accountant trading profitably, and if not why not? Are drawings from the practice sufficient to fund the lifestyle of the individual(s)? How do profits compare with other accountants within the same geographical area? Unexplained variations in profitability and means are an open invitation to enquiry. It is therefore very important for the accountant to pre-empt such an occurrence by the use of the 'white space' in the self-assessment tax return and/or explanation to the Revenue by letter.

Tax defaults

The commission of routine tax defaults in connection with the self-assessment legislation can be another obvious trigger. Failure to file the self-assessment return and accounts on time is one. Failure to pay tax on time is another. Although both of these defaults lead only to fixed-rate penalties, the Revenue may use them to institute a full SA enquiry.

Disclosure and discovery

The principles of making a clear and full disclosure has been preached to us by our institutes and others, and no doubt we have passed the message on to our clients. However, the message applies to each accountant as well. It is essential that full disclosure of necessary items is made in the white space of the tax return and/or accompanying letter. Failure to do this leaves the door wide open for the Inland Revenue to institute a full enquiry, which will not be limited to the usual self-assessment enquiry time-limits where the inspector has made a 'discovery'.

Representation before the Revenue

If the worst comes to the worst and an investigation or enquiry takes place into the accountant's affairs, the accountant has to make a decision as to whether he will represent himself or arrange representation by a third party.

Some accountants will feel that they do not want another professional person to be involved in their affairs. If the sole practitioner, or a partner in a small practice is competent to handle an investigation, then the matter can be dealt with in-house.

The other point of view includes the following points:

- Enquiries and investigations are time-consuming and costly, and the accountant will be diverted from practice work and more remunerative fee-earning potential if the enquiry is dealt with personally.
- It may well be that the investigation is being dealt with by an inspector known to the accountant. Engaging a third party investigations specialist will 'take the heat out of the situation'. The accountant may wish to retain the current friendly relationship with the local inspector. On the other hand, the proceedings in *Mr & Mrs Scott trading as Farthings Steak House SpC 91* (although a client case) demonstrate that the intervention of a tax investigations specialist and a solicitor versed in criminal matters can have a salutary effect on a thoroughly awkward inspector.
- Unless the accountant is an investigations specialist, it may well be more time and cost effective to engage an expert to carry out the work.

Fee insurance

This brings us to the issue of professional fee protection insurance. This product is much more established now, and there are several reputable insurance providers in the market. Nevertheless only a small number of firms have taken this product up for their clients.

Whether or not the practitioner has recommended the product positively to his clients, he or she needs to consider whether or not to take out personal cover. The writer has taken out cover personally on two of the main grounds mentioned above - 'taking the heat out of the situation' and delegating the work of an enquiry, should it occur, to a well qualified and experienced third party.

Final point

If the worst comes to the worst and the accountant undergoes an SA enquiry which he or she feels has been handled inefficiently, then a complaint should be considered. This does not include technical issues, which are appealable to the Commissioners and the courts.

Complaints about the conduct of the investigating inspector(s) should be made first to the inspector in charge of the District Office. Failing satisfaction, the accountant may then complain to the Area Manager. If he or she is still not satisfied a complaint can then be made to the Adjudicator and/or the Parliamentary Commissioner (Ombudsman). A complaint to the Adjudicator can later proceed to the Ombudsman, but not vice versa. Complaints to the Ombudsman must be routed through the accountant's Member of Parliament.

If maladministration can be proved, the Revenue may be recommended to pay compensation to the accountant.

Ask a question

Readers with a current case should post their query in Any Answers.

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