HMRC BENCHMARKS

TRADERS' PROFITS 2014

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HMRC trials benchmarking initiative

Produced by Tolley in partnership with Guy Smith of Abbey Tax

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HMRC has begun testing the value of publishing 'benchmarks', in an effort to improve voluntary compliance and behaviour in various trade sectors. By drawing attention to the benchmarks, HMRC hopes to reduce the scope for errors being made by the businesses falling within the targeted trade sectors, both before and after their Tax Returns have been filed.

So far this year HMRC has written to painters and decorators, as well as driving instructors, to tell them what their benchmarking range is and the common risk areas identified where the most mistakes are made.

What is a benchmark?

In simple terms, a benchmark is a 'bottom line' net profit ratio.

In order to calculate the net profit ratio, HMRC deducts the total expenses claimed from the turnover declared to arrive at the net profit. The net profit is then divided by the turnover figure and multiplied by 100 to arrive at the net profit ratio.

For example, HMRC has used information from the Tax Returns of all painters and decorators for the last three years to arrive at a benchmark range of between 59-79%. A similar exercise was undertaken on the Tax Returns submitted by driving instructors to arrive at a range between 31-67%.

What do the letters say?

Titled 'Helping you complete your 2013/14 Tax Return', the letters issued by the Transparent Benchmarking Team within HMRC state:

> "We are testing the use of benchmarks because we think it could help business owners to make sure that their Self Assessment Returns are correct... Research in other countries has shown that telling businesses in the same trade how similar businesses are performing, can help them get their return right. We want to see if this works in the UK."

The letters include examples to highlight why some businesses may fall below or above the benchmark range.

What are the common risk areas?

Aside from advising the businesses involved to check that all cash payments and other ancillary income has been declared in the turnover figure, the letters refer to items of expenditure which are most commonly computed incorrectly:

- travel expenses
- telephone costs
- utility and insurance charges
- professional fees
- capital expenditure

Advice is provided by HMRC in the letters to explain what can and cannot be claimed.

Click here to read an anonymised copy of a typical letter.

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What is likely to happen next?

If a business within the targeted trade sector files a 2013/14 Tax Return showing a ratio outside the benchmark range, HMRC has a generic letter ready to issue.

The letter titled 'Benchmarking - Are you happy with your performance?' refers to the first letter introducing the benchmarking initiative and states "Your Return shows you are outside the 'norm' for performance in your industry". HMRC Research Report 307, Appendix C

The business owner is then invited to telephone HMRC and explain what amendments are required to his Tax Return or confirm that the Return is correct.

How does benchmarking fit into wider HMRC compliance activity?

HMRC has adopted a promote, prevent, respond approach to compliance work. See the speech by Jennie Granger, the Director General (Enforcement and Compliance) for HMRC, on 18 July 2013.

By **promoting** a new initiative such as benchmarking, HMRC is being open about the net profit ratio it expects to see and the potential risk areas which have been identified. The purpose of the first letter titled 'Helping you complete your 2013/14 Tax Return' is the promotion element to benchmarking.

The **prevention** aspect of the approach is where HMRC flags up the risk of non-compliance close to or shortly after the Tax Return has been filed or the statutory filing date. The letter titled 'Benchmarking - Are you happy with your performance?' is an example of HMRC trying to prevent an error after a Tax Return has been filed, by encouraging a voluntary amendment.

After attempting to be transparent in promoting benchmarking and trying to prevent any errors, HMRC is likely to **respond** by launching a compliance check into any Tax Returns which have been filed below the benchmarking range. The compliance check could be in the form of a business records check or even a full enquiry. See the HMRC relaunches business records checks news item and the HMRC powers to open an enquiry into a return guidance note.

Are only businesses being targeted?

It is not only businesses which are being targeted.

HMRC has also been benchmarking Tax Returns filed by individuals, which has proven to be very controversial. A thousand letters titled 'Your effective rate of tax' have been issued with the recipients told "we can see that your effective rate of tax is lower than the average for people with a similar amount of income to you. This could mean that there is something wrong with your Self Assessment Tax Return."

Further into the letter, the individual is asked to:

> "Please check that the entries on your Self Assessment Tax Return are correct and that you have:
>
> - declared all your income and gains
> - claimed the right amount of expenses, deductions and tax reliefs"

Many people who received these letters immediately pointed out that they had made a large one-off gift aid donation during the year, a pension payment or even carried forward a loss. Several tax advisers were quoted in the media calling the letters 'bullying' in tone and issued in a 'scattergun' fashion, without a thorough check of the individuals' personal circumstances.

Click here to read an anonymised copy of a typical letter.

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What are the wider issues?

HMRC knows from market research it commissioned last year and published in March 2014 that businesses whose net profit ratio is outside the prescribed benchmarking range will look for ways to get back into the range.

Business owners who were interviewed during the research said if they were outside the top end of the range, they would assume they were paying too much tax and would look to increase their costs or ask their accountant what other businesses were doing which they could replicate to bring their profit ratio down. HMRC Research Report 307, Chapters 7.4, 7.7

Some of the other business owners interviewed said tax evaders would manipulate their figures to fall within the accepted limits to escape detection, if their ratio fell outside the lower benchmark range. HMRC Research Report 307, Chapter 7.7

Overall, the business owners assumed transparent benchmarking was about deterring evasion and a threat of an impending investigation.

Most worrying of all, benchmarking is a threat to the long standing principle of people and businesses paying the right amount of tax at the right time, with business owners considering manipulating their net profit ratios to fall within their benchmarking range, in order to avoid any further intervention from HMRC.

What are the points tax advisers need to consider?

Tax advisers need to consider a number of points:

- HMRC has written directly to the business owners within the targeted trade sectors and not automatically sent copies to the authorised tax agent. Indeed, the benchmarking letters state "If you have a tax agent (eg accountant) please let them have a copy of this letter as soon as possible". As a result, tax advisers may wish to circulate a news alert amongst their clients warning of this ongoing activity and ask to be kept informed if any such letters arrive

- When preparing the accounts and completing the 2013/14 Tax Returns on behalf of clients, it would be sensible to discuss the common risk areas and to make a note in the white space of the Return of any pertinent factors affecting any expenditure claims and / or any fluctuations in trade

- The tax adviser would be wise to highlight HMRC's attitude towards behaviour if errors are found during a compliance check. If a business owner has received a benchmarking letter and then an error is found during an enquiry, HMRC will no doubt argue that the error was made deliberately because the letter was not acted upon. See the Penalty rates and structure for inaccuracies in returns and Calculating the penalty for inaccuracies in returns -- behaviour of the taxpayer guidance notes

- The approach with benchmarking letters issued to individuals is slightly different. Firstly, HMRC has been sending copies to the authorised agent. Secondly, the adviser can afford to be more aggressive with HMRC concerning these letters as they refer to a closed year. The letters are quoting figures submitted in respect of the 2011/12 tax year, with the enquiry window already closed for that year, as well as the opportunity to self amend. Unless HMRC has made a discovery or a late Return has been filed, the year cannot be opened and the individual and tax adviser can ignore the letter if they know the figures declared are accurate

- The benchmarking initiative is an opportunity for tax advisers to remind their clients of the importance of good record keeping, particularly surrounding motor and travel expenditure post-*Samadian*. See the Upper Tribunal rejects Samadian appeal news item