Response to the consultation paper "HM Revenue and Customs and the Taxpayer: Modernising deterrents, powers and safeguards"

Introduction

The Professional Contractors Group is the cross-sector representative body for freelance contractors and consultants in the UK. Its members operate their own one or two-person companies and provide their services to a range of clients. They work in IT, engineering, project management, oil and gas extraction, marketing and many other sectors.

The UK's freelance contractors and consultants are a highly skilled, highly flexible and highly mobile workforce. The UK's model of freelancing is uniquely sophisticated and, by affording companies the ability to acquire specialist skills on a flexible basis, offers the UK a meaningful competitive advantage, particularly in the knowledge-based industries on which its future growth depends.

PCG's members are among the 1 in 7 workers in the UK who choose to work for themselves in some way. They sit outside the traditional divide of employer and employee; as part of the "third way" of working, they are therefore often overlooked in the policy discourse, which remains dominated by the traditional dichotomy.

PCG has long campaigned for consistency, clarity and common sense in the tax system and responded to the consultation on HMRC's powers conducted in 2005. Freelance consultants and contractors operate an extremely simple business model: they offer some of their time in exchange for some of the client's money. As highly skilled and highly flexible workers who have gone into business as a career choice, they are an asset to the UK's economy. It is to be regretted that both the law and the administrative requirements surrounding the taxation of this business model have become extremely complicated.

Many of the specific changes suggested in the consultation document "HM Revenue and Customs and the Taxpayer: Modernising deterrents, powers and safeguards" are to be welcomed as sensible proposals for useful simplification. This response will consider these points in some detail and also highlight proposals which PCG regards as being problematic. It will also address the relationship between tax authority and taxpayer from first principles and offer comment on the general approach of the consultation document and what this implies about the current administration of the tax system.

"Compliance"

Page three of the consultation document states that HMRC desires to, "support those who seek to be compliant but come down hard on those who seek to gain an unfair advantage through non-compliance." This seems uncontroversial and PCG supports what seems, superficially, to be its aim. This statement begs several questions about HMRC's overall approach, however.

Firstly, the term "unfair" remains undefined. Undoubtedly this is a very difficult definition to pin down, but it is of concern that no attempt has been made. The Treasury's discussion document "Small companies, the self-employed and the tax system", published alongside the Pre-Budget Report in 2004, stated that companies should have the freedom to adopt whatever commercial form is appropriate, but should do so for genuine commercial reasons, not solely for tax advantage. PCG supports this policy and feels that a working definition of what is "unfair" that is framed with reference to commercial realities would be useful.

More seriously, the terms "compliant" and "non-compliance" are not defined. It can be observed that HMRC often uses the term "non-compliance" as an umbrella term for both evasion and avoidance. PCG has argued against this practice in the past and continues to do so – indeed, we are disappointed not to see this issues addressed in the summary of response to the consultation of 2005.

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Evasion is the non-payment of tax owed and is illegal. PCG condemns it unequivocally. Avoidance is the minimising of tax liabilities by using legal means. PCG urges that when HMRC wishes to tackle evasion it refers explicitly to evasion, and that when it wishes to tackle avoidance that offers an unfair advantage, it refers explicitly to avoidance that offers an unfair advantage, with a full and sensible definition of the term "unfair".

The loose use of such vague terms as "unfair" and "non-compliance" without full definition has the effect of rendering the law obscure and allowing for practice by tax inspectors that does not respect the law. It allows for attacks to be mounted, without consultation, transparency or any change in the law, on avoidance practices which are legal, have become standard practice and may even have been officially encouraged. This in turn has the effects of causing uncertainty and possibly unforeseen financial hardship for businesses, with the risk to the economy this implies. In the longer term, it creates a serious risk of confidence in the tax authorities being undermined.

HMRC operations and "customer service"

The consultation document observes on its second page that during the merger of the former Inland Revenue and HM Customs and Excise, "business as usual, and a high standard of service, were maintained." PCG is not the first organisation to feel obliged to question whether standards of service from HMRC, particularly to businesses, have not in fact deteriorated somewhat in the years either side of the merger. In particular, HMRC stands accused of an increasingly aggressive and invasive attitude towards taxpayers, and this response will now consider this apparent trend.

i) Commercial understanding

It is suggested on page 16 of the consultation document that mutual trust between the taxpayer and HMRC is essential, and that tax inspectors should have greater commercial awareness. PCG welcomes this and calls for this recommendation to be followed through forcefully, with compulsory placements in the private sector for all tax inspectors and a thorough programme of training regarding the nature of commercial practices and business risk.

Tax inspectors have historically shown only limited commercial awareness and increasingly acted with insensitivity to taxpayers' commercial positions. One example of these concerns is the practice among inspectors of approaching a freelancer's clients during a tax investigation. This has proved problematic on many occasions and for several reasons. There is no guarantee that the inspector will find the right person within the client company or obtain the right information; very often information is taken from the first person spoken to, irrespective of whether it relates to the individual freelancer's circumstances. Also, this process creates administrative bother for the client and casts doubt over the contractor's *bona fides*, even when they have done nothing wrong; this in turn damages the freelancer's prospects of winning further business from that client. Furthermore, section 20 of Taxes Management Act is often used incorrectly; under a s20(3) notice inspectors may only request documents; in practice, they often tend to ask for a lot of information, not all of which takes the form of documentation.

It is of vital importance that tax inspectors fully understand modern commercial practices: without such understanding, they may view with suspicion commercial arrangements which are entirely legitimate and standard, but which do not fit with the individual inspector's preconceptions. This could, in turn, have a negative impact on risk-profiling carried out to facilitate risk-based inspection as proposed in the consultation document. While PCG welcomes the shift to risk-based assessment in principle, the risk is that businesses whose practices are entirely regular and who are fully compliant may in fact be unduly targeted by HMRC because it mistakes *bona fide* commercial practices with

practices likely to indicate "non-compliance". When risk-based assessment is introduced, HMRC must publish a full summary of which businesses are being targeted as "high risk", broken down by turnover and the number of employees.

The UK's sophisticated freelancing model entails flexible ways of working that do not sit inside the traditional framework of working practices. HMRC must be fully conversant with commercial reality in the 21st century in order to administer the tax system fairly.

ii) Use of existing powers and laws

The principles underlying safeguards for businesses and citizens set out on page 11 of the consultation document are sound and PCG welcomes them. The concomitant suggestions in the document that HMRC needs to expand its powers, for instance developing its criminal investigatory powers by tapping into PACE, are however a cause of some concern. HMRC has proved to have difficulty in using correctly the powers and laws already available to it and PCG does not recommend broadening the scope of HMRC's powers, particularly not for criminal investigation.

Examples of HMRC being unable to utilise existing laws and powers are plentiful. The frequent cases involving improper approaches to a taxpayer's clients have already been noted. The low success rate in applying the intermediaries legislation, or "IR35", is also a case in point: the government has stated that it does not compile figures for IR35 investigations mounted or their success rate, but of the 1,241 cases of which PCG is aware, only three have resulted in the contractor being found to owe tax under IR35. This is doubtless partly due to the complexity of the legislation, but also suggests operational failings within HMRC: in the case of Lime IT, for instance, the tax inspector concerned issued a lengthy apology to the hearing of the Special Commissioners and admitted that he had neither handled the case adequately nor been fully competent to do so. Systemic failure in HMRC's administration of the tax credits system has also been widely noted.

iii) Conduct of inspectors

Page 10 of the consultation document observes that HMRC's powers and the resulting statutory obligations must be easily understood by the taxpayer and by HMRC staff. PCG welcomes this statement but would like to see it extended: as well as being understood, powers and obligations must be accepted by HMRC staff. There is evidence of a developing trend of tax inspectors' conduct not being bound by the law. HMRC's increasing public emphasis on providing high-quality customer service and their continuing efforts to determine what services it can most usefully offer taxpayers are all welcome; in light of them, however, the increasing aggression of tax inspectors is a worrying trend.

For customer experience to be positive, the full implications of the term ("customer") must be taken on board by all HMRC staff. HMRC must offer taxpayers the same level of service as any reputable company offers to its customers, despite the difference between the two situations. Customers are in a voluntary arrangement in which they obtain goods or services; they can reasonably expect that these goods or services will be delivered to their satisfaction and that they will receive recompense if this is not the case. A customer's relationship with HMRC is clearly not voluntary; but it should proceed along the lines of a customer relationship in all other respects. When a taxpayer's experience falls short of reasonable standards of customer service, full and appropriate mechanisms for accountability and redress must be in place.

iv) Accountability

The most obvious mechanism for securing accountability would be for the Taxpayer's Charter to be revived, strengthened and placed on a statutory footing such that the performance of individual tax

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inspectors can be measured against it. PCG is unconvinced by the idea of a "compact" between HMRC and the taxpayer: the taxpayer's responsibilities are already set out in statute and HMRC has ample powers to hold taxpayers to account for failing to meet them. The obligations on HMRC and its inspectors are not so clearly set out and accountability mechanisms remain weak. A revived Charter would be one solution to this.

Failing that, a brief code of principles, which need be no more than common sense and common courtesy, against which individual tax inspectors can be held to account, could be compiled. These might include:

- HMRC is there to help determine the correct amount of tax a customer owes - not to extract the maximum amount of tax it thinks it can.
- HMRC must at all times act so as not to prejudice the commercial relations of its customers.
- HMRC should limit its questioning of customers to matters which directly affect their tax bill.
- HMRC should start with the assumption that its customers are honest people trying to pay the right amount.

An alternative solution would be to allow taxpayers to give a rating to their tax inspector after each inspection or other contact: most taxpayers seek to pay their tax correctly and will be happy to acknowledge assistance given to them in making this a straightforward process. Inspectors' ratings could be held on file, made available to the taxpayer in the event of a complaint and taken into account in the event of a disciplinary hearing. Tax inspectors with ratings significantly below average should be re-trained, disciplined or dismissed as appropriate.

HMRC should routinely consider disciplinary or criminal proceedings against tax inspectors who make false statements or provide false information. Criminal proceedings are routinely considered for taxpayers who behave in this manner and the same standard should apply to inspectors. Similarly, as taxpayers are liable for penalties over late payments, so to should HMRC be: many taxpayers had to wait weeks or even months to receive their £250 for filing their return online in the last tax year. This is to say nothing of errors committed when administering tax credits, although no further comment on this point will be offered as it is beyond PCG's areas of interest.

v) Onus and burden of proof

PCG suggests a further safeguard should be listed in addition to those already in the consultation document: in order to rectify the disparity in resources between the parties, the burden of proof in a dispute between an individual and the state should always be on the state, in this case HMRC, and the standard of proof should be "beyond reasonable doubt".

Comparison with other areas in which the state holds individuals to account will illuminate this issue. A criminal justice system expects a culture of neutrality in the investigation of a case. In practice, of course, investigators will come to form theories and look for proof; sometimes there is a risk that an investigator will become so convinced of a theory that rational judgement suffers. In a complex case, however, other specialist investigators such as forensic scientists and pathologists are called upon and they can provide a fresh view to keep the investigation on appropriate lines.

In general a tax inspector is likely to be denied such sources of review. Furthermore, we have no evidence that such a culture of neutrality exists in HMRC and feel that, in view of the pressures of expectations inevitably placed on tax inspectors to ensure that they generate sufficient revenue to meet government expectations, it would be difficult for it to exist.

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If a taxpayer challenges an assessment and the case proceeds to the Commissioners or beyond, however ruinous an adverse decision might be for the taxpayer, the burden of proof is on the taxpayer and the standard of proof is "balance of probabilities". Although it might appear that the lesser standard of proof might be to the advantage of the taxpayer the fact remains that he or she needs to provide that balance against the state machine, whereas in the criminal justice system it would be necessary to provide no more than a measure of reasonable doubt. We feel that the lesser standard of proof required of HMRC *vis a vis* the criminal justice system is apt to undermine the judgment of tax inspectors and of their senior officers who are, therefore, inclined to back them in situations where the CPS might reject a case with comparable levels of evidence.

To ensure a continued culture of neutrality in HMRC, an externally audited quality assurance programme should be instituted. Central standards for the checking of evidence in cases should also be instituted and inspectors regularly audited for compliance.

Proposed procedural changes

The consultation document makes a number of extremely useful observations and recommendations, which PCG welcomes. The observations that the "enquiry" system pertaining to direct tax is inflexible and tends to operate many months after transactions to which any tax relates are sound. It would indeed be preferable for some of the matters currently dealt with under that system instead to be considered under a system more akin to the more straightforward VAT inspections. The ability to rectify minor errors with a phone call or exchange of letters instead of a full enquiry would also be welcome.

The new tribunal system mentioned on page 27 has potential to streamline the process of appealing against a tax decision. PCG has some concerns about the proposals in practice, however: they risk placing restrictions on the right to appeal; the right to choose which tier of a tribunal hears a case should be retained from the current Commissioners system; and Alternative Dispute Resolution should not be extended so far as to allow a Tribunal Judge to enforce a compromise at his or her discretion, as has been hinted at in the past.

The new interventions to assure "compliance" listed in Annex B of the consultation document unfortunately seem, in places, to be unnecessarily heavy-handed, or otherwise impractical. While option A seems to be reasonable in as far as it goes, option B is subject to the concerns about risk-assessment already raised: inaccurate risk-profiling based on inadequate understanding of commercial reality could make this activity unduly onerous for groups of which HMRC is still developing a full understanding, such as freelance contractors and consultants.

Option C appears sound, but option D is problematic. Again, risk assessment, if done badly, could lead to taxpayers who have done nothing wrong but who belong to a particular group being disproportionately inconvenienced with telephone contact. This is a particular worry for freelancers, as HMRC, as has already been noted, has difficulty in applying the relevant legislation; many taxpayers who owe no tax under IR35 could be contacted as a result, and many might wrongly pay up. The use of prepared scripts is also likely to lead to situations in which the taxpayer has a query or can offer an explanation with which the HMRC representative, not being a fully-trained inspector, is unable to deal. This idea seems frought with practical difficulties and PCG cautions strongly against it.

Option E also causes us concern. This will allow tax inspectors to take additional money off taxpayers and place the onus on the taxpayer to prove that it is not owed. This is unacceptable, and doubly so given the current causes to doubt the accuracy of the work of some inspectors. Given the

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introduction of full and robust accountability procedures for inspectors plus a fully-audited shift to a culture of neutrality it might be workable, but in their absence should certainly not be implemented.

PCG has no specific problems with option F, notwithstanding points already made about "compliance" and the necessity for a culture of neutrality and full accountability at HMRC.

Mistakes and penalties; reasonable care and unreasonable tax positions

The proposed changes to the treatment of innocent mistakes and the issue of reasonable care are, on the whole, welcome, but PCG recommends that some further fine-tuning be undertaken along the following or similar lines.

On page 17 it is stated that if an error is made even when reasonable care has been taken, interest should be charged on any tax not paid. PCG cannot see that this serves any useful purpose other than to penalise the taxpayer and recommends against it. Similarly, the principle expressed in the second bullet-point on page 11 (3.8) is sensible but should be expanded to specify that in this scenario no penalty or interest will apply.

The suggestion on page 18 that taxpayers with good records of compliance should pay lower penalties if they have made an error is sound, notwithstanding the previous points regarding "compliance". Similarly, the principle that the persistently non-compliant should face tougher penalties than would usually be the case is sound, so long as past non-compliance has been proven and all non-compliance in question is evasion, not legitimate avoidance.

PCG recommends against the principle of penalties for those who deliberately obstruct tax investigations, however, as no indication is given in the consultation document of who would judge what counts as "deliberate obstruction". In practice, this risks being a threat with which tax inspectors could pressure taxpayers into acceding to the inspector's analysis, whether it is correct or not.

PCG is also concerned at the proposal on page 7 that if a taxpayer has not sought HMRC's advice it could be held against them. Until trust between the tax authorities and business has been fully re-built, businesses in particular should not be penalised for failing to approach the tax authority. It has been PCG's experience that those who do so are more likely to face a hostile investigation; until a full culture of neutrality is instigated to counter this, the taxpayer can be forgiven for being wary of the tax authorities.

Finally in this section, it is stated on page 21 that, "[W]here there is evidence that taking an unreasonable tax position was a deliberate attempt to understate liability… the offence could be treated as being deliberate." This can be summarised as, "when it seems to be deliberate, it could be treated as deliberate," which appears to be a tautology.

Further points

The summary of views sought includes a request for thoughts on what can be done to encourage compliance. PCG recommends that in order to encourage compliance HMRC must ensure confidence in the tax system, both that the taxes being levied are fair and that they will be collected correctly and in a timely, courteous and convenient fashion.

It has recently been observed by some commentators that trust between the tax authorities and business has broken down, which is clearly unacceptable in a self-assessment system. The Institute of Chartered Accountants in England and Wales have made this observation most recently, in their

report prior to the Pre-Budget Report of November 2005. Perceptions that HMRC has become increasingly aggressive are becoming more widespread. If this trend is allowed to continue unchecked, it has obvious dangers: if taxpayers fear being attacked for extra tax irrespective of whether or not they have done anything wrong, than the idea of "compliance", however it is defined, will become irrelevant.

If the individual perceives that it does not matter whether or not they comply, they may increasingly stop complying at all. Indeed, this illustrates why the catch-all use of the term "compliance" is so dangerous: if it becomes seen as a cover used by tax inspectors to attack legal and illegal activity indiscriminately, taxpayers may cease to regard the system as legitimate. The consultation document acknowledges on page 7 that, "the compliant need to be confident that the system is fair," but does not seem to acknowledge the seriousness of the current situation or how far there is to go before this confidence is restored.

On pages 18-19 the consultation document requests suggestions for how intermediaries may be able to assist in promoting "compliance" among taxpayers. Trade associations and representative bodies have an obvious role to play here, particularly cross-sector bodies whose members tend to have a business model in common rather than a sector of operation. PCG already urges its members to follow best practice in tax matters and offers them extensive guidance on how to do so. We are well-placed to take on a further role for advising freelancers on "compliance" – notwithstanding issues of definition - and will be happy to do so.

Summary of key recommendations

- No further official use of the terms "compliance" and "non-compliance"; more accurate and descriptive terms to be used instead
- Greater commercial awareness among tax inspectors; compulsory private sector placements for all
- Full accountability of HMRC:
    - Tax inspectors to be held personally accountable
        - Taxpayer's Charter to be strengthened, reintroduced and placed on a statutory footing such that individual inspectors can be held accountable under it
        - And / or a system whereby taxpayers can rate their experiences of individual inspectors
        - And / or a code of conduct for inspectors
    - Failing inspectors to be re-trained, disciplined or dismissed
    - HMRC to publish a full summary of which businesses are being targeted as "high risk", broken down by turnover and the number of employees
- Culture of neutrality to be established within HMRC and an externally audited quality assurance programme instituted to oversee it
- Burden of proof always to be on HMRC; standard of proof always to be beyond reasonable doubt
- No interest to be payable on tax under-paid when reasonable care was taken
- Failure to seek HMRC's advice not to be held against the taxpayer in the event of an error
- Greater use of trade associations and cross-sector representative groups to encourage good practice