Food for thought

Salman Anwar explains why the unprepared restaurateur and the inexperienced accountant was a recipe for disaster

In this article, which is similar in theme to that of the article written in the last issue of this magazine by my mentor, colleague and good friend Tony Monger, we discuss a recipe which almost always leads to disaster for the taxpayer.

The main ingredient requires a business in the restaurant/takeaway/hospitality trade, but it can be served to any business which involves significant cash sales.

This 'disaster' is a commonly experienced dish and has been served by HMRC to many a taxpayer. The disaster in this dish comes in the shape of a business facing certain extinction, the proprietor facing possible prosecution and the pain of public humiliation. You can find a recent example of a successful prosecution by HMRC of a restaurant owner which stems from a 'test eat' purchase by searching the internet for 'Mossley restaurant owner jailed', from January 2020. For those not familiar with 'test eats' we will explain the recipe for this particularly poisonous concoction below.

There is a list of 'deliberate defaulters' that is regularly published by HMRC, which names and shames those businesses where HMRC has taken civil (as opposed to criminal) action for recovery of underpaid duties. The most recent publication (to March 2020) shows that out of a total of 323 businesses that have been named and shamed an astonishing 99 (30%, up from 25% at the last publication of such data) are within the restaurant/takeaway industry. The total tax claimed by HMRC to have been evaded by these businesses is almost £16m (up from 12m) to which HMRC has added penalties of almost £10 (up from £7m). That suggests that the tax understated by each business (before penalties) is around £162,000 apiece (up from £115,000 apiece), which, at a tax rate of 20% suggests omitted sales of nearly £810k each. That's an awful lot of hidden meals.

Now back to the recipe for how this disaster comes about. The other ingredients are:

- An HMRC enquiry (either a personal S9A enquiry, a VAT audit or Corporation tax enquiry);
- A distinct absence of appropriate professional representation; and
- The infamous 'test eat' purchases followed by a check of the cash in the till at the end of a given night.

A 'test eat' is an undercover operation conducted by HMRC officers where they visit a business and make cash purchases. They spend a specified time at the premises, covertly, and record their 'observations' of how many customers were present, how many cash and card sales have taken place, how many takeaway deliveries have gone out and how many staff were present. This just gives a flavour of what they might record and the full ingredients will differ from night to night.

The cooking instructions for this disaster are as follows. Conduct your test eat visits at a restaurant over a couple of nights. Allow to simmer for several weeks and then follow up with a VAT visit in which HMRC reviews the books and records of the restaurant at the premises. As an optional extra HMRC may, if desired, also carry out a check of the cash in the till at the end of a given night after it has carried out a test eat purchase. There is usually a common pattern/methodology for the days picked for these operations, and these typically include a weekday and a busy weekend night. This is to allow for an extrapolation exercise to be undertaken if the records are said to be 'incomplete/broken'.

If the records review by HMRC shows that some or all of the test eats are missing then we can move onto the next stage of the recipe. At this point HMRC will use the information gathered by the officers who conducted the test eats to extrapolate the alleged amounts of undeclared sales on which it will seek additional Income/Corporation tax, VAT, interest and penalties.

It is perhaps unsurprising that, somehow, HMRC always claim to have seen more customers, or more sales, or more cash receipts or more takeaways than have been recorded in the books. Of course, every good chef has their secrets and HMRC is no different.

In our experience HMRC's subsequent extrapolation of the 'understated profits' tends to include a number of tenuous assumptions made by HMRC and is also reliant on the observations made being accurate. The recent decision by the First-tier Tribunal in the case of Peng & Anor (t/a Zhu Guang Restaurant) v HMRC provides a long list of the kinds of errors that might be found in HMRC's recipe. To analyse and list the litany of errors in the Peng case would requires a separate blog in itself but for now we content ourselves with this quote of Judge Gething's remarks from para. 53(2) of the decision:

"The ratio adopted also produced an irrational result. The ratio implied that the turnover had been suppressed by £143.000 per year or £3,000 per week and that between 27 to 43 extra daily sales would be required. It is in my view difficult to see how [HMRC's officer] could have subjected the assessment to the common sense test as required by HMRC Guidance." [emphasis added]

We can wholeheartedly confirm that we have seen, and successfully argued against, several real examples of this.

In our experience this type of investigation is particularly fast moving in comparison with other HMRC compliance activities and in cases we have seen the time taken between test eat visits being conducted and the first interview taking place can be as little as 12 to 14 weeks. This type of pace can be difficult to cope with and if not managed from the outset can lead to significant errors being made (by both parties).

The next ingredient to be added to the mix is an accountant who is not familiar with HMRC's methodologies, powers and processes – in other words, no more than a smidgen of specialist expertise. Unfortunately it seems that, from HMRC's viewpoint, the lack of adequate representation is a vital ingredient in that it enables HMRC to press the case through – and extrapolate the alleged understatement of profits – at a tremendous pace.

To mix our metaphors freely, in short the whole mess is brought to the boil fairly quickly – and many accountants and their clients have little idea how to get HMRC out of their kitchen. The result, which follows shortly, is a mass of bloated assessments accompanied by a sauce of heavy penalties which the taxpayer is unable to refute or consume. The result is that the business goes bust with the speed of a deflating soufflé. The resultant tax and penalties that HMRC claims so proudly in its list of Deliberate Defaulters are very rarely paid and the restaurateur goes bankrupt swiftly afterwards.

Given the statistics mentioned above it becomes apparent that a failure to adequately contest these allegations leads to very real and serious consequences for anyone who doesn't fight back. The suggestion is, of course, that the business proprietor has been cooking the books. But a read of the tax case when coupled with a review of the list of deliberate defaulters leads one to ask the question: e*xactly who is cooking which books?*

We have helped a number of clients who have been faced with this probable and potential disaster and working with their agent or accountant we have managed to unpick HMRC's assumptions thereby casting serious doubt on the extrapolated figures and saved the clients from going out of business.

If you or your client has been faced with an enquiry which stems from similar circumstances, then please seek specialist professional advice.

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