Construction Industry Scheme (CIS) – ‘Material difference’

Employment Tax | Tax voice



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Patrick Crookes considers the challenges facing contractors operating within the CIS, focusing on the requirements for checking the direct costs of materials incurred by subcontractors

Perhaps one of the most difficult areas of compliance for contractors operating within the CIS is ensuring the correct amount of tax is withheld from payments to subcontractors with net payment status.

Under CIS, subcontractors can claim a deduction for the direct cost of materials incurred, making it imperative that the amount deducted before tax is withheld is accurate. Consequently, this is an area of complexity in terms of what type of costs qualify as materials, as well as the steps the contractor must take to ensure they are satisfied the amount claimed as a deduction for material is reasonable. Many contractors find that there is a reliance on having a good working relationship with the subcontractor to ensure the correct documentation is provided when requested prior to payment being made.

Unfortunately, in reality it is seldom the case that all runs to plan, with subcontractors keen for payments to be made as soon as possible, or resistance to sending detailed records of materials used / plant hired to their customer, as such information would reveal the level of profit margin from the work undertaken. Given a subcontractor with gross payment status would not be required to provide such level of information, this is considered as reducing the competitive advantage with such suppliers.

As a result many contractors can find themselves in a difficult position to ensure they are compliant within the scheme on a monthly basis.

Materials – looking at the detail

The relevant legislation (FA 2004 s61) states that ‘On making a contract payment the contractor must deduct from it a sum equal to the relevant percentage of so much of the payment as is not shown to represent the direct cost to any other person of materials used or to be used in carrying out the construction operations to which the contract under which the payment is to be made relates.’

HMRC guidance specifies at CISR15060 that the ‘Direct cost’ means what the purchaser can demonstrate they have paid for the materials. Typically, the following costs (VAT exclusive where the subcontractor is VAT registered) will be accepted by HMRC as a deduction for the direct cost of materials before any tax withholdings are applied:

- building materials and consumables
- fuel (excluding fuel for travelling)
- the actual amount spent on plant hire
- Purchase of land

Common errors in this area arise where the subcontractor incorrectly includes costs relating to travel to the site (including fuel for such purpose), accommodation near the site, waste removal, insurance and plant / tools owned or leased.

Subcontractor record review

Under regulation 4(3)(b)(iii) SI 2005/2045, it is the contractor's responsibility to check that the subcontractor is claiming accurate material costs. In order for this to be a robust check, the contractor should request evidence from the subcontractor of the material costs (i.e. copies of invoices for the materials, fuel and plant hire).

As mentioned, obtaining this level of detail can be arduous. In the event of the subcontractor not providing any response to the contractors request for such details, the contractor would be within their rights to withhold tax on the full VAT exclusive value of the payment to be made for the construction operations.

Reasonable estimates

However, given that such a step would be deemed contentious by the subcontractor given the low profit margins typically operated within the sector, CISR15060 provides an alternative approach 'On occasions a contractor may be unable to obtain satisfactory information from the subcontractor about the cost of materials. In this case the contractor may make a reasonable estimate of the cost of materials and apply the deduction to the remainder.'

For individuals who have the relevant expertise within the organisation to undertake a reasonable estimate (i.e. a quantity surveyor) this guidance is useful in ensuring payments can be made on a timely basis even in the event of no response from the subcontractor on request of evidence for the costs of materials incurred. However, not all contractors would have such expertise, typically deemed contractors who are brought into the scheme by virtue of their level of construction spend, will be operating in non-construction sectors, and therefore such expertise will not be available. It is important for organisations to identify key stakeholders internally and establish clear roles in the monthly return process and take on / review of subcontractors, particularly given that the impending April 2020 off payroll changes are also likely to be important to consider too (more on that later).

Given the complexities within CIS and the difficulty in obtaining accurate records from subcontractors, HMRC compliance visits typically focus on material deductions

which often results in underpayments of tax to HMRC. HMRC compliance visits will typically focus on CIS returns which have reported a high level of material deductions, especially if the work would typically have a low direct cost of material. A common example is scaffolders, who may claim a deduction for scaffolding which they own outright. As such equipment has not been hired no deduction is allowed under CIS.

Underpayment of tax

Unfortunately for the contractor, as the withholding and payment of tax is their responsibility, HMRC will seek underpayments from them in the first instance. HMRC can apply concessions to offset the CIS liability under Regulation 9(5) SI2005/2045 if they believe there is a reasonable excuse under Regulation 9(3) SI2005/2045 or they are satisfied the subcontractor has included the income in their own self-assessment tax return and paid the tax due under Regulation 9(4) SI2005/2045. However, such reliefs are not automatic.

In reality, contractors often find themselves making good to HMRC an underpayment in a tax year in which the subcontractor has not yet been required to file a tax return and pay the tax due. In this situation HMRC does not pursue the subcontractor, and would leave both parties to settle the matter themselves. If the subcontractor agrees to reimburse the contractor for the amounts paid to HMRC on its behalf, which it is not obliged to do under tax legislation, the subcontractor can obtain a repayment from HMRC by providing evidence of making good the amount to the contractor and of course including the underlying income in its own self-assessment tax return. This can be administratively burdensome for all parties.

Future developments?

As mentioned above, an interesting development in this area is likely to arise following the implementation of the planned off payroll workers' legislation from 6 April 2020. Although the new legislation is set to take precedence over CIS, the same issues will be faced to ensure the deemed employer in such scenarios makes the correct deductions from payments made to the worker before PAYE and NIC is deducted. To date, guidance on what information should be obtained from the worker, and whether reasonable estimates would be allowed in certain circumstances is still unclear.

For CIS, given the number of times issues around material deductions are identified during HMRC compliance reviews, perhaps guidance should be provided to help deemed contractors without the relevant expertise a mainstream contractor would hold to be able to review levels of material deductions claimed by subcontractors / or make a reasonable estimate. A solution could be publishing typical material percentages for common construction operations a contractor can allow as part of CIS guidance, perhaps set low to incentivise subcontractors to provide evidence to contractors which will improve their in-year cash flow.

Finally, we are approaching the planned implementation of the domestic reverse charge for VAT from 1 October 2020 (following its delay from 1 October 2019). As per my article in the June 2019 edition of Tax Adviser there is a strong emphasis on CIS in this new legislation, given the scope of the reverse charge is based on the CIS definition of construction operations. Although deductions can be made from the payments subject to CIS tax withholding for the direct cost of material, for VAT purposes the full amount will be subject to the reverse charge where applicable.