Construction Industry Scheme (CIS) update

Employment Tax | Tax voice



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Patrick Crookes considers the forthcoming changes to CIS from 6 April 2021, looking at the impact to both the construction sector and organisations with significant construction spend.

Tax in the construction sector is very much in the spotlight. With the implementation of the domestic reverse charge effective from 1 March 2021, and the impending introduction of the off payroll workers legislation from 6 April 2021, it would be perhaps forgiven for the forthcoming changes to CIS from 6 April 2021 to have fallen

off the radar!

I have considered the impact of arguably the two most pertinent changes included in the draft legislation concerning CIS, effective from 6 April 2021.

Cost of materials

A subtle change of wording can have a lasting impact. At the time of writing (February 2021) s.61(1) of Finance Act 2004 states:

"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."

However, from the 6 April 2021, this section of the draft legislation will read:

"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 the sub-contractor 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."

The impact?

The amendment now makes it clear that only the sub-contractor who directly incurs the cost of materials purchased will be able to claim a deduction from any payments under CIS.

This is a significant change to the legislation as HMRC seek to bring clarity to the extent to which subcontractors with net payment status can claim deductions for the cost of materials and reduce the level of tax deductions made.

It brings into focus the area of material deductions, which is one of the most difficult areas of compliance for contractors operating within the scheme, as set out in last year's Employment Taxes Voice magazine:

https://www.taxadvisermagazine.com/article/construction-industry-scheme-cis---'material-difference'

It should not be underestimated how big a change this amendment will now have on the sector. As an example:

Company A is an electrical contractor, and is registered as a subcontractor for CIS, with payment under deduction at 20%. Over many years Company A has been engaged by contractors to supply and fit fire protection systems in commercial buildings. Payment for the work is £10,000 and Company A has provided evidence to the contractor that the materials incurred in undertaking the works are £3,000. Therefore, CIS deductions have been made to date for £1,400 (£10,000 - £3,000 @ 20%).

This work is of a specialist nature, and Company A engages Company B to supply and install the system.

Under the legislation from 6 April 2021, Company A will no longer be allowed a material deduction for materials in this instance, as Company B is the subcontractor who directly incurs the cost of the materials for the work undertaken. From 6 April 2021, the contractor will be required to operate CIS on the full payment to Company A, and therefore CIS deductions of £2,000 will be made.

The above is an example of one payment but across a number of payments from 6 April 2021, this will result in cash flow issues for the subcontractor. When you also factor in that Company A will no longer be charging VAT for standard rated supplies from 1 March 2021, the cash flow implications of this legislative change could be very problematic for smaller entities further down the construction supply chain who do not qualify for gross payment status.

HMRC have long contended that their interpretation of the legislation has always been that the subcontractor directly incurring the costs is the only person that can claim a deduction for material costs, however this has not been consistently applied and the current legislative wording is very much open to a different interpretation

The solution?

Given the legislative change now makes a somewhat grey area of CIS more clear cut, one option might be to consider lowering the threshold for the gross payment status turnover test (currently £100,000) to allow smaller businesses to receive payment gross provided they meet the compliance and business tests. Perhaps the incentive to receive gross payment status will help HMRC increase tax compliance in

the sector given this is a key test for subcontractors to receive gross payment status. As making tax digital is rolled out to those subject to income tax and potentially also corporation tax, HMRC will have greater visibility over the direct tax liabilities of smaller businesses. This may make it easier for the Government to contemplate a reduction of the gross payment status threshold.

Deemed contractors

The draft legislation from 6 April 2021, will also revise the definition of a deemed contractor for CIS purposes.

Under the existing legislation, most organisations (other than those carrying on a business including construction operations and certain other specified organisations) will only be required to register as a deemed contractor for CIS where at any time construction expenditure is greater than £1 million on average over the period of 3 years ending with the end of the last period of account ending before that time.

Under the draft legislation from 6 April 2021, this category of organisation will now become a deemed contractor where construction expenditure exceeds £3 million during a 12 month period.

As an example:

A company incurs construction expenditure during the last three financial years as follows:

y/e 31 December 2018 - £950,000
y/e 31 December 2019 - £875,000
y/e 31 December 2020 - £1,500,000

Under the existing legislation, the registration point for registration as a deemed contractor will be from 1 January 2021 as the average construction expenditure will be more than £1 million on average over a 3-year period at 31 December 2020.

However, if we used the definition of a deemed contractor as per the draft legislation (effective 6 April 2021), there will be no registration requirement as the Company does not incur construction expenditure of more than £3m during a 12-month period.

The impact?

This appears a welcome change for non-construction businesses, however this should be welcomed with caution!

Firstly, although it may prevent a registration requirement, it may actually expedite the point of registration as this is now an expenditure review over any 12 month period rather than at the financial year end. Therefore, if a non-construction business does not monitor its construction expenditure on an ongoing basis and misses the point in which the £3 million threshold is exceeded, they will have missed the contractor registration point under CIS. HMRC can issue late filing penalties for this failure, and if this includes payments made to net payment subcontractors, a loss of tax to the exchequer will also be at stake.

Secondly, under the current legislation under s.59(3) of Finance Act 2004, an organisation will remain registered as a deemed contractor under the scheme until their construction expenditure falls to less than £1,000,000 in each of three successive years beginning in or after that period of account. However, the draft legislation effective from 6 April 2021, appears to replicate the deregistration point for a deemed contractor to that of a mainstream contractor, meaning an organisation can only exit from the scheme at the point they cease to incur construction expenditure. Given there will always be an element of construction work to undertake, i.e., repair and maintenance work, reaching this de registration point may never arrive! Therefore, this transitional provision seems unduly harsh on non-construction businesses with declining construction expenditure.

The solution?

Firstly, HMRC will have new powers, which legislates existing guidance, to provide a grace period of up to 90 days to those contractors who inadvertently or unexpectedly breach the new deemed contractor threshold.

This will give impacted organisations time to set up processes to enable them to operate the CIS rules effectively. However, such powers are at the discretion of HMRC, and there is no wording to suggest that the grace period can be applied retrospectively. Ultimately, this will not prevent the consequences for failure to register if an organisation is not properly monitoring expenditure levels.

Secondly, we await the publication of HMRC guidance around the new changes, especially the de-registration point for deemed contractors from 6 April 2021, to provide clarity on whether registration as a deemed contractor will have as lasting

implications as the draft legislation suggests.

Summary

In less than 6 weeks between 1 March 2021 and 6 April 2021, the landscape of the construction sector will change significantly from a tax perspective. This will have implications for all entities operating in the sector and will shape the engagement of subcontractors indefinitely.

Crucially, from a CIS perspective, the engagement of subcontractors without gross payment status will become a problematic area if details around the level of material costs and the person incurring the costs are not forthcoming between parties in the construction supply chain.

The cash flow implications for smaller subcontractors should not be understated, and when coupled with the VAT domestic reverse charge, a revisit of the qualifying conditions for gross payment status would be a welcome easement for all parties concerned.

We hope the updated CIS guidance on when deemed contractors are required to register and deregister provides greater clarity on the points mentioned above, particularly in that the level of construction expenditure will invariably fluctuate for deemed contractors, because it is incidental to be business rather than its main purpose.