The Construction Industry Scheme: avoiding unintended pitfalls

Employment Tax | Large Corporate | OMB | Property Tax



21 September 2022

The Construction Industry Scheme can apply to more than just UK construction businesses and property developers. Awareness of and compliance with the scheme is key.

Key Points

What is the issue?

The Construction Industry Scheme (CIS) is a tax withholding and reporting regime that applies to payments from contractors to subcontractors, made under contracts which include construction operations undertaken within the UK or UK territorial waters.

What does it mean for me?

Deemed contractors may have to operate the CIS immediately after the threshold is exceeded or is expected to be exceeded, and before the next contract payment is made. A continuous rolling 12 month check on construction expenditure is therefore required to monitor construction expenditure against the threshold.

What can I take away?

Mistakes by contractors can be costly as they can be held liable for CIS tax under deducted from contract payments to subcontractors. If reasonable care has not been exercised HMRC is able to recover that CIS tax for up to six years from the end of the tax year it relates to, together with interest charges and penalties.

The Construction Industry Scheme (CIS) is a tax withholding and reporting regime that applies to payments from contractors to subcontractors, made under contracts which include construction operations undertaken within the UK or UK territorial waters (extending 12 nautical miles from the high watermark).

CIS was originally introduced in the 1970s as a preventative mechanism to target tax evasion perceived to be prevalent in the construction industry. It has taken different forms since then with the most recent version being introduced on 6 April 2007 (although there have been more recent adjustments to the rules, most recently from 6 April 2021).

The primary CIS legislation is within Finance Act (FA) 2004 ss 57 to 77 and Schedules 11 and 12. The secondary CIS legislation is contained in the Income Tax (Construction Industry Scheme) Regulations 2005.

Key definitions

To understand the CIS, it is important to define the following terms.

1. Construction operations

These are the services to which the scheme applies and include a wide range of work done to permanent or temporary buildings, structures or the associated land (such as site clearance and civil engineering works). The legislative definition is set out in FA 2004 s 74.

2. Construction contract

A legally binding agreement or arrangement, under which one person (the subcontractor) does work or provides services or labour for another (the contractor) which are construction operations. An employment contract is not a construction contract for CIS purposes, and so the CIS will not apply to payments made by contractors to their employees. The legislative definition is set out in FA 2004 s 57(2).

3. Contract payment

This includes any payment made by a contractor to a subcontractor (or another party, for example someone nominated by the subcontractor) under a construction contract. It can include payments by cash, cheque or credit (such as loan). The legislative definition is in FA 2004 s 60. Certain materials costs are not treated as contract payments and some payments are excepted from being contract payments, namely:

- payments treated as made under a contract of employment under the labour 'agency' provisions (Income Tax (Earnings and Pensions) Act (ITEPA) 2003 Part 2 Ch 7); *
- payments which can reasonably be taken to be for the services of an individual, and where the provision of those services gives rise to an engagement to which the off-payroll working rules (ITEPA 2003 Part 2 Ch 10) apply and are treated as employment income under those rules; *
- payments where the person receiving the payment is registered for gross payment at the time the payment is made (there are special rules to consider where the recipient is a partnership); or
- any other payment specifically excepted by virtue of the Income Tax (Construction Industry Scheme) Regulations 2005 Regs 18 to 24 (see CISR17190 to CISR17250).

* This means that the agency rules at ITEPA 2003 Part 2 Ch 7 and the off-payroll working rules at ITEPA 2003 Part 2 Ch 10 take priority over CIS.

4. Deduction

This is the amount of tax that a contractor must withhold and pay to HMRC from a contract payment. The deduction will either be at the standard rate of 20% or at the higher rate of 30%. The legislative definition of a deduction is set out in FA2004 s 61.

5. Contractor

This is the party to a construction contract which is either:

- a business which includes the carrying out of construction operations such as a construction business or property developer (FA 2004 s 59(1)(a)). HMRC refers to these contractors as **mainstream contractors**;
- a business that is not a mainstream contractor but whose cumulative VAT exclusive expenditure on construction operations within the previous 12 month period exceeds £3 million (FA 2004 s 59(1)(l)). HMRC refers to these contractors as **deemed contractors**;
- a type of other body (local authority, housing association, etc) whose cumulative VAT exclusive expenditure on construction operations within the previous 12 month period exceeds £3 million (FA 2004 s 59(1)(b)-(k)). HMRC also refers to these contractors as **deemed contractors**; or
- a subcontractor who engages other subcontractors to carry out construction work (FA 2004 s 57(2)).

A householder having construction work undertaken on their own home is not a contractor in respect of these works.

6. Subcontractor

The subcontractor is a party to a construction contract that carries out, arranges or provides labour for construction operations to a contractor, or is answerable to a contractor for the carrying out of construction operations by others. The legislative definition is set out in FA 2004 s 58.

Subcontractors can fall into one of three categories, namely:

- unregistered: contract payments from contractors require a 30% deduction rate;
- registered for net payment status: contract payments from contractors require a 20% deduction rate; or

- registered for gross payment status: contract payments can be paid without a CIS deduction by the contractor.

Obtaining and keeping gross payment status is beneficial where a deduction would otherwise cause cash-flow issues for the subcontractor. Furthermore, many contractors will only want to deal with subcontractors that have gross payment status because of the administrative burden and risks associated with making CIS deductions. See more on gross payment status and these risks below.

A subcontractor who pays persons below them in the contractual chain for construction operations will also be a contractor for CIS purposes.

7. Tax month

CIS operates in relation to tax months. A tax month runs from the sixth of one month to the fifth of the next month.

Does the CIS only apply to UK construction businesses and property developers?

No, the scope of the CIS is much wider than that. Firstly, HMRC treats overseas contractors and subcontractors in the same way as if they were based in the UK. If a construction project is undertaken in the UK or within UK territorial waters, the CIS will need to be considered and potentially applied. That means overseas based contractors and subcontractors will need to register for and (for contractors only) operate the scheme in relation to UK construction projects.

Secondly, the inclusion of deemed contractors means that non-construction businesses and certain other bodies whose annual expenditure on construction operations exceeds the deemed contractor threshold are within scope.

Deemed contractors may have to operate the CIS immediately after the threshold is exceeded or is expected to be exceeded, and before the next contract payment is made. A continuous rolling 12 month check on construction expenditure is therefore required to monitor construction expenditure against the threshold. The requirement to register is subject to a discretionary period of grace (to be agreed with HMRC) not exceeding 90 days.

Do deemed contractors need to apply CIS to construction expenditure on property they use in their own business?

Under Regulation 22 of the Income Tax (Construction Industry Scheme) Regulations 2005, a payment made under a construction contract by a business treated as a deemed contractor under FA 2004 s 59(1)(l) is not regarded as a contract payment where it is made in respect of premises used for the purpose of the business of either:

- the person making the payment;
- another company within the same group; or
- another company in which the business holds at least 50% of the shares.

Note that Regulation 22:

- exempts the payment not the contractor;
- can only apply to a **business** treated as a deemed contractor under FA 2004 s 59(1)(l); and
- cannot be applied where the property to which the construction operations relate is for sale or let, except where the sale or letting of that property is purely incidental to the business of that person, or it is held as an investment.

Based on HMRC's guidance at CISR12060, it is possible for a deemed contractor to deregister as a contractor where all payments made by them under a construction contract are entirely exempted from CIS under Regulation 22. Interestingly though, neither the HMRC guidance nor the legislation specifically states that a deemed contractor in this position when they first exceed the threshold does not need to initially register as a contractor.

What CIS obligations do contractors have?

Contractors must consider the following obligations which need to be satisfied.

1. Register as a contractor

The timing of registration depends on the contractor type. Mainstream contractors must register for CIS before paying their first subcontractor. Deemed contractors must register only once they have exceeded, or are expected to exceed, the

deemed contractor threshold.

2. Consider the employment status of subcontractors engaged directly as individuals

There is a requirement for the contractor to determine whether the subcontractor has employment status. This requires a status assessment to be undertaken. If that status assessment shows that the subcontractor is employed by the contractor, they should be placed on the payroll and income tax and Class 1 NIC must be applied under PAYE. CIS does not then apply.

If that status assessment shows that the subcontractor is self-employed, then (subject to the services falling within the definition of construction operations) the contractor must apply CIS.

3. Consider whether the agency provisions or IR35 regulations apply

As highlighted above, the agency provisions (ITEPA 2003 Part 2 Ch 7) and IR35 rules (ITEPA 2003 Part 2 Ch 10) take priority over the CIS provisions and must be considered first. If a payment is to be treated as employment income under either the agency provisions or the IR35 rules, then the CIS does not apply. If that is not the case then (subject to the services falling within the definition of construction operations) the contractor must apply the CIS rules.

4. Identify construction operations

A contractor must consider whether the services being performed by the subcontractor fall within the definition of construction operations. The definition of construction operations includes a broad range of construction work. Examples include site preparation, alterations, dismantling, construction, repairs, decorating and demolition.

Determining which operations constitute construction operations can be complex, as demonstrated by the extensive index of construction operations in HMRC’s guidance at CISR14330.

It is particularly important to note that if a construction contract includes both construction operations and non-construction operations (commonly referred to as a ‘mixed contract’), then the contractor will be required to report and apply a tax

deduction to all contract payments made under that contract.

For example, carpet fitting in isolation does not fall within the definition of construction operations, but if carpet fitting is undertaken as a finishing operation on a wider construction project, or under a single contract which includes other services falling within the definition of construction operations such as painting and decorating, a contract payment for that carpet fitting will be within the scope of the CIS.

5. Verify subcontractors

The contractor will need to verify each subcontractor's registration status with HMRC before the first contract payment is made to them. This is undertaken online by contractors and HMRC will confirm whether the subcontractor is registered for net or gross payment status or unregistered. A contractor does not have to verify a subcontractor if they last included that subcontractor on a CIS return in the current or two previous tax years.

6. Deduct tax and pay it to HMRC and give a statement to the subcontractor

Where a subcontractor does not have gross payment status, the contractor must deduct tax from the contract payment before paying the subcontractor, pay that tax to HMRC and provide the subcontractor with a statement showing the deduction made.

When calculating the CIS tax deduction, the direct cost to the subcontractor of the following are not treated as part of the contract payment:

- materials;
- consumable stores;
- fuel (but not fuel for travelling);
- plant hire; and
- the cost to the subcontractor of manufacturing or prefabricating materials used.

Materials costs can only be excluded where they represent the actual direct cost of materials to that subcontractor and specifically relate to the construction contract between the contractor and subcontractor under which the payment is being made.

For plant (scaffolding, cranes, etc.), it is only when the subcontractor **hires** plant to carry out construction work for the contractor that the cost (and any necessary consumable items such as fuel) may be excluded from the contract payment. If the subcontractor owns the plant but includes a charge for this on their invoice to the contractor, this charge must be included as part of the contract payment.

Contractors need to be particularly careful here because if the cost of any of such items excluded from the contract payment are excessive or incorrect, HMRC can hold the contractor responsible for the under deducted CIS tax.

Contractors must pay any CIS tax deducted over to HMRC within 14 days of the tax month end to which it relates if paying by post, or within 17 days of the tax month end if paying electronically. The contractor must also provide a written statement to every subcontractor from whom a tax deduction has been made within 14 days of each tax month end. Contractors must include certain information in the statement but are otherwise free to decide on its style.

These risks and additional steps demonstrate why many contractors only want to engage subcontractors with gross payment status.

7. Submit monthly CIS returns

Contractors are required to send HMRC a monthly return (a CIS300), which includes all payments made to subcontractors in that tax month. The return must include details for the tax month of the subcontractors paid, payments made (including those to subcontractors with gross payment status), costs treated as materials and tax deductions. The return must be submitted to HMRC within 14 days of the end of the tax month end it relates to.

Strictly nil returns (where no subcontractors have been paid) are not required. However, HMRC will issue a penalty if no return is submitted for a tax month (unless the contractor has registered for a period of inactivity) meaning nil returns are required in practice.

How do subcontractors obtain gross payment status?

To obtain gross payment status, the subcontractor must apply to HMRC and pass a business test, a turnover test and a compliance test.

To meet the business test, the subcontractor’s business must be carried on in the UK via a bank account.

The turnover test to be applied depends on the circumstances and whether the business is an individual, partnership or company. For example the standard test requires, for the 12 month period prior to application:

- an individual to have net construction turnover of at least £30,000;
- a partnership to have net construction turnover of at least £30,000 multiplied by the number of partners, or £100,000 if this is lower; and
- a company to have net construction turnover of at least £30,000 multiplied by the number of directors, or £100,000 if this is lower. A company wholly owned by a parent company or companies holding gross payment status does not need to pass the turnover test.

To meet the compliance test, the business’s tax affairs for the 12 month period prior to application must be up to date, although there are some compliance failures which HMRC will overlook (referred to as compliance tolerances). HMRC is also able to refuse gross payment status if it has strong grounds for doubting the applicant’s future compliance. If gross payment status is refused, HMRC should notify the subcontractor of the decision and reasons in writing.

Businesses which are granted gross payment status will have their tax compliance automatically checked by HMRC annually. The compliance tests and compliance tolerances applied by HMRC are the same as during the application process. If, during this annual check, tax compliance failures beyond the tolerances are identified, HMRC will notify the subcontractor that their gross payment status will be removed and that 90 days after the notice date their payment status will change to the standard rate of 20%. Contractors who have paid or verified that subcontractor within the last two years will be notified of that change. Subcontractors have the right to appeal the HMRC decision where there is a reasonable excuse for the non-compliance identified. Subcontractors must ensure they appeal on a timely basis.

Common pitfalls and problems

- Not registering for and applying CIS as a contractor at the correct time.
- Not identifying when the deemed contractor threshold is exceeded. Ongoing monitoring of construction spend is required.

- Missing that a subcontractor is performing construction operations. The definition of construction operations is widely drawn and complex, and the mixed contract rule must be considered.
- Not applying the correct CIS tax deduction rate. Robust procedures relating to the verification of subcontractors are important.
- Not applying CIS tax deductions to purported materials and plant hire costs that should have suffered a tax deduction.
- Not considering employment status, employment intermediaries and ‘IR35’ obligations before the CIS. These rules take priority over CIS rules and are contentious areas frequently targeted by HMRC.
- Losing gross payment status as a subcontractor. Subcontractors in this position should carefully consider if there are grounds to appeal and, if there are, to submit the appeal on a timely basis.
- Incorrectly applying or missing the VAT domestic reverse charge for construction services. The domestic reverse charge can result in the contractor, rather than the subcontractor, being required to account for the VAT due on supplies they receive for construction operations.

Conclusions

The CIS can be complex and is a focus area for HMRC and there are several traps and pitfalls for the unwary. Subcontractors with gross payment status must remain compliant to keep that status. Losing gross payment status can have a serious impact on the subcontractor’s business.

Mistakes by contractors can be costly as they can be held liable for CIS tax under deducted from contract payments to subcontractors, and if reasonable care has not been exercised HMRC is able to recover that CIS tax for up to six years from the end of the tax year it relates to, together with interest charges and penalties. While there is scope under Regulation 9 of the Income Tax (Construction Industry Scheme) Regulations 2005 to reduce such settlements with HMRC in certain circumstances, this cannot be relied on and may not reduce the final settlement with HMRC to nil.