Construction Industry Scheme: determining mainstream and deemed contractors

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One of the potential pitfalls involved in the Construction Industry Scheme revolves around the issue of whether a contractor is a mainstream or deemed contractor. We examine why it is so important to get this right.

Key Points

What is the issue?

Following on from our previous *Tax Adviser* article on the Construction Industry Scheme in October 2022, we consider one of the potential pitfalls in more detail; namely, the issue of whether a contractor is a mainstream or deemed contractor, and why getting this right is so important.

What does it mean for me?

If a business does not identify it is a CIS contractor when applicable, then it will be at risk of failing to operate CIS. This could potentially result in the business being held liable for under-deducted CIS tax, HMRC penalties and HMRC interest charges.

What can I take away?

Businesses undertaking construction operations and incurring construction expenditure must properly consider how CIS applies to their business and the issue of whether mainstream or deemed contractor status applies is central to this analysis.

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 in the UK or within UK territorial waters. An important question that businesses brought within the scheme as contractors need to consider is whether they are ‘mainstream’ or ‘deemed’ contractors.

Mainstream or deemed contractor status

The terms mainstream and deemed are HMRC terms which are not specifically defined in legislation, but there accepted meanings can be briefly summarised as follows:

A mainstream contractor

A mainstream contractor is a business which includes the carrying out of construction operations and might include a construction business or property developer.

It will need to register as a CIS contractor with HMRC, regardless of the level of its construction expenditure, before making its first payments to subcontractors.

A deemed contractor

A deemed contractor is a business (or other organisation) that is not a mainstream contractor but whose cumulative VAT exclusive expenditure on construction operations within the previous 12 month period exceeds £3 million. Ongoing monitoring of construction expenditure against the threshold is therefore required.

It will need to register as a CIS contractor with HMRC only when it has exceeded (or is expected to exceed) this threshold. Furthermore, for deemed contractors the following factors apply:

1. HMRC can allow a period of grace before the business needs to start operating CIS, recognising that it can take time for such a business to set up the appropriate procedures to operate CIS correctly. Since 6 April 2021, this period of grace has been included in legislation, allowing deemed contractors to agree an extension of up to 90 days with HMRC before they must operate CIS. This period of grace is not available to mainstream contractors.

2. Deemed contractors can deregister from the CIS if their construction expenditure falls below the £3 million threshold in the previous 12 month period, and the business does not expect to incur more construction expenditure in the future which would cause it to exceed the £3 million threshold again. Deemed contractors can do this by writing to HMRC or calling HMRC’s CIS helpline but should continue to operate CIS until HMRC has approved the deregistration. The ability to deregister for the CIS when construction expenditure falls below the £3 million threshold does not apply to mainstream contractors.

3. Under Regulation 22 of the Income Tax (Construction Industry Scheme) Regulations 2005, certain deemed contractors do not need to operate CIS on construction expenditure relating to premises that are used in its business, the business of another company within the same group, or another company in which the deemed contractor holds at least 50% of the shares. This is provided that the premises are not for sale, let out (unless the letting out is incidental) or otherwise held as an investment. Regulation 22 does not apply to mainstream contractors.

Establishing whether a business is a mainstream or deemed contractor

The terms mainstream and deemed contractor are used by HMRC to add context to and try and make sense of the legislative definitions at Finance Act 2004 s 59(1).

The main distinction between the two contractor types is whether the contractor's business includes the carrying out of construction operations or not. If it does, mainstream status applies; otherwise deemed contractor status applies if the construction expenditure exceeds the £3 million threshold.

The problem is understanding what is actually meant by the term 'includes the carrying out of construction operations'. HMRC's guidance does not clearly explain its interpretation of this term, nor is it defined in the primary legislation within ss 57 to 77 and Schedules 11 and 12 of Finance Act 2004 or the secondary legislation within the Income Tax (Construction Industry Scheme) Regulations 2005.

So, what does the term mean? In our experience of dealing with this point, the key consideration is whether the carrying out of construction operations is fundamental to or incidental to the business being carried on.

If the carrying out of construction operations is fundamental to the business model, then the business 'includes the carrying out of construction operations' and mainstream contractor status applies. If the construction expenditure a business incurs is incidental to its business model, the business does not 'include the carrying out of construction operations' and deemed contractor status applies but only if construction expenditure is large enough.

Sometimes the position will be clear. Take the example of a building company which builds new homes for others. The carrying out of construction operations is clearly fundamental to its business of building homes, and if it uses subcontractors to undertake construction work it will need to register as a mainstream contractor.

Contrast that with a retail company whose main business is retail. It has many stores and a head office which it uses in its retail business, all of which need to be maintained (repairs to the structure of the building, painting and decorating, light refurbishments, etc.), meaning that it will incur construction expenditure.

Its main business is retail and the construction operations undertaken are incidental to that main business activity. It is not a mainstream contractor but if its construction expenditure is large enough and exceeds the deemed contractor threshold, it will need to register as a deemed contractor. There is then an additional consideration as to whether Regulation 22 can apply to its construction expenditure.

There will, however, be circumstances and cases where the distinction is not as clear. The classic problem area is the issue of property investment and property development businesses, and when property investors start to undertake activities attributable to property development.

Property investment vs property development

At the time of writing, HMRC's guidance (at CISR12080) states the following about property developers:

> 'Property developers are included within the meaning of mainstream contractors because their business activity is the creation of new buildings, or the renovation or conversion of existing buildings, or other civil engineering works. The same is true of a speculative builder.'

The same guidance goes on to say the following regarding property investment businesses.

> 'A property investment business acquires and disposes of buildings for capital gain or uses the buildings for rental; it need not be involved in the construction, alteration or extension of buildings. Even so, if its property estate is substantial enough, its expenditure on construction operations may well cause it to fall within the meaning of a "deemed contractor".'

This guidance is clear up to this point. For a property investment business, construction operations undertaken in keeping its investment properties in good repair (such as painting and decorating, and minor repairs) are incidental to its main business as a property investor, and it therefore should only register as a contractor if it exceeds the deemed contractor threshold.

The position is more complicated and less clear when a property investor starts to undertake property development activities. The HMRC guidance at CISR12080 goes on to say that where a business that is ordinarily a property investor undertakes some activities attributed to those of 'property development', they will not usually be considered a mainstream contractor during the period of that development. This is because the usual nature of the business is 'property investment' and not 'property development'.

However, the guidance continues:

> ‘Where the property investment business enters into multiple or substantial contracts relating to construction operations for the purposes of development of one or more properties, you will need to decide if the nature of that business has now changed from “property investor” to “property developer”, in which case they would now be considered to be mainstream contractors as the nature of their business has changed.’

HMRC clearly accepts that some limited activities of property development undertaken by a property investment business would not usually cause its business to change such that it should be treated as a mainstream contractor. But once it enters into multiple or substantial contracts relating to construction operations for the purposes of development of one or more properties, mainstream contractor status could be triggered.

How this works in practice

The HMRC guidance goes on to provide an example of a property investor becoming a mainstream contractor.

Example: Property investment business

‘A property investment business acquires a number of properties which it intends to let, but before letting, minor refurbishment is required to bring the properties up to a suitable standard to be able to let them. For CIS purposes, we would see this as the normal activities ofa property investor, and where the expenditure on such activities exceeds £3 million in a rolling 12 month period then CIS applies.

‘The property investment business then acquires a large dilapidated hotel to add to its portfolio, and decides to convert the building into a series of flats which it will then individually let out. As a result, substantial development is required to the property to change the building to its new use.

In respect of this particular development and contract, we would regard the property investment business as having taken on the mantle of a mainstream contractor as its business activity is now that of construction operations.’

What to draw from this

This example confirms that HMRC regards ‘minor refurbishment’ works as incidental to a property investment business. However, where construction works are undertaken to enable a change in the use of a building, HMRC would view the construction work as then being fundamental to its business and regard the property investor as having become a property developer and mainstream contractor for CIS purposes during the development.

It is important to note in this example that the property investment business’s intention to let these converted flats out is, in HMRC’s view, unimportant. Neither do the property investor’s longer-term intentions appear to be important to HMRC; there is no mention in this example of whether the property investor intends to undertake similar projects in the future, or whether this is a one-off. It is the fact that substantial works have been carried out (even without a view to sale and without needing to understand the property investors longer term intentions) that triggers mainstream status.

In this example, which involves a substantial project to develop a dilapidated hotel and change the use of the building to residential flats, it is understandable that HMRC would regard the property investor as having changed its business model and become a mainstream contractor. But these are two very different situations at either end of a scale and there will be other cases in the middle ground which might not be so clear and which the HMRC guidance does not address. In these circumstances it may be appropriate to obtain HMRC’s view on the position.

Why is it important to get this right?

If the business does not identify that it is a CIS contractor, then it will be at risk of failing to operate CIS.

This could potentially result in the business being held liable for under-deducted CIS tax, HMRC penalties, and interest charges which HMRC could, if the business did not exercise reasonable care, recover within a six-year time limit (from the end of the relevant tax year).

Not identifying that it is a contractor over an extended period could therefore be an expensive mistake for a business to make. While claims under Regulation 9 of the Income Tax (Construction Industry Scheme) Regulations 2005 could mitigate the liabilities due to HMRC (for example, under Regulation 9(5) HMRC may direct that a

contractor is not liable to pay CIS tax if HMRC is satisfied that the subcontractor paid by the contractor is not chargeable to tax on those payments, or has included those payments when computing profits liable to income tax and Class 4 NIC/corporation tax), such claims are by no means guaranteed and cannot be relied on.

The issue of underpaid CIS liabilities, penalties and HMRC interest charges are a key risk where a business incorrectly determines that it is a deemed rather than mainstream contractor. There are several areas of risk; for example, the business making this mistake might:

- never register as a contractor if it never exceeds the deemed contractor threshold (this threshold would not apply to a mainstream contractor);
- recognise that it exceeded the threshold and register as a contractor, but there could be a period before registration when it was incurring construction expenditure and paying subcontractors where it has not correctly operated CIS (i.e. the business registers too late);
- incorrectly applying Regulation 22 to construction expenditure on property it uses in its own business (for example, a property investment business which applies Regulation 22 to construction expenditure it incurs on refurbishing its own head office at a time when it would be regarded as a mainstream contractor);
- deregister because its construction expenditure drops below the £3 million threshold in a 12 month period after registration (deregistration for these reasons would not be open to a mainstream contractor); -or
- cause VAT issues because of the interaction with the VAT reverse charge for building and construction services.

Summary

Businesses undertaking construction operations and incurring construction expenditure must properly consider how CIS applies to their business and the issue of whether mainstream or deemed contractor status applies is central to this analysis. Getting this wrong can be a major headache and an expensive mistake.