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The construction industry - and the tax rules

Protecting your business

The construction sector has its own compliance regime: the Construction Industry Scheme (CIS) and the VAT domestic reverse charge (DRC).

With the bar for compliance set to be raised still higher, businesses need to be confident that they are applying the rules correctly.

Why it matters

The rules matter because compliance can be linked to the ability to claim gross payment status (GPS) – important to cash flow for many businesses. They also matter because non-compliance can bring financial risk.

Errors can leave contractors liable for tax that should have been withheld from CIS payments to subcontractors. There can be interest when tax is underpaid, and penalties for late payment, and in extreme cases, HMRC can require payment of security from contractors. For subcontractors, ongoing tax compliance is one of the three tests for GPS and is checked annually by HMRC.

Are you compliant? Protecting your business

Understanding the CIS rules and applying them, making sure that you're getting essential classifications right will protect your business. Knowing what the CIS applies to; how construction operations are defined; and the responsibilities of players in the labour chain, is key.

The CIS rules apply:

- to contracts 'relating to construction operations' (which are not contracts of employment)
- where one party is a contractor
- and the other is a subcontractor.

What are construction operations?

The legislation defines these as:

- construction, alteration, repair, extension, demolition or dismantling of buildings or structures (whether permanent or not), including offshore installations

- construction, alteration, repair, extension or demolition of any works forming, or to form, part of the land – such as walls, roadworks and sewers
- installation in any building or structure of systems of heating, lighting, air-conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection
- internal cleaning of buildings and structures, so far as carried out in the course of their construction, alteration, repair, extension or restoration
- painting or decorating the internal or external surfaces of any building or structure
- operations which form an integral part of, or are preparatory to, or are for rendering complete, such operations. This includes site clearance, earth-moving, excavation, tunnelling and boring, laying of foundations, erection of scaffolding, site restoration, landscaping and the provision of roadways and other access works.

It's also worth keeping in mind what is not included:

- the installation of seating, blinds and shutters
- the installation of security systems, including burglar alarms, CCTV and public address systems
- signwriting and erecting, installing and repairing signboards and advertisements
- the making, installation and repair of artistic works such as sculptures and murals, which are wholly artistic in nature.

Also excluded are activities on a construction site that are not, by nature, construction operations, such as running a canteen, hostel, or temporary office facility.

Real life situations: In practice, there are many areas where confusion can occur, such as the difference between:

- the **installation** of the systems listed above (within scope of CIS), as opposed to their repair, maintenance, alteration or extension (excluded)
- the installation of **systems** (within scope) as opposed to component parts (excluded)
- work to **prepare or complete** an operation, such as landscaping or tree felling (within scope) and routine landscaping or tree surgery (excluded).

Understanding the labour chain

Contractors: Many construction businesses act as contractors: they are involved in construction operations and pay others for the work involved. They may operate as companies, partnerships or on a self-employed basis. Gang masters organising labour for construction work may be included, as well as property developers and speculative builders. HMRC calls these mainstream contractors.

Some organisations, whose primary business is not construction, may be caught by the CIS rules because they regularly carry out or commission construction work. HMRC calls these deemed contractors. Government departments and local authorities, for example, can fall into this category. If spending on construction operations by such organisations goes over a specified threshold, they also need to apply the CIS rules. From 6 April 2021, businesses spending more than £3 million on construction over a rolling 12-month period are within scope. A different test applied before this period.

Businesses based outside the UK but carrying out construction operations within the UK or UK territorial waters, up to the 12-mile limit, also fall within the CIS. Private householders, having work carried out on their own premises, are not contractors.

Subcontractors are businesses carrying out construction operations for a contractor.

Reality, however, is more complicated. Many businesses act both as contractors and

subcontractors, working for businesses higher up the labour chain, and employing businesses further down the chain.

Responsibilities in the labour chain

Contractors need to register with HMRC before they can take on a subcontractor. There are stringent initial procedures to follow. Contractors must:

- verify the identity and tax status of their subcontractors
- carry out employment status checks to establish whether a subcontractor is to be treated as employed (in which case the CIS rules don't apply); self-employed; or whether the agency provisions and the IR35/off-payroll working rules apply.

Ongoing compliance requirements include:

- making payment in accordance with the CIS rules (below)
- providing subcontractors with details of payments and any tax withheld
- submitting monthly returns of payments made within CIS (or providing nil returns if appropriate) to HMRC
- confirming monthly that they are satisfied that subcontractors are correctly classed as self-employed, and are not employees
- paying to HMRC deductions from subcontractors.

Subcontractors must also register with HMRC. This allows them to be paid by the contractor in one of two ways, and HMRC specifies which method the contractor is to use as part of the verification process:

- payment made gross, with no tax withheld
- or payment subject to a withholding tax deduction of 20%.

Unregistered subcontractors are subject to a higher, 30%, tax deduction. So too are any subcontractors who cannot be verified by HMRC. Deductions represent advance payment of the subcontractor's tax and National Insurance liability. These monies are paid by the contractor to HMRC.

Change coming: gross payment status

Applications for gross payment status (GPS) may face stricter scrutiny in future. At present, HMRC only checks compliance with direct tax obligations when it makes its decision on GPS. It is consulting on whether to add VAT compliance to the decision making process and annual compliance checks. HMRC publicity suggests nearly 16% of businesses currently holding GPS would fail a VAT compliance test if introduced immediately. 'More timely' meeting of VAT obligations would however, move these businesses from non-compliance to compliance. Other proposals include bringing forward the first 'annual' review of compliance, to six months, and moving GPS applications online to allow for more stringent verification procedures.

VAT domestic reverse charge

VAT is never a tax to get wrong – and the possibility of linking VAT compliance to GPS only serves to underline the point. As well as routine VAT housekeeping, businesses need to be sure that they are on top of the rules around the domestic reverse charge (DRC).

The DRC was introduced as an anti-fraud measure - and it's still relatively new. HMRC guidance in some areas, such as scaffolding and the treatment of labour-only subcontractors, has been published only in the last six months.

The DRC doesn't change the VAT liability, but it does change who accounts for it. The DRC applies for most supplies of building and construction operations which are:

- standard or reduced rated supplies (not zero rated supplies)
- for businesses registered for VAT in the UK (not those made to private domestic customers)
- and payments for the supplies are reported within the CIS.

Employment businesses supplying construction workers are treated differently for the DRC: we can advise further here.

In outline, the person receiving the supply of services, not the person supplying the services, accounts for the output VAT due. Rather than the supplier being paid the VAT monies, the supplier instead issues a VAT invoice (with wording specified by HMRC) stating that the service is subject to the DRC. The recipient deducts the VAT due on the supply as input VAT, subject to the normal VAT rules. In most cases, no net tax on the transaction is payable to HMRC.

Broadly, the DRC procedure applies right the way up the CIS supply chain, until it gets to what are called end users or intermediary suppliers. An end user is a business or group of businesses, registered for VAT and the CIS, which does not make an onward supply of the building and construction services it receives. It might be, for example, a large retail business having a trading store built for its own use. An intermediary supplier is a business registered for VAT and the CIS, which is connected, or linked to, an end user. This means it must either have a relevant interest in the same land where the construction work is taking place, such as a landlord and tenant: or be part of the same corporate group or undertaking.

When a supply is made to an end user/intermediary supplier, normal VAT rules apply, and the person supplying the service accounts for the output VAT. It is vital that this is only done, however, where the supplier obtains written notification of the end user or intermediary supplier status of their client.

Helping you protect your business

The tax rules for construction are complex - and it's only too easy to drive through one of HMRC's red lights. Do please contact us to help you review how your business is performing.