

CIS - how the scheme works

(Lecture B1077 – 13.57 minutes)

Introduction

The Construction Industry Scheme (CIS) is a scheme under which contractors are required to withhold tax on certain payments made to sub-contractors. The CIS was introduced in the 1970s as a reaction to the amount of tax being lost as a result of under-declarations or failures to register by itinerant sub-contractors who came to work in the UK for relatively short periods of time and then left without paying tax on the profits from their UK self-employment.

The CIS ensures that some tax is withheld at the point of payment. However sub-contractors who can prove that they are fully compliant with their UK tax obligations can apply to receive payments gross. These people will thereafter account for the full amount of any tax and NIC due on their profits under self-assessment.

Contractors

The CIS only applies to “contractors”. A contractor for the purposes of the CIS is either:

- A person carrying on a business which includes “construction operations” (most commonly builders or building companies);
- A person whose business does not normally involve constructions but whose expenditure on construction operations across a 3 year period exceeds £1 million per annum (for example, supermarkets and certain specified bodies such as housing associations and local authorities).

The CIS does not apply to homeowners engaging the services of subcontractors to work on their own home.

“Construction operations” covers a wide variety of activities including;

- The alteration, repair, extension, demolition or dismantling of buildings (including structures such as road and bridges);
- The installation of heating, lighting, air-conditioning, power supply, drainage or sanitation systems; and
- Cleaning, painting, decorating and other operations integral to the construction process (such as excavation and site-preparation).

The manufacture of components used in the building trade is not within the scheme. Neither is the professional work of individuals involved in the building process such as architects and engineers (or other individuals such as scaffolders, carpet fitters and caterers).

The CIS is restricted to construction operations carried on in the UK. This does however mean that:

- A non-resident contractor who pays sub-contractors for construction work carried out in the UK; or
- A non-resident sub-contractor who is being paid for construction work carried out in the UK

will both be within the CIS.

All contractors must register with HMRC for the CIS. Registration is made online. HMRC will then set up a Contractor Scheme. HMRC has a New Employer Helpline which also deals with CIS registration. The number is 0300 200 3211.

Sub-contractors

A person is a sub-contractor if he is under a duty to the contractor to carry out the construction operations or to furnish his own labour or the labour of others in carrying out the construction operations.

Sub-contractors can be sole traders, partnerships or companies.

If a sole-trader subcontractor carries out work exclusively for one contractor, it is highly likely that he should be treated as an employee of the contractor with any payments subject to deduction of tax and NIC at source under PAYE. Individuals sub-contractors are therefore only within the CIS if there is a genuine case for them to be treated as self-employed traders.

Employment status

The CIS only applies to self-employed sub-contractors.

Contractors have to make a monthly declaration, via their monthly CIS return, that they have considered the employment status of each sub-contractor and they are satisfied that the sub-contractors are self-employed. A penalty of up to £3,000 can be charged if the wrong employment status for a sub-contractor is declared on the monthly return.

Status has always been a very hot topic in the construction industry and HMRC has been making a concerted effort to categorise sub-contractors as employees wherever an opportunity presents itself.

There is no legislation on employment status for tax purposes, but case law suggests that the following three factors are always key in any status discussion:

- Mutual obligation – is the contractor obliged to offer work and is the sub-contractor similarly under an obligation to accept?
- Control – does the contractor exercise control over how the work is done? [Note here that detailed instructions given to the sub-contractor with regard to the nature and extent of the work which is required to be done are not the same as exercising control.]
- Substitution - is sub-contractor obliged to carry out the work personally rather than hiring an assistant or sending along a substitute?

If the above three points are missing then case law strongly suggests that an employment relationship cannot exist so the sub-contractor will be self-employed.

It is vitally important that contractors pay proper attention to the status of a worker engaged to do a job as the risks of failing to do so are with the contractors who are normally held liable for any unpaid PAYE.

Tax treatment of payments

Payments by a contractor to a self-employed sub-contractor can either be made:

- Gross; or
- Under deduction of income tax at 20%; or
- Under deduction of income tax at 30%.

Gross payment

Sub-contractors can only receive payment without deduction of tax if they are “registered for gross payment”. Indeed many construction companies do not engage labour nowadays unless they see evidence of the sub-contractor’s gross payment status as they do not want the additional compliance burdens of monthly CIS returns and tax deduction.

Sub-contractor registration can be made online (normally by logging in with a Government Gateway ID) or via the CIS Helpline on 0300 200 3210.

For limited companies there is an online registration form CIS305 (form CIS304 for partnerships).

Registration for gross payment will be granted by HMRC if the sub-contractor satisfies three tests:

1. The business test;
2. The compliance test; and
3. The turnover test

The business test requires the sub-contractor to be in business carrying out construction operations or supplying labour for construction operations. The business must be substantially carried on through a bank account. Cash trades will not qualify. Proper business records must be maintained.

The compliance test requires the sub-contractor to be up to date with his tax affairs, including paying all tax liabilities, throughout the 12 months up to the application. Minor compliance failures in this period can be overlooked. HMRC seem to be relatively generous here in their interpretation of the word ‘minor’ as up to 3 late monthly return submissions in a year or 3 late payments of PAYE, or a late SA return or a late year-end PAYE return are all considered minor infringements which would not jeopardise the compliance test.

The turnover test is the most complex test. Sole traders must have a construction turnover of at least £30,000 in the 12 months prior to the application. For partnerships, the turnover is £30,000 multiplied by the number of partners or £100,000 (whichever is lower).

The standard turnover test for companies is also £30,000, but for close companies this is multiplied by the number of individuals who are shareholders and/or directors of the company. Again this is capped at £100,000.

“Turnover” is net of any materials used to generate the income (such that the turnover test is effectively measured in relation to the supply of labour).

Before a contractor makes a payment to a sub-contractor, the contractor will use HMRC’s online verification system to check his status. This is mandatory and tells the contractor whether payments can be made gross or whether tax needs to be deducted (and if so at what rate).

Verification is only required in relation to sub-contractors who have not received a payment from the contractor in the previous 2 years. Contractors do not therefore need to use the verification service every time they make a payment to a sub-contractor. HMRC will notify contractors of any changes in the status of a sub-contractor to whom payments have been made in the previous 2 years.

Where a sub-contractor is registered for gross payment, HMRC will undertake an annual review of his compliance record to ensure that gross payments status can continue. This is an automatic check that all tax returns have been submitted and all tax has been paid on time and any information requested has been provided. Minor failures can be overlooked.

The 20% deduction rate

Sub-contractors who are registered with HMRC but are not registered for gross payment – for example due to not meeting the turnover test or because of outstanding tax returns etc - will be subject to tax deduction at 20%. Contractors will be notified of this via the online verification system. There are no bars to registration so all self-employed sub-contractors can register.

The 20% rate is designed to equate (approximately) to the average tax and NIC rate suffered by a typical sub-contractor taking into account expenses and personal allowances etc. Extra tax or NIC will be paid (or repaid) via the self-assessment system.

The 20% rate is applied to the VAT-exclusive part of the payment that does not represent the cost of materials incurred by the sub-contractor.

Example:

John is a self-employed central heating engineer.

He is registered with HMRC but is not registered for gross payment.

He is VAT registered. John submits the following invoice to a contractor for work carried out:

	£
Supply of labour	4,000
Travelling & subsistence expenses	600
Materials supplied (excluding VAT)	<u>400</u>
	5,000
VAT @ 20%	<u>1,000</u>
Total payable	<u>6,000</u>

The tax to be withheld by the contractor is as follows:

	£
Re: Labour	4,000
Re: Travelling & subsistence expenses	<u>600</u>
Amount liable to 20% deduction	<u>4,600</u>
Withholding tax @ 20%	920

The contractor will therefore pay John $£(6,000 - 920) = £5,080$.

Note here that John must account for the VAT of £1,000 via his normally quarterly VAT returns. The £920 tax deduction will be a credit against any tax and NIC due on submission of his SA return.

Where materials as well as labour are supplied ('supply and fix' contracts), if the sub-contractor is registered for VAT (as with John above), any input VAT paid on materials should be excluded. This is because the sub-contractor will recover this VAT via his monthly returns. However where the sub-contractor is not registered for VAT, any VAT paid on materials should be included within the amount invoiced.

The 30% deduction rate

Subcontractors who are not registered with HMRC will be subject to tax deduction at 30%. The higher deduction acts both as an incentive for sub-contractors to register and as a safety-net for HMRC in the event of a sub-contractor default. The deduction is applied as above.