

Exposing HMRC's scrutiny of the CIS

David Brindley and Jas Jhooty look at HMRC's increased focus in the Construction Industry Scheme (CIS) space. So what's the issue?

The CIS is designed to regulate payments to subcontractors working in the construction industry in order to prevent tax evasion and ensure subcontractors pay the correct amount of income tax and NICs. Under the CIS regime, contractors are required to deduct money from payments to subcontractors and pass this to HM Revenue and Customs (HMRC).

HMRC can open investigations mainly to determine if CIS has been applied correctly in particular around the proper treatment of expenses, such as materials costs and equipment hire. During HMRC investigations, contractors and subcontractors are usually required to provide detailed documentation and evidence to support their accounting of materials and third-party plant hire expenses to establish the correct split.

It is important to note that the HMRC investigation will be into the contractor, where the obligation for CIS applies, rather than subcontractors. This can lead to an inequitable position where if the contractor has underpaid or not paid CIS, and paid the subcontractor gross for the work, they are then also obliged to pay any understatement of CIS plus interest and penalties and thus potentially creating a double charge on the contractor.

Areas of HMRC activity

We have found from discussions with our contacts within HMRC, along with our peers, that HMRC investigations into CIS have increased over the last few years, with a particular focus on two main areas, being:

1. Identifying failures to apply CIS correctly; and
2. Ensuring the correct division of costs have been applied.

HMRC have also started a new CIS 'nudge letter' campaign with our understanding that initially they are targeting insurers. We suspect should this project be successful, HMRC will then look to issue them to any CIS companies they suspect may not be declaring the correct amounts. As such, it is a key area to be aware of.

Record keeping

Maintaining accurate and detailed records of third-party plant hire agreements, invoices and receipts is crucial. From our experience, subcontractors on some occasions will not split the costs but rather issue an invoice with one expense for everything. From our experience when dealing with HMRC, one of the key difficulties when managing an enquiry and negotiating with HMRC is establishing the correct third-party plant hire and material split in these instances.

Quantity surveyors can assist in preparing documentation and providing expert analysis to substantiate the legitimate cost of materials and third-party plant hire where the position is not clear, helping construction businesses demonstrate compliance with CIS regulations. HMRC have their own industry-level percentages that they will often opt to use if the position is not clear, dependent on the project, although from our experience this can sometimes be lower than the reality. As such, it is important for contractors to ensure they have the correct costings split when processing invoices. It is worth noting however that they have to use the correct split as we have seen instances where material expenses have been inflated, for example a 95% expense for third party plant hire and a 5% labour cost, which were clearly not the correct rates and could lead to larger penalties being imposed.

Statutory defences and resolution options

Should the contractor have been found to have underpaid on CIS due to either an error in quantifying the correct costs or not believing that CIS applied in the first place, there are a couple of defences in place which mean that the contractor will not have to retrospectively bear the tax burden for the CIS payments, being:

1. That the contractor took reasonable care to comply with the CIS regulations; and either

- The failure to fully comply was due to an error made in good faith; or
- They held a genuine belief that CIS did not apply to the payment.

2. HMRC are satisfied that the subcontractor was not chargeable to income tax or corporation tax on the payments or has paid them in their personal self-assessment return or company tax return.

From our experience, we have found that HMRC are quite challenging when considering these defences, with the bar in particular for reasonable care being placed higher than in some other taxes.

We have also found that second defence is notoriously difficult to agree as it relies on HMRC conducting checks on a 'third party' being the subcontractor. This means that HMRC will not share any detailed information with the contractor. For those who have only completed a few projects and have lost contact with the subcontractor there is a reliance placed on HMRC to conduct the right checks to ensure this is correct, which HMRC can sometimes get wrong. However, despite an initial rejection, we have previously been successful in arguing the point with HMRC where we do have access to the subcontractor and have been able to obtain records to evidence the second defence applied.

Whilst HMRC can be quite challenging in CIS investigations, they are as a whole reasonable and, with the correct approach, both defences can be valuable tools. For those where HMRC are extremely entrenched in their view, we have also found some success in taking cases to Alternate Dispute Resolution (ADR).

Proactive preventative measures

To aid swift resolution of any HMRC investigation or where a nudge letter is received, it is essential for businesses who partake in construction to ensure they fully understand the implications of the CIS on the cost of materials and third-party plant hire. If the CIS submissions are correct and sufficient evidence is in place, this will usually alleviate the need to go through prolonged enquiry negotiations with HMRC.

However, it is worth noting that the construction industry continues to evolve and adapt to changing market dynamics and regulatory landscapes. As such staying informed about updates and amendments to CIS regulations is essential as it is easy to fall afoul of changes. Regular monitoring of HMRC guidelines and official communications can provide valuable insights into any changes that may impact the treatment of materials and crane hire costs under the CIS. By staying abreast of regulatory developments, construction businesses can proactively adjust their practices to maintain compliance and minimise their chances of being placed into a HMRC investigation.

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