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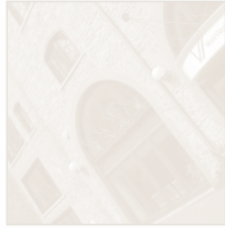
Construction Industry Scheme

A guide to the new Construction Industry Scheme and its
impact for contractors and subcontractors

January 2007



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Introduction

The revised Construction Industry Scheme will apply to payments made after the 5th April 2007. The scheme will operate under new legislative framework and regulations, but in many ways it is very similar to the existing scheme. There have, however, been major changes focussing on:-

1. Verifying registration;
2. Reporting monthly;
3. Declaring employment status.

This has consequences for the contractors and subcontractors.

The New Scheme!

The new Scheme applies to *payments* made by a *contractor* to a *subcontractor* under a contract that involves *construction operations*, where the subcontractor is not an employee of the contractor.

Payments

A payment is anything paid out to a subcontractor under a contract for *construction operations* regardless of whether or not it is made directly to the subcontractor.

A Contractor

As with the existing scheme the term *contractor* is wide in scope and includes two groups; mainstream contractors and deemed contractors.

A mainstream contractor includes i) any business that carries on *construction operations* (including foreign businesses that operate in the UK), ii) property developers or speculative builders and iii) gang-leaders who organise labour for construction work.

Businesses and local authorities that are not mainstream contractors may still fall under the scheme if their average annual expenditure on *construction operations* for the three years up to the end of the last accounting date exceeds £1 million or, where a business has not been trading for three years, if it has, in its trading period, spent more than £3 million on *construction operations*. If either of these criteria is met, the business is regarded as a deemed contractor and will continue to be so until it demonstrates to HMRC that it has spent less than £1 million on *construction operations* in each of three successive years.

It is important to note, however, that in calculating expenditure on *construction operations* a business does not need to include expenditure that relates to property used for the business itself. Furthermore, if the business is a company it does not need to include expenditure on property used by other companies within the same group or other companies of which the company owns more than 50% of the shares.

A Subcontractor

A *subcontractor* is any person who engages in a contract with a *contractor* to carry out *construction operations*, whether the subcontractor is to carry out the work himself or have the work done by their own employees or subcontractors.

Construction Operations

The wide definition of construction operations is contained in section 74 Finance Act 2004 and covers work such as construction, alteration, repair, extension, demolition, decorating (internal and external) or dismantling. The work may be on a permanent or temporary building or structure or on a civil engineering work or installation.

This broad definition is subject to certain exceptions, most notable the works of architects, surveyors and other consultants.

What changes have been made?

The previous scheme requiring subcontractors to provide a contractor with either a Registration Card or a Tax Certificate was an unnecessary administrative burden on the industry. The new system of verification obliges the contractor to verify the registration of the subcontractor.

To improve compliance, the new scheme requires a contractor to provide monthly returns to HMRC, which replaces the current requirement to submit a yearly return.

Finally, HMRC has introduced an employment status declaration obliging contractors to ensure the correct employment status applies to their workers.

What does this mean for Contractors?

Verification

A contractor must verify the registration of the subcontractor to whom they are making a payment. Whilst existing subcontractors will continue to be paid on the same basis as before, a contractor must contact HMRC for verification when taking on **a new subcontractor or one that has not worked for the contractor in the previous two years**. A contractor will be able to check the registration status of the subcontractor either online, by telephone, using third party software or by electronic data interchange. The contractor will be asked to provide HMRC with the following details:

For subcontractors who are **sole traders**:-

1. Name;
2. Unique Tax reference;
3. National Insurance Number.

For subcontractors who are **partners in a firm**:-

1. Partner's name;
2. Firm's name;
3. Firm's Unique Taxpayer Reference, and either;
4. Partner's Unique Taxpayer Reference or National Insurance Number, if the partner is an individual, or;

5. Corporate partner's Unique Taxpayer Reference or Company Registration Number if the partner is a company.

For subcontractors who are **companies**:-

1. Company name;
2. Company Unique Taxpayer Reference;
3. Company Registration Number.

HMRC will confirm the status of the subcontractor and how the contractor should make the payment. The contractor will be instructed either to pay the subcontractor a gross payment or to make a deduction from the part of the payment that does not represent the cost of materials incurred by the subcontractor. At present the deduction is 20%, but if the subcontractor has failed to register with HMRC, the contractor will be directed to deduct 30%. The contractor must continue making this deduction until the subcontractor registers with HMRC.

Whether or not the deduction is actually made, the contractor is obliged to pay the amount deductible from payments to subcontractors to HMRC's Accounts Office each month. Where payment is made electronically it must reach the Accounts Office within 17 days of the end of the tax month, otherwise a contractor must pay deductions due within 14 days of the end of each tax month.

Once verified, HMRC will provide the contractor with a verification number, which will be identical for each subcontractor that has been verified at that time. In the event that HMRC are unable to verify one or more of the subcontractors, one or two letters will be added to the verification number so it is unique to that subcontractor. It is vitally important that the contractor makes a note of this verification number as a contractor must include the reference number on their monthly return and on the subcontractor's payment statement when they have had to make a deduction at a higher rate.

If the payment status of the subcontractor changes, HMRC will inform both the subcontractor and any contractor who has verified or used the subcontractor within the previous two tax years. Where a subcontractor loses the right to be paid gross, HMRC will write to them giving 90 days notice of the change. They will also give 30 days' notice of the change to all contractors who have verified or used the subcontractor within the previous two tax years.

Payment Statements

A contractor must produce a written statement for each and every subcontractor that has received payment under deduction, which replaces the CIS25 voucher. The contractor can choose the format of the statement but it must include the following information:

1. The contractor's name and employer's tax reference;
2. The end date of the tax month to which the statement applies or the date of the payment if the statement relates to a single payment;
3. The subcontractor's name and their Unique Taxpayer Reference;
4. The personal verification number if deduction was made at a higher rate;
5. Gross amounts of payments made to the subcontractor (less VAT);
6. Cost of materials incurred by the subcontractor;
7. The amount of the deduction

The statement should be completed at the end of each tax month and must be produced to the subcontractor by the 19th of every month. HMRC have the power to charge penalties of up to £3,000 if the contractor fails to give the statements to the subcontractors or if the contractor has negligently or deliberately provided incorrect information in the statements.

Submit Monthly Returns

A contractor must now submit monthly returns to HMRC, which must include details of the following:-

1. All payments made under the new scheme to all the contractor's subcontractors, whether paid gross or under deduction;
2. Any deductions made from those payments; and
3. Declarations that the contractor has:-
 - a. considered the employment status of each subcontractor; and
 - b. verified any new subcontractor with HMRC

The return must **reach** HMRC, by post or electronically, no later than 14 days after the end of the tax month. A return that reaches HMRC after the 14 day deadline will incur an automatic penalty payment of £100. Where the return should have included more than 50 subcontractors the penalty will be a further £100 for each additional 50 subcontractors and this penalty will be repeated for every month the return is outstanding.

If the contractor has made no payments in any particular month, they must submit a "nil return". If a contractor believes that they will not be making any payments to a subcontractor for a while, it is possible to apply to HMRC to be shown as "inactive". A contractor can remain inactive for a maximum period of six months but must contact HMRC when they resume making payments to subcontractors.

Employment Status Declaration

The new scheme requires a contractor to make a statutory declaration, which is included in the contractor's monthly return, confirming the employment status of a subcontractor. HMRC may charge penalties where they believe an error or omission has been caused by negligence or intentionally, therefore, it is vitally important that the contractor regularly assesses the relationship between themselves and the subcontractor. It is important constantly to monitor the relationship with the subcontractors as the position may change with time.

When assessing the relationship the contractor must look at the reality of the situation. Who controls the work that the subcontractor is doing? If a contractor has control over what work is done, when it is done and how it is done, it will tend to suggest that the relationship is one of employment. Furthermore, it is necessary to assess who provides the equipment for the work done. Whilst the supply and use of small tools by the contractor is not of great significance, situations where a contractor engages workers to operate expensive or heavy equipment which they own or have hired from another source, tend to suggest that the subcontractor is an employee.

Other factors to take into consideration are the financial risk to the subcontractor, the freedom to hire and pay another person to undertake the work and the length of their engagement. If a subcontractor is to receive a fixed fee for carrying out defined works then this is more likely to suggest that subcontractor is self-employed. On the other hand, if the subcontractor receives a fee in relation to hours worked on the job, it is more likely that they are an employee. Similarly if the subcontractor is at liberty to hire and pay a third party, it is more likely that they are self employed.

If a contractor is in any doubt as to the status of the subcontractor he must seek professional advice. Not only will their advisers be able to help in clarifying the position but it provides evidence to HMRC that an error in declaring the status was not intentional or due to negligence on their own part providing they have disclosed all details to their advisers about the relationship.

Furthermore, in the event that HMRC reclassify the subcontractor as an employee then the contractor is liable for their PAYE and NIC contributions for the previous 6 years. HMRC will refund the tax paid by the subcontractor but there is no legal obligation for them to account for that amount to the contractor.

Veale Wasbrough's business tax scheme is well placed to give commercial advice on the employment status, or otherwise, of relevant subcontractors.

Contracts

Construction contracts generally provide for the Contractor to make the deductions from payments according to the CIS scheme. This is a sensible protection for the Contractor and clears the air for the subcontractor.

Veale Wasbrough is happy to review the application of such clauses in the light of the changed system. We can also provide revised clauses for future contracts.

How are subcontractors affected?

Subcontractors already registered under the existing scheme will be automatically transferred to the new scheme and need not re-register unless they hold a temporary registration card which expires, and is not renewed, before April 2007.

With the introduction of the verification procedure, subcontractors will no longer need registration cards, tax certificates or vouchers. Subcontractors will, however, have to provide contractors with the necessary details required for verification (please see above).

One area of change to note, however, is that the basis for registering for gross payment has changed slightly. The new scheme has abandoned the 6 month and three year turnover test in favour of a simpler one year test.

To register for gross payment a subcontractor's business must meet the following conditions:-

- It carries out construction work in the UK, or provides labour for such work, and is run through a bank account;
- It satisfies the turnover test;
- It complied with all of its tax obligations in the twelve months prior to the application.

Turnover Test

The turnover test operates as follows:-

An individual must show that the business had a net construction turnover of at least £30,000 in the 12 months prior to the application.

A Partnership must show that it had either a net construction turnover of at least £30,000 per partner in the 12 months prior to the application, or that the partnership itself, has a net turnover of at least £200,000 during that 12 months.

A company must show that it is either a wholly owned subsidiary of another company registered for gross payment, or it has a net construction turnover of at least £30,000 for each director (plus each beneficial shareholder in the case of a close company) in the 12 months prior to the application, or that it has a net turnover of at least £200,000 during that 12 months.

Compliance Test

Whether an individual, partnership or a company, the subcontractor must have complied with all of its tax compliance obligations in the twelve months prior to its application to be registered for gross payment. The compliance test extends to each individual partner in a partnership and each director if the subcontractor is a company.

In order to comply with all of its tax obligations a subcontractor has to have done the following:

1. Completed and returned all tax returns sent to the subcontractor;
2. Supplied any information to do with tax that HMRC may have requested;
3. Paid the following by their due dates;
 - i. All tax due from the subcontractor;
 - ii. All National Insurance Contributions due from the subcontractor;
 - iii. Any PAYE tax and National Insurance Contributions due from the subcontractor as an employer.

HMRC will, however, disregard the following:

1. Three late submissions of the monthly return, providing they are no more than 28 days late;
2. Three late payments of CIS/PAYE deductions providing they are no more than 14 days late;
3. One late payment of Self Assessment tax providing it is not more than 28 days late;
4. Any employer's end of year return made late;
5. Any late payments of Corporation Tax providing they are no more than 28 days late;
6. Any Self Assessment return made late;
7. Any failures classed as "minor and technical" in relation to the subcontractor's obligations under the existing scheme, which fell within the 12 month period up to the application.

Conclusion

The new scheme has introduced several changes aimed at improving compliance by the industry. It is important that contractors, and subcontractors, are aware of their obligations under the new scheme and begin to put into place a structure for managing the administrative changes.

Further guidance on the new scheme can be found in booklet CIS 340, the series of fact sheets CIS341-349, or by consulting your advisers.

The Veale Wasbrough business tax team is happy to advise on the technical aspects of applying the new CIS rules or in any disputes with HMRC.

Richard Pincher, the partner who heads the team, has more than 20 years' experience of advising businesses in relation to all aspects of their operations.

We take a positive approach to resolving issues but are also experienced and ready to take matters to judicial proceedings to achieve the best outcome.

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