

The construction industry scheme: A wolf in sheep's clothing?

Chris Hyde and Laura Oliver expose the hidden teeth of a seemingly straightforward scheme designed to collect tax on cash-in-hand work.

Of the tax-compliance challenges faced by commercial landlords, the construction industry scheme (CIS) can seem relatively benign. Yet it is easy for landlords to be lulled into a false sense of security. Belying its outward appearance, the CIS has the potential to derail transactions and, if ignored, can resurface long after completion to bite the unwary tax manager.

Why should a withholding scheme primarily intended to protect tax receipts in the arena of cash-in-hand construction work affect real estate investors? The answer is that the CIS casts a lazy but broad net by catching contractors and "deemed contractors" at the top of the pyramid and electrifying the chains of construction contracts that flow down.

Risks faced by landlords

Difficulties arise when a CIS deduction is not made when it should have been, as there is no easy way of rectifying the mistake. At worst, a considerable period of time elapses before the mistake comes to light and triggers penalties referable to the amount that should have been deducted. Getting it right in the first place is significantly less painful.

Landlords will be most at risk where they contribute towards their tenant's works on the grant of a lease. If the landlord is a deemed contractor, the application of the CIS will generally turn on two key factual questions:

- Is the tenant under an obligation to carry out the works?
- If so, what is the nature of those works?

Specifically are they restricted to ordinary fit-out works or will they benefit the landlord (for example, by increasing the value of its reversionary interest)?

Where the tenant is responsible for the works under the letting documents and the landlord benefits from them, then the landlord's contribution will fall within the remit of the CIS.

Those working on letting transactions on a day-to-day basis should be aware that the CIS requirements cannot be circumvented or ignored. Deliberately evading the

CIS may even give rise to penal consequences for the individuals involved.

Excuses, excuses

It is not uncommon for tenants to make creative assertions that the CIS can be disregarded – unsurprising, given that the compliance risk falls solely on the landlord. Suggestions that should be given short shrift include:

- CIS does not apply because the tenant, as subcontractor, will be occupying the property itself: The exemption for "own build" work applies to a deemed contractor paying for work to its own business premises, not on a payment to someone who has agreed to commission works to the property they are renting, with someone else paying.
- The contribution is only an inducement to enter the lease, not payment for works: Provided the tenant is obliged to carry out (or is otherwise answerable for) the works under the letting documents (and assuming the works go beyond fit-out), CIS applies regardless of what the payment relates to (save for exceptions for building materials, which should be applied with caution, and payments relating to separate works that do constitute pure fit-out).
- CIS is irrelevant because we are registered for gross payment: The landlord itself must verify the tenant's CIS status with HM Revenue & Customs (HMRC).
- CIS does not apply because the tenant is only arranging the work, not undertaking it: "Sub-contractor" includes anyone who is responsible for construction works under the letting documents, regardless of whether they are actually undertaking them.

One long-established practice that does not fall foul of the CIS is where the tenant is compensated for works by a rent-free period. As a matter of law, the CIS applies only to "payments" (though guidance indicates that HMRC may not always agree). It is doubtful that a landlord could be said to have made a "payment" merely by agreeing an initial rent-free or reduced-rent period.

Taming the wolf

Recouping CIS deductions from HMRC can involve considerable delay for tenants. It is seldom practicable for tenants to obtain gross registration status, allowing 0% deductions, within an acceptable timeframe. Even where the timeframe is viable, tenants may be resistant

to the level of personal information required from directors in order to complete the application. It can be worthwhile, however, to have discussions with the tenant about the impact caused by CIS deductions.

The more basic CIS registration (which requires less information and only minimal effort) reduces the deduction to 20%. If a corporate tenant is required to make its own CIS deductions on payments to those carrying out the works, the deductions it suffers can be offset against the deductions it is required to make.

Finally, if the tenant is a corporate entity that operates a payroll, deductions can be offset against PAYE and NICs liabilities to HMRC. In many cases, the deduction will “wash through” within a month.

Ultimately, landlords must remember that they are legally responsible for applying the CIS correctly and they should manage tenants’ expectations accordingly. If addressed at the outset of negotiations, these issues

should be uncontroversial. Left unattended, the CIS has a potentially nasty bite.

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CIS: The bare bones

- Just as PAYE involves employers deducting tax before making salary payments under employment contracts, the CIS involves “contractors” deducting tax before making payments to “sub-contractors” under contracts relating to construction works.
- A “contractor” includes mainstream contractors within the construction sector, but also “deemed contractors” – broadly, anyone with an average annual construction spend in excess of £1m. Many commercial landlords will therefore qualify.
- A “sub-contractor” broadly means anyone who has responsibility for construction works under an agreement. Tenants who are required to undertake works under the terms of their letting will be caught.
- If the contract is within the scope of the CIS, payments are caught regardless of what they relate to (subject to limited exceptions).
- Deductions apply at a rate of 30%, 20% or 0%, depending on the sub-contractor’s CIS registration status.