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Tackling Construction Industry Scheme (CIS) Abuse

Response by the Chartered Institute of Taxation

1 Introduction

1.1 The Chartered Institute of Taxation (CIOT) sets out below its response to the consultation document on 'Tackling Construction Industry Scheme Abuse' published on 19 March 2020.

1.2 The consultation concerns ways HMRC might tackle abuse of the Construction Industry Scheme (CIS). It sets out various suggestions to prevent tax loss within construction supply chains and invites feedback on the same. It is intended to build on the VAT reverse charge for the construction industry, which is due to come into effect on 1 March 2021, and Off-Payroll Working rules for the private sector which take effect from 6 April 2021.

The document also explains a new power for HMRC to adjust the CIS deduction amounts claimed by limited company sub-contractors that are employers via their PAYE Real Time Information (RTI) Employer Payment Summary (EPS) and seeks views on the implementation of this new power.

In addition, the document sets out changes to existing CIS rules aimed at clarifying their meaning or expanding their scope that are apparently not being consulted on and seeks views on other changes that could be made to the CIS rules to tackle abuse.

1.3 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers, and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

1.4 Our stated objectives for the tax system include:

- A legislative process which translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.

- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.]

2 Executive summary

2.1 *General Comments*

We think it is disappointing that only the implementation of the proposed new provision (Chapter 3 of the consultation document) aimed at ensuring CIS deductions claimed by employers are correct is being consulted on, and not the design of the policy. It is also disappointing that, of the other proposed changes (Chapter 4), there are no questions asked regarding (i) amending the definition of 'deemed contractor', (ii) the proposal on restricting claims for deductions for materials, and (iii) the change to the false registration penalty. We are unclear why these proposals are not subject to consultation in the normal way.

2.2 *Correcting the CIS deductions claimed on an EPS*

This issue relates to offset claims by limited company sub-contractor employers to set-off CIS deductions suffered on payments from contractors against their in-year employer liabilities. The proposed approach is for HMRC to be empowered to '*correct the CIS deduction figure an employer has recorded on an EPS; and to prevent the employer from setting further CIS deductions against their employer liabilities for the rest of the same tax year where the correction power has been used*'. However, the proposed approach seems a somewhat muted response to what appears to be characterized as a deliberate intent to misrepresent the amount of CIS deductions that a sub-contractor has suffered. In other words, actions which would seem to be tantamount to fraud. This said, we assume that in reality over-claims for CIS deduction offsets can arise in a range of circumstances from genuine mistakes, to careless claims to deliberate attempts to defraud. Consequently, we think that the proposed 'one size fits all' approach is not the right solution to this issue and that the appropriate compliance response from HMRC should be tailored according to the underlying reason for the incorrect claim (see below).

2.3 We also think that the proposed 14-day period for the employer to provide evidence of CIS deductions suffered/correct their return is too short and should be at least 21 days and, preferably, 30 days (for the reasons given at paragraphs 3.19 and 3.20 below). And that HMRC should develop 2-way email/PAYE online communication processes for HMRC to notify requests for evidence etc. to sub-contractor employers, and for sub-contractor employers to reply to those requests. If a paper-based notification process is to be used, then we think the minimum period should be at least 30 days (and, preferably, 45 days) from date of receipt of HMRC's letter.

2.4 We suggest that, as a safeguard for taxpayers that make honest mistakes, HMRC tailor its responses to sub-contractor employers so that the response is calibrated and proportionate to the reason why the over-claim arises. For example, those that make a genuine mistake should be suitably educated to prevent future mistakes, those that are careless are prevented from claiming future offsets for the remainder of the tax year, and that those deliberately or fraudulently claim offsets are subject to a much more robust response, including prosecution.

2.5 *Deemed contractors and the trigger for CIS registration*

This issue apparently concerns the current rule to determine whether/when a business undertaking 'construction operations' is a 'deemed contractor' – the consultation document indicates that the rule is open

to abuse. However, it is unclear to us what precisely this abuse is (as it is not explained) and why the new definition is to be preferred. In any event in moving away from measuring spend on construction operations by reference to periods of account it seems to us this will add to the administrative burden for contractors in tracking such spend.

2.6 We are also concerned that the proposed process to allow deemed contractors to deregister from CIS only when no further payments on any construction operations are expected to be made may prove impossible given that there is likely to be some ongoing, albeit minimal, construction works (for example, minor repairs).

2.7 ***Deductions for materials***

The problem here is explained as the way in which contractors take a deduction for materials purchased by sub-contractors. However, it is again unclear what the 'mischief' is that needs correcting. We would expect CIS deductions to apply only to labour costs and not to the actual costs of materials. This is regardless of which entity in the supply chain actually purchases the materials, albeit we accept that a mark-up on those materials would fall within the CIS. The point being that, as stated, materials are not in principle subject to CIS deduction and applying such deduction will mean that too much tax is accounted for to HMRC and so it would need to be refunded in due course to the sub-contractor.

2.8 ***Expanding the scope of the false registration penalty***

The proposal is that the existing penalty for providing false information when registering for the CIS should be extended to apply to a 'relevant person', which is to be defined broadly as anyone HMRC believes is able to exercise control and direction over a business and/or the person making the CIS registration. We think that the proposed new measure is fair enough in principle, but would propose that there be a defence available where it can be shown that the person concerned was not involved/had no knowledge of the wrongdoing - and that the burden of proof should rest with HMRC.

2.9 ***Consultation on supply chain proposals***

The consultation document notes that '*organised fraud in labour provision is being used to extract cash from the tax system. The fraudsters insert themselves almost anonymously into construction supply chains, artificially lengthening those chains to make it difficult for HMRC to reconcile the main contractor's CIS declaration to all sub-contractors below it…*'. This early stage discussion as to what could be done to address this issue is therefore welcome and we agree, in principle, that focusing on supply chain measures is an appropriate response to addressing the issue. This said, we think that larger contractors already undertake a reasonable amount of due diligence on the sub-contractors with whom they are contracting. Therefore, any additional measures must be proportionate so that the potentially considerable extra administrative burden that may be placed on <u>compliant</u> contractors is justified by HMRC's need to identify and prevent fraud by non-compliant contractors, sub-contractors or workers, and to apply appropriate sanctions when this has occurred.

2.10 We would suggest a further exploratory consultation on what more a contractor could reasonably require of its <u>immediate</u> sub-contractor(s) around tax compliance and what obligations and requirements could reasonably be placed on contractors when deciding who it will, and won't, contract with. We also suggest focusing on what each contractor/sub-contractor in a chain might reasonably be expected to do as regards ensuring tax compliance of the sub-contractor(s) they <u>immediately</u> contract with, rather than imposing an obligation solely on the main contractor in relation to every sub-contractor below them in the chain, however remote.

2.11 ***Site number***

We are unclear what benefits a site registration system would bring to HMRC and how it would improve tax compliance. This is in light of what we think would involve a potentially sizeable administrative burden for contractors. We also think that to make use of such information would require HMRC to analyse it effectively and quickly and that this would likely entail investment in suitable IT systems – we think this aspect should be explored carefully as part of any further examination of this proposal.

2.12 ***Reporting supply chains***

We think that the work involved in a main contractor notifying HMRC of their entire supply chain for a particular project or contract would be very sizeable and so very expensive to complete. In many cases this would be a very difficult task and, in some cases, probably impractical or impossible. We are not convinced that this cost to compliant main contractors is justified by the benefits to HMRC in receiving this information and using it to monitor compliance by all sub-contractors.

2.13 We would suggest a more reasonable approach is to consider a cascading approach such that the main contractor is required to undertake rigorous due diligence on those entities with which they directly engage, and that those entities are then required to undertake the same activities on the sub-contractors with which they in turn engage, and so on. We believe that this approach is a more proportionate response and would help in ensuring that proper governance is exercised across the supply chain as a whole.

2.14 ***Securing losses due to fraud in the supply chain***

We think that where appropriate due diligence reporting processes are in place then it should be possible for HMRC to notify a contractor about a suspected fraudster in a supply chain. However, for the proposals on retrospectively applying CIS deductions to work there would need to be significant investment by HMRC in a 2-way real-time notification process so that the contractor can take action before the fraudster can disappear. There would also need to be robust safeguards in place to protect innocent parties being mischaracterised as fraudsters. This said, where there is clear evidence of fraud, we would anticipate that HMRC's actions would go well beyond merely recovering past CIS deductions and involve imposition of penalties, prosecution etc.

3 Correcting the CIS deductions claimed on an EPS

3.1 ***The problem***

HMRC identifies 3 areas where some employers are incorrectly reducing their PAYE liabilities by claiming a PAYE offset that they are not entitled to for CIS deductions suffered. These are where:

- The employer is not working in the construction sector;
- The employer is a sub-contractor that is not a company; and
- The amounts claimed by a sub-contractor exceed the sums recorded (and reported) by contractors as having been withheld from payments to that sub-contractor.

In particular, HMRC say that it is '*aware that some employers are using this process to falsely reduce their tax liabilities, to create spurious sums to set off against other tax liabilities, or to create false repayments for themselves and/or their sub-contractors*'.

3.2 ***The proposed solution***

To address the above problem the government has decided to introduce a new provision from April 2021 to allow HMRC to amend the CIS deductions figure claimed by the sub-contractor on their monthly employer EPS return. The new powers will allow HMRC to:

- Correct the CIS deduction figure an employer has recorded on an EPS return; and
- Prevent the sub-contractor employer from setting further CIS deductions against their PAYE liabilities for the remainder of the relevant tax year.

3.3 ***General comments***

On the face of it the government's proposed approach seems to be a somewhat muted response to what is characterized by HMRC as a deliberate intent by some employers to misrepresent the amount of CIS deductions that they have suffered. In particular, it seems to us that the measurers are disproportionate to the culpability of the behaviour in that they are both too harsh for the genuine mistake and not harsh enough for the fraudster.

3.4 While in some cases no doubt incorrect claims arise from a genuine error or a misunderstanding of the CIS rules, which we think could be better addressed with suitable advice and guidance, from what is said the focus of HMRC's concern here appears to be a deliberate intent to make a false or inflated claim which seems to us to be tantamount to fraud. In particular, the focus seems to be on cases involving the making of repeated improper claims for offset and the wilful concealment of the position from HMRC. If we are correct in our understanding of HMRC's concern, then the proposed approach seems to be an insufficiently robust response to such a serious matter. On the other hand, if the issue is more about negligence/carelessness, then this is different. We think it is very important that the government is clear on the problem that it is looking to address so that the response is calibrated accordingly.

3.5 In this respect, we also think that it would be helpful to understand what amounts of tax are viewed to be as at risk as a result of these incorrect claims and how this splits between (a) genuine errors, (b) carelessness, and (c) deliberate intent. As noted above, this is so consideration can be given to whether the new power is suitably focused, or whether a more tailored approach of providing advice and guidance, backed up with the use of existing powers to tackle carelessness and deliberate errors, would achieve the same result. Or whether indeed further powers are needed and, if so, what they should be.

3.6 The current process of contacting a sub-contractor employer to ask for an explanation and evidence to determine whether the employer is entitled to the set-off and, if so, the correct amount of the set-off does not seem to take account of why the CIS deduction claimed by the sub-contractor employer was too high in the first place. Or in the case of an entity which is not a limited company, inappropriate. Where a sub-contractor employer cannot adequately explain the CIS deductions claimed, it seems that HMRC simply ask the employer to amend the employer EPS return to reflect the proper amount (if any) to be offset. But this is insufficient. We would have expected HMRC to (a) provide suitable advice to sub-contractor employers to help ensure future CIS deduction claims are correct where there has been a genuine mistake, or (b) where there is carelessness, to impose a penalty, and (c) in the case of repeated and/or deliberate errors (ie fraud), to use existing powers to prosecute, as appropriate.

3.7 The new process proposes that if there isn't a reply from the sub-contractor employer to HMRC's request for an explanation within the specified timescale – or there is no evidence provided to support the extent of the CIS deduction offset claimed, or the sub-contractor refuses to amend an incorrect employer EPS – then HMRC will (i) itself correct the EPS, and (ii) tell the sub-contractor employer what to pay and when. The sub-

contractor employer will also be prevented from making further CIS deduction offset claims for the remainder of the same tax year. The sub-contractor employer will, however, start with a 'clean slate' for the following tax year and so, it would seem, would be able to offset accumulated CIS deductions not offset in-year against PAYE liabilities for the following tax year. We also note that where an employer '*belatedly provides genuine evidence of CIS suffered HMRC will consider allowing them to set off further CIS deductions on a later EPS return*'. This will presumably by way of a revised employer EPS return for the relevant tax year.

3.8 This approach appears aimed at correcting CIS deduction offset errors in a wide range of circumstances where there has been an over claim/offset. Where there is carelessness short of deliberate intent to mislead then we think this is a fair and proportionate response. However, where there is deliberate intent, we think a much more robust approach is needed, albeit one which we are surprised is not available to HMRC under its existing powers. In contrast, where there is a genuine mistake and the sub-contractor employer has a genuine reason for believing they had claimed the correct CIS deduction, or a reasonable excuse for not responding to HMRC within the specified timescale, then we think safeguards should apply to protect the sub-contractor employer at as early a stage as possible.

3.9 ***Preventing later claims for CIS deductions where HMRC has corrected the CIS credit***

As noted above, the new powers aim to prevent a sub-contractor employer from reclaiming CIS deductions disallowed by HMRC in later employer EPS returns by preventing the employer from setting <u>any</u> CIS deductions against PAYE liabilities for the remainder of the same tax year. Albeit that where a sub-contractor employer belatedly provides genuine evidence of CIS deductions suffered HMRC will consider allowing them to set-off further CIS deductions on a later employer EPS return in the same tax year.

3.10 ***Q1: Are there other circumstances where HMRC should allow an employer to claim CIS set-offs later in a tax year following HMRC correction of an EPS return?***

We think that where there is a genuine misunderstanding on the part of the employer sub-contractor and information is supplied to HMRC to confirm this then, whilst clearly the CIS deduction off-set in point should not be permitted, this should not prevent CIS deductions more generally to continue in the tax year concerned.

3.11 ***Interest and penalties***

HMRC note that as a result of the CIS deductions off-set being amended a sub-contractor employer will have to pay their 'corrected' net PAYE liability by the next PAYE payment due date. Interest will apply to any PAYE liabilities that are outstanding if the revised sum is not paid in full on the next PAYE payment due date. HMRC will also consider imposing late payment penalties for defaulting sub-contractor employers after the end of the tax year.

3.12 ***Q2: Do you have any comments on the interest and penalty consequences of HMRC making these corrections to an EPS return?***

We think that it will be important that before amendments are made that HMRC have made sufficient enquiry as to whether there has indeed been an incorrect CIS deduction offset claimed. Assuming that this is so then we agree that interest would normally follow if the corrected liability is not paid on time on the basis that this is, in effect, a delay in payment of PAYE. However, the penalty position will need careful consideration, as there is a world of difference between genuine mistake and deliberate intent to over-claim a CIS deduction offset. Our comments above refer.

3.13 ***Evidence of CIS deductions suffered***

To evidence CIS deduction offsets claimed HMRC generally expect the sub-contractor employer to provide the 'payment and deduction statements' (PDS) that contractors are required to provide to their sub-contractors. Where the PDS is not held by the sub-contractor then we consider that HMRC should accept any other suitable evidence – without being unduly prescriptive – if a duplicate PDS cannot be obtained from the contractor.

3.14 ***Q3: Are there other sources of evidence HMRC should accept as proof that a CIS deduction on account of tax has been made?***

We think that the suggestions proposed on forms of evidence appear fair enough (ie the PDS, a duplicate PDS, bank statement showing deposit plus supporting evidence such as invoices). As noted above, in principle we think that HMRC should accept any reasonable evidence of CIS deductions, especially as, in practice, not all contractors are prompt in providing PDSs.

3.15 ***Q4: Do you have any comments on HMRC being able to disregard certain evidence in deciding to use the correction power?***

We think that all evidence must be considered on its merits. It cannot be right for HMRC ever to ignore evidence. This said, it should be made clear to all parties (contractor and sub-contractor) that any collusion to produce false documents, or indeed any fraudulent acts, is an extremely serious matter. In such cases, HMRC's compliance response should move beyond using the new correction power and, where appropriate, should proceed to potential prosecution.

3.16 ***Timing for providing evidence of deductions and employer correction***

The new power will provide for a specified timescale in which sub-contractor employers will have to provide evidence of CIS deductions suffered. This timescale will be 14 days. Where a sub-contractor employer cannot meet this deadline, they are expected to provide HMRC with details within that timescale of when the evidence will be provided. If the sub-contractor employer does not contact HMRC within the specified timescale (ie with satisfactory evidence or an explanation of when the evidence will be provided), HMRC will instruct the sub-contractor employer to correct their EPS return in accordance with HMRC's figures within the specified timescale and this amendment should be made within a further 14 days. Where the amendment is not made by the sub-contractor employer within the specified timescale, HMRC will amend the employer EPS return.

3.17 ***Q5: Is 14 days the right amount of time for the employer to provide evidence of CIS deductions suffered?***

No – see paragraphs 3.19 and 3.20 below.

3.18 ***Q6: Is 14 days the right amount of time for the employer to correct the return?***

No – see paragraphs 3.19 and 3.20 below.

3.19 ***Q17: If not, what timescale do you suggest?***

We think that to take account of illness, holidays, the potential need to contact contractors for duplicate PDSs etc the timescale to provide suitable evidence etc and the timescale to amend the employer EPS return should be at least 21 days (and, preferably, 30 days), with discretion allowed so that HMRC can allow such further period of time as may be needed in exceptional circumstances (eg in cases of severe business disruption arising from, say, a flood or fire, or any restriction on access to business premises or records, loss of key

personnel etc). This assumes that HMRC will develop a 2-way electronic real time notification system that will both notify requests for evidence of CIS deductions suffered/requests to correct the return electronically and allow sub-contractor employer to submit the evidence of deduction/requests for an extended time period electronically. Otherwise, if a paper-based notification and/or reply process is to be introduced then we think that the minimum period should be at least 30 days from receipt of the notification and, preferably, 45 days.

3.20 Also, there needs to be clarity over whether the timescale runs from the date HMRC issues a request for evidence etc, or the date the sub-contractor employer receives that request, especially if non-electronic means are to be used by HMRC when requesting evidence etc, as on occasions there can be many days between the date on a letter and the date that letter is received by a business, let alone the date by which it is received by the 'correct' person in that business. For example, we understand that the general experience of paper communications from HMRC is that they are sent by second class post and can arrive about 10 days later than the date stamp. We would suggest, therefore, that a protocol should be introduced as part of these changes that mandates the use of email communications with prompts and notifications through the PAYE online account to address this issue.

3.21 ***Taxpayer safeguards***

The new powers will provide that where a sub-contractor employer provides evidence late HMRC will be able to reconsider any amendment made to the employer EPS return. The sub-contractor employer will also be able to ask HMRC to review their correction decision and, where not satisfied with HMRC's response, the sub-contractor employer will be able to appeal HMRC's correction to the tax tribunal. In addition, where the sub-contractor employer does not appeal HMRC's correction and HMRC prevents further set-offs of CIS deductions against PAYE for the same tax year, the sub-contractor employer will be able to request an independent HMRC internal review of this decision and, if appropriate, then appeal to the tax tribunal. Sub-contractor employers will not, however, be able to continue to set-off CIS deductions against PAYE liabilities during the review and appeal processes.

3.22 ***Q8: Does this review and appeal process provide adequate protection for sub-contractor employers making errors?***

In principle, we think the review and appeal process does provide adequate protection. However, as mentioned above, there appears to be a range of situations where over claimed CIS deduction offsets arise. In particular, consider the situation where '*the employer is not undertaking construction operations*' (paragraph 3.26 of the consultation document). Here there would surely appear to be a larger underlying issue, ie why is the 'contractor' making any deductions in the first place? We think that HMRC's compliance response should *prima facie* then be geared more to an educational process around what does/does not comprise construction operations. If a 'sub-contractor' employer has suffered CIS deductions while not undertaking construction operations, then the Exchequer should not have lost out – assuming that the contractor has (albeit, it would seem, incorrectly) accounted for the tax deducted to HMRC. Clearly, if the contractor has not done so and there is deliberate intent on the part of the contractor to defraud the sub-contractor, and (where that sub-contractor employer attempts to off-set against its PAYE) indirectly HMRC, then matters are much more serious. And particularly where there is collusion involved. This is the reason why we think it is very important that before these proposed changes are introduced everybody is very clear on the extent and nature of the underlying problem(s).

3.23 ***Q9: Should other safeguards be considered in relation to these powers? If so, what should those safeguards be?***

We think that, first and foremost, HMRC and sub-contractor employers (and, indeed, contractors) should be encouraged to have an open and ongoing dialogue with each other/HMRC so that any misunderstandings about whether CIS deductions are due, how/when CIS deductions should be reported to HMRC by contractors, in what amount and when offset against PAYE applies can be addressed at an early stage. In this way any appropriate amendments to employer EPS returns can be agreed without the need for any sanctions to be imposed. Also, we think that decisions on prevention of future in-year offsets of CIS deductions should go through an appropriate escalation/governance process at HMRC's end, to ensure that the response is proportionate to the issue that has been identified.

3.24 ***Q10: Are there other options to disallow CIS deductions claimed on an EPS return that are not supported by satisfactory evidence?***

We think that, ultimately, if there is continued and systemic abuse of the CIS deduction offset rules then government would clearly need to consider changing the rules to disallow all in-year CIS offset claims for limited companies across the board. (We note that for partnerships and other entities that are not limited companies these offsets are not permitted in any event.)

4 Other legislative changes

4.1 ***Deemed contractors***

The problem

HMRC considers that the current rule to determine whether a business undertaking construction activities constitutes a 'deemed contractor' is open to abuse through businesses manipulating both the amount and timing of construction-related payments – and others altering their accounting periods to endure they remain outside the deemed contractor rules.

4.2 ***The proposed solution***

The government will amend the current rule so that businesses spending above a certain amount on construction operations have to operate the CIS rules when this threshold is reached. This new rule will consider the construction spending of a business calculated on a rolling basis, so that when the cumulative spend on construction operations reaches the prescribed threshold, the business has to register for CIS as a contractor and begin operating CIS on their next payment to a contractor for construction operations. The prescribed threshold is to be £3 million. Paragraph 4.9 of the consultation document refers to when expenditure under '*a*' construction contract exceeds this figure, and it is presently unclear whether this means 'a' or should properly be understood as 'one or more'. In any event the CIS rules will then apply until no further payments on construction operations are made under that contract or any other construction contract.

4.3 ***General comments***

We note that the consultation document indicates that the manipulations outlined above are compromising the CIS rules and putting at risk tax that should be being accounted for. The consultation does not, however, mention the amounts involved. We think that all tax policy should be evidenced based and would strongly recommend that more details are given to help understand what amounts of tax are viewed to be as at risk as a result of these actions and why remedial action is required.

4.4 We further note at paragraph 4.6 of the consultation document that the process for determining whether a business is a deemed contractor '*is relatively complex and … is relatively easy to manipulate*'. In general, we would have thought the more complex the rules are the more difficult it would be to manipulate them and so we do not quite follow this statement. Also, we would have thought that most sub-contractors working on a £3 million plus contract would have gross payment status anyway.

4.5 Also, paragraph 4.4 of the consultation document says that CIS applies if (emphasis added) '*average annual expenditure on construction operations … exceeds £1 million in each of the last 3 years ending with the end of the last period of account*'. However, section 59(1)(l)(i), FA 2004 refers to (emphasis added) '*average annual expenditure on construction operations in the period of three years ending with the end of the last period of account … exceeds £1,000,000*'. While the words '*in each of*' are used in section 59(2)(b) this is in a different context. We would therefore query whether the identified manipulations of CIS arise from a genuine misunderstanding of the rules in section 59(1)(l) as, wrongly, meaning £1 million in each of the last 3 years, rather than, correctly, meaning on average in each of the last 3 years? If so, we would suggest that this is indeed a genuine misunderstanding in light of HMRC's own description of the registration trigger as operating in this way.

4.6 As noted above, the proposed rule change will use a 'rolling basis' so that where construction operation spend on a particular construction project (as opposed to all construction projects?) reaches the prescribed limit, then CIS will apply to the business and the business will have to register for CIS as a deemed contractor and apply the CIS rules etc to the next payment to a sub-contractor. While *prima facie* this appears simple it does mean that the trigger to register for/apply CIS will no longer tie into the end of a period of account. So, this will require ongoing tracking of contract expenditure by businesses, rather than – as now – focus on the position at the period end, which means process will need to be adapted accordingly.

4.7 We make three further observations:

Firstly, that given the concern about manipulation, what is to stop a business either (i) splitting construction expenditure into phases with separate construction contracts that will not involve expenditure on construction operations of over £3 million per contract (given that the consultation document refers to rolling expenditure under '*a*' construction contract and not rolling expenditure over time under all concurrent construction contracts), or (ii) ceasing to trade from one company and starting to trade from another so as to reset the clock?

4.8 Secondly, we think the main issue for property owners that enter into contracts to rebuild or refurbish its property is whether it is a mainstream or deemed contractor. We understand that HMRC has contended that because there are mainstream contractors in a group (such as internal developers to contract with third party contractors and bear development risk) no entity in the group can be a deemed contractor. This is even though CIS has no group concept and each entity must register separately.

4.9 Thirdly, in relation to deregistration from CIS, we understand that it is currently difficult to deregister any entity that owns property as it will always incur some minimal construction works such as minor repairs although well under the threshold. The new rules seem to perpetuate this issue by saying that before a deemed contractor can deregister no further payments under any construction contract are to be made. Thus, in our opinion, this makes deregistration impossible.

4.10 ***Deductions for materials***

The problem

HMRC considers that the rule covering deductions for materials (ie allowing CIS deductions to be calculated on payments net of the cost of materials) is being interpreted incorrectly by some contractors and sub-contractors. In particular, as meaning that a cumulative deduction can be taken for materials purchased by every sub-contractor in a chain working on the same overarching project, and not just for materials purchased directly by the sub-contractor with whom they are contracting. HMRC are concerned that this reduces the sums to which CIS applies at each level in the chain, so undermining the purpose of allowing materials deductions within the scheme.

4.11 ***The proposed solution***

The government will amend this rule so that a materials deduction for CIS purposes can only be made where the sub-contractor has directly purchased the materials.

4.12 ***General comments***

It is unclear to us what the mischief here is and what needs correcting. We would expect deduction of tax under CIS only to apply to supplies of labour and it should not matter how many entities up a supply chain get a deduction for the same level of expenditure on materials. For example, say, we have a supply chain with contractor A and sub-contractors B, C and D, and A contracts with B, B with C and C with D. If D buys some materials which are required by C to supply to B for B to supply to A and the invoicing between the parties identifies the materials, which cost, say, £100, then why – when the invoice is presented by B to A – should A not make an allowance for materials?

4.13 We think the correct approach surely has to be that the cost of materials in the above example is taken into account, because the cost of the materials from D to C, then from C to B and their onward supply from B to A is indeed £100. If A makes a CIS deduction on the £100 cost of materials, then it is a deduction from an item – the materials – on which no profit accrues to B. The whole point of the materials deduction is to avoid this situation.

4.14 We could understand if the rules were to be amended to prevent any mark-up on the cost of materials from being taken into account in calculating the amount of an invoice on which a CIS deduction has to be made. But to prevent the cost of materials *per se* from being taken into account where the entity directly purchasing those materials is further down the supply chain will, in our view, result in over-deduction. In terms of the above example, a CIS deduction would apply to a cost of £100 that A is paying to B to procure materials ultimately purchased by D and where there is clearly no profit element in that £100.

4.15 ***Expanding the scope of the false registration penalty***

The problem

HMRC is concerned that the penalty it can impose on a person for providing false information when registering for CIS only applies to the entity to whom registration applies. And that it does not therefore deter the non-compliant, fraudsters or their associates from persuading or coercing others to wrongly register for CIS by providing HMRC with false information, or from hijacking the IDs of other entities and in making repeated false CIS registrations.

4.16 ***The proposed solution***

The government will amend the rules so that the false registration penalty can be applied to a 'relevant person', including an agent, director, company secretary or anyone HMRC believes is in a position to exercise control and direction over the entity making the CIS registration.

4.17 ***General comments***

While the stated target of this measure is obviously correct, imposing penalties on third parties is potentially a very serious matter, so this area needs much more careful consideration. In particular, we think the definitions will need very careful calibration to ensure that the new penalty only targets those who were involved/responsible for the supply of false information (and those who should have taken action but turn a blind eye) and not those who were only incidentally involved or who have no knowledge (and no real ability to have gained that knowledge) of the position. In this regard, there should be a defence available to those who were not involved/had no knowledge of the wrongdoing that has taken place. As this is a penalty provision, we think that the burden of proof should rest with HMRC.

4.18 ***Q11: Do you have other ideas that could protect the CIS from abuse?***

We think that where there is wilful or deliberate behaviour which is designed to undermine the CIS then HMRC should make it plain that they will prosecute in egregious cases. Penalties should also be reviewed so that they are sufficiently high to act as a deterrent. Furthermore, the names of those individuals and businesses involved should be publicised in such a manner that others who may be tempted to act in this way think twice before doing so.

5 Early consultation on supply chain proposals

5.1 ***The problem***

HMRC is concerned that fraudsters are continuing to insert themselves, almost anonymously, into construction supply chains with the result that they (and in some cases the labour force they engage) are extracting cash from the tax system by deliberately not paying their taxes and NICs to HMRC.

5.2 ***The proposed solution***

To address the identified problem the government is looking for measures that will allow HMRC to combat this type fraud of fraud.

5.3 ***General comments***

HMRC note that the government wants to improve supply chain due diligence in the construction sector to tackle significant losses from supply chain fraud. Paragraph 5.4 of the consultation document notes that responses to the 2017 consultation on '*Fraud on provision of labour in the construction sector*' indicated that, with exceptions, contractors do not undertake sufficient due diligence on the sub-contractors they contract with, because they do not ordinarily have access to the ownership structure of their sub-contractors, and certainly not of the sub-contractors further down the supply chain. Furthermore, that some contractors '*will act in collusion with the fraudsters*'. Understandably, the government wants to explore what more could be done in conjunction with larger contractors to address this issue.

5.4 ***Q12: Do you consider supply chain measures to be an appropriate response to this fraud?***

We think that, in principle, a focus on supply chain measures is an appropriate response. This said, it will be very important that measures are suitably targeted and calibrated to deliver results in driving down the level of fraud, while being proportionate in terms of the administrative burden on businesses operating in the construction industry.

5.5 These measures must operate in conjunction with the application of suitable penalties, including prosecution, on those perpetrating or colluding with fraudsters in the construction sector. Businesses that meet their tax obligations will want to see that the additional administrative burdens being imposed on them are having effect and driving down fraudulent activity – not simply adding more to their costs whilst fraudsters continue to operate with impunity. In this respect, post-implementation review would be key to demonstrate that the measures are having the intended effect. If post-implementation review cannot demonstrate a suitable cost-benefit ratio then the measures should be amended or withdrawn, and fresh proposals considered.

5.6 Current practice

Q13: what due diligence checks do you currently undertake on your sub-contractors/suppliers?

5.7 Q14: When do you undertake these and why?

5.8 Q15: Would you consider undertaking such checks further down your supply chain?

5.9 Q16: What actions would you take if you were not satisfied following your due diligence checks?

5.10 Questions 13 to 16 are addressed to the construction industry. As a tax professional body, we are not best placed to answer these questions. Nevertheless, we do have a few points to make which we think may be helpful.

5.11 We think that, generally, most larger contractors already do a reasonable amount of due diligence on the sub-contractors with whom they are contracting. These larger contractors are relying on the sub-contractors to deliver work for them to time, to budget and to standard. So clearly it is in their own interests to perform due diligence on them to ensure the sub-contractors are legitimate businesses that can fulfil, and have a history of fulfilling, their contracts.

5.12 This being so the question that then arises is what more due diligence the government would like these contractors to undertake over and above that which they are undertaking already? In particular, larger contractors will often insist that the sub-contractors they are dealing with are registered for gross payment status under CIS. They may also require under the contract that the sub-contractor adheres to all tax compliance obligations to which it is subject, file returns on time etc. Furthermore, they will require that the sub-contractor requires similar standards from the sub-contractor(s) that it contracts with and who are responsible for delivering work which will form part of that which the sub-contractor delivers to the contractor.

5.13 Logically, the above due diligence process should, where there is a larger contractor at the top of the chain, flow down the supply chain. This would all be sensible in terms of the main contractor seeking to ensure the integrity of their supply chain as a whole, particularly because the chain is only as strong as its weakest link. However, for the main contractor to perform due diligence on <u>all</u> sub-contractors in its supply chain (and, indeed, in some cases for the first sub-contractor below the main contractor to perform due diligence on all sub-contractors below them) is unlikely to be feasible because the contractor simply does not know, and will never know, all those who are involved in the chain, as well as it knows (and trusts) the sub-contractor(s) with whom it is directly contracting. Furthermore, the main contractor cannot enforce obligations on those other parties as its sole contractual relationship is with the first sub-contractor in the chain.

5.14 We think that effective enforcement by the main contractor is key. For example, in answer to Question 15, if a contractor is not satisfied with the answers it receives from its immediate sub-contractor then it would be unlikely to want to take a risk in contracting with them.

5.15 In this respect we think something to be explored further is what more a contractor could reasonably require – or be obliged to require – of its immediate sub-contractor(s) around tax compliance. For example, there could be a prescribed checklist of points to be covered including confirmation that CT, VAT, PAYE and CIS returns are up-to-date, that returns have been filed on time for the last X years, that no substantive HMRC enquiries were pending etc. These would effectively become part of the contractual warranties. The list could also include requiring that the immediate sub-contractor obtains similar warranties on the next sub-contractor(s) that they contract with down the chain, and so on.

5.16 Also, more emphasis could also be placed on businesses Anti-Money Laundering (AML) obligations and on 'Know Your Customer' (KYC) requirements for the contractor in deciding who it will and won't contract with. The government is also separately considering tighter rules around 'licence to operate' and maybe it should be incumbent on those in the supply chain to satisfy these standards before others will be permitted to trade with them. Clearly evidence that these standards had been met would need to be available in a form suitable for inspection, or alternatively a central database would be needed access to which to be available via HMRC. In effect an expanded form of the database which HMRC maintains for CIS registration purposes.

5.17 ***Site number***

The consultation document suggests adding contract or site information to the monthly CIS returns contractors send to HMRC, so that payments can be matched to particular contracts, sites and/or projects. Reference is also made to the system currently in operation in the Republic of Ireland where the main contractor for a site/project is obliged to register that site/project with HMRC. It is suggested that such a system would help HMRC to understand the supply chain and ensure all entities are compliant with their CIS obligations.

5.18 ***Q17: Could a site registration system work in the UK?***

At first blush we have to say we are unclear as to what benefits a site (or contract or project) registration system would bring to HMRC. What would HMRC do with the additional information that they would obtain on sites that the contractor is working on and who is working there?

5.19 From a contractor's perspective we would expect those working at a particular site will be a mixture of individuals covering various roles/trades/occupations including, for example, the contractor's own employees, agency staff, staff of sub-contractors, architects, surveyors, engineers, utility workers, security, painters and decorators, etc. Some of these individuals will be present for longer periods, some shorter. Also, for larger contracts, sites and/or projects the work is likely to be spread across multiple locations, so it will not always be that clear whether there is a single site or multiple sites.

5.20 Thus, gathering the information that HMRC are looking for would potentially entail a huge amount of effort, depending on the level of detail/how regularly it would need to be compiled. Contractors already have to comply with Health and Safety (H&S) rules on noting comings and goings at construction sites and so our question is what more do HMRC have in mind? And what exactly will HMRC do with all this information? How will all the information improve HMRC's (non-)compliance responses?

5.21 We think that if a site registration system was to be introduced then aside from the huge administrative burden on contractors this would also require a sizeable investment in IT and real-time information systems by HMRC, one which we are unclear that HMRC is in position to make. For example, our understanding is that under the system in Ireland no payments can be made to sub-contractors without a site reference number, but equally the process of registering as a sub-contractor is via a live information system, so it is quick and

easy to register for gross payment status where it should apply to you. This contrasts with the UK where applications can take months and use a largely manual process.

5.22 If the government wants contractors to buy into a site registration system, it would help to understand exactly how the resulting information would help HMRC clamp down on fraudsters. Contractors will want to understand the balance between the additional effort involved and the benefits, as compared to other approaches etc.

5.23 ***Reporting supply chains***

The consultation document suggests that 'main contractors' could have to notify HMRC of their supply chain for a particular project or contract, and that doing this would encourage the main contractor to undertake more extensive due diligence on who they contract with, and who their sub-contractors engage with and to flag any concerns to HMRC on lengthy supply chains or unidentifiable entities.

5.24 ***Q18: How much detail is needed for these reports to be effective?***

5.25 ***Q19: What burdens would such a process place on contractors?***

5.26 ***Q20: How could these burdens be mitigated?***

5.27 In answer to questions 18 to 20, the work involved here could be quite extensive, depending on exactly what HMRC have in mind. While a main contractor would be expected to undertake a sizeable amount of due diligence on the sub-contractor with whom it immediately contracts, this seems much less likely to be the case in relation to parties further down the supply chain. Indeed, this is precisely the issue identified in paragraph 5.4 of the consultation document in relation to the 2017 consultation, ie '*some contractors undertake rigorous due diligence activities, but usually only on those entities they intend to directly engage*'.

5.28 Therefore, if additional requirements were imposed on main contractors to obtain the level of detail suggested on parties other than the immediate sub-contractor, we think this would represent a significant extra administrative burden (with a significant extra cost to the main contractor). This said, and as we have noted above at paragraph 5.15 above, we think what might be a more reasonable approach is to specify (a) what information that a main contractor should obtain in relation to the <u>immediate</u> sub-contractor it is engaging, (b) to impose a requirement on that party to obtain information of its own in relation to the next immediate party down the supply chain/confirm that it had no concerns as regards to tax compliance, and (c) impose a similar requirement down the supply chain. We think that following this cascading approach would help in getting to a position where proper governance is exercised across the supply chain as a whole – but, crucially, that the effort involved by all parties is proportionate.

5.29 One aspect that HMRC may be particularly interested in, where due diligence requirements are imposed on a supply chain, is if there is a non-UK based entity in the supply chain. We think that one of the requirements could be to ensure that such information (ie the existence of a non-UK based entity in the supply chain) is passed up the chain to the main contractor so that it can advise HMRC accordingly.

5.30 Similarly, HMRC may be interested in any sub-contractors not registered with HMRC under the CIS, ie for neither gross nor net payment status.

5.31 Clearly, if particular obligations are placed on the main contractor a definition would be needed of 'main contractor' and how far this may extend down a supply chain. For example, as currently proposed it would seem that the obligations would apply to both mainstream and deemed contractors all the way up the chain. However, while some property owning groups (deemed contractors) will have some oversight of the supply

chain it is likely that the entity with the most oversight of the chain will be the 'main contractor' with which the deemed contractor contracts (ie the entity that is a 'pure' construction company). It may be that HMRC would consider that all sizeable businesses should be covered and, say, use the large/medium sized Companies Act test in this respect (as for the Off-Payroll Working (OPW) rules). However, as noted, we would suggest that an approach whereby assurances are required from each contractor in the supply chain to the party immediately above it could significantly improve compliance without being unduly burdensome. We would also suggest that it may make more sense for the proposal not to apply to end users or intermediaries (companies connected with the end user) and therefore just to the construction companies. Both end users and intermediaries have been defined in the new Domestic Reverse Charge VAT for construction services legislation so the same definition could be used.

5.32 Clearly any supply chain reporting regime that is introduced would need to be underpinned by sanctions for failure to comply. In our view this makes it all the more important that the regime is suitably targeted/calibrated, so it is proportionate in all the circumstances. In framing any new reporting requirements, sanctions etc. we think it is important to have in mind what the perceived tax leakage is in relation to the CIS supply chain issue discussed in the consultative documents. And also, whether the leakage arises because of genuine mistakes, carelessness, evasion, organised crime etc. This being in the context of the overall tax gap of c£32 billion per annum.

5.33 ***Securing losses due to fraud in the supply chain***

The consultation documents suggests that where fraud is identified in a supply chain then, as for VAT supply chains, HMRC would notify the main contractor and encourage the main contractor to remove the fraudster from the supply chain and/or retrospectively apply CIS deductions to payments those entities have received. And, if the fraud continues, it is suggested that HMRC could (i) prevent the main contractor paying sub-contractors gross and/or (ii) hold the main contractor responsible for tax losses.

5.34 We note that under this proposal further work would be needed on the definition of 'main contractor, 'fraud', 'losses due to fraud', timescale to undertake due diligence/remove a fraudster from the supply chain, the evidence required to show the main contractor had tried to deal with the fraud, how long the retrospective payment under deduction would last, how losses to be recouped from a main contractor are calculated when they fail to act, appeal rights etc.

5.35 ***Q21: Would these two measures encourage better supply chain due diligence?***

We consider that contractors should always undertake sufficient and proportionate due diligence checks prior to engaging with a sub-contractor to ensure that it is legitimate, and that appropriate governance applies as regards tax compliance. And we agree that where fraud is identified in the supply chain, removing the fraudster from the supply chain is clearly necessary. But this is surely not enough – and nor is merely removing gross payment status from a fraudulent sub-contractor. Rather we would expect HMRC to take significantly more robust action against those evading their tax liabilities and defrauding the Exchequer of tax revenues (see also paragraph 5.42 below).

5.36 As regards the proposal that a contractor retrospectively applies CIS deductions to payments already made, then we think HMRC would need to make a significant investment in a 2-way real-time communication process so that the contractor can take action before the fraudster disappears. But again, we think this should not be the end of the matter and that action should also be taken against those who were perpetrating the fraud.

5.37 In the context of VAT, we understand that where it can be shown that a business knew, or should have known, that transactions in its supply chain are linked to fraud then they may lose the right to recover VAT they paid on these transactions. Whether, in the context of fraud in a construction industry supply chain, this should extend to potentially holding a contractor liable for such tax losses (eg unaccounted for CIS deductions) must surely depend on the precise circumstances. For example, what action(s) a contractor took to prevent an identified fraud from continuing, whether there was any collusion etc. In any event we suggest analysing the approach currently being taken for VAT purposes to determine how successful this has been in deterring VAT supply chain fraud in order to inform whether a similar or modified approach might work for CIS purposes.

5.38 This said, we do not think it would be right to hold a contractor retrospectively liable for tax losses arising from events prior to the fraud being uncovered (paragraph 5.17 of the consultation document) where (a) the contractor has put appropriate measures in place to monitor and control the supply chain's activities in order to prevent and detect supply chain fraud and (b) there is no suggestion of any collusion.

5.39 ***Q22: Do any of these supply chain proposals merit further consideration?***

5.40 ***Site numbers***

In answer to question 22, we are not convinced by the 'site numbers' measure proposed in the consultation document.

5.41 ***Supply chain reporting***

In terms of contractor due diligence, we do think that contractor due diligence on the immediate sub-contractor is important (and so on down a supply chain). Of course, formalising what would be required in this respect from a HMRC perspective will be crucial and it would be helpful if HMRC could set out its further thoughts in this respect with a view to consulting further. We would suggest that some sort of 'tax compliance passport' for sub-contractors might be the answer. We have set out a few examples of what this might encompass at paragraphs 5.15 and 5.16 above.

5.42 ***Supply chain fraud***

As regards HMRC intervention around fraud in the supply chain and looking to the main contractor to sort it out, we think some care needs to be exercised here particularly given the seriousness of the matters involved and the potential sanctions facing the main contractor for not reacting or not reacting quickly enough. We think that if this proposal is carried forward to the next stage it needs to be clear precisely what HMRC want the main contractor to do. The main contractor then needs to be in a position to comply with HMRC's instructions and, importantly, needs to be able to so without offending AML rules on tipping off. Furthermore, given the seriousness of the matters the main contractor would no doubt want to take legal advice, advise the police etc. Finally, we think that if any action was to be taken by HMRC against the main contractor under this proposal, this would in itself clearly be very serious and we think would require the criminal rather than civil standard of proof, due protocol around the Police and Criminal Evidence Act 1984 (PACE), etc.

5.43 ***Fraud generally***

In terms of potential fraud in the construction sector and in the tax system generally, we would hope that if HMRC is aware of frauds being perpetrated by any party, whether in the construction sector or otherwise, then HMRC is already taking necessary steps to ensure that the tax base is secured as quickly and effectively as possible. We think such action is clearly a vital part of the tax system.

5.44 ***Q23: Do you have other ideas that could help combat fraud in construction supply chains?***

We think that other ideas to increase supply chain compliance might include (i) naming and shaming, (ii) more prosecutions and publicity around this, and (iii) the need to show a good tax compliance record to be undertaking any government contracts.

6 Assessment of impacts

6.1 ***Q24: What impact will the changes have on your business?***

As noted above, we think that some of the proposals will have a lot of impact on businesses unless they are suitably targeted/calibrated. In particular, we think that the Assessment of Impacts needs to be expanded to show what tax revenues are at risk if no action is taken. We think this will focus minds and inform the discussion on the effort required to address the overall issue of supply chain integrity on the construction sector.

6.2 ***Q25: Are there any specific impacts on small and micro businesses that are not covered in the impact assessment? If so, please provide details of the anticipated one-off and on-going costs and burdens***

We think that the aim must be to drive compliance with tax rules. To this end we think it would be helpful to understand from HMRC how much of the compliance problem lies with the small/micro business and how much with the large/medium entities. The challenge is then for any new measures to effectively target the bad apples without adding undue burden to those already doing the right thing.

6.3 ***Q26: Do you think these proposals will have any impacts on sub-contractors not already covered? If so, please provide details***

We think the main impacts on sub-contractors have been covered in the consultation document and our response.

Acknowledgement of submission

6.4 We would be grateful if you could acknowledge safe receipt of this submission and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

7 The Chartered Institute of Taxation

7.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other

countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 19,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation

27 August 2020