

**Construction Industry Scheme
Landlord contributions to tenant works
Submission by the Chartered Institute of Taxation**

1 Introduction

1.1 The Construction Industry Scheme (CIS) requires a contractor to withhold tax from payments to subcontractors for certain construction work. The aim of the scheme when introduced (in 1972) was to counter the hidden economy that was perceived to exist in the industry and improve compliance. The Scheme was last revised in 2007 with the policy aims of:

- Making it easier for businesses to comply with their income tax obligations, and;
- Reducing the regulatory burden through making the scheme simpler to administer.¹

1.2 The scope of CIS means that it extends (or it may extend) to landlords making payments to tenants where tenants have contracted to carry out construction works, unless the payments fall within the definition of reverse premiums. Landlord contributions to tenants for landlord works (Cat A) and landlord contributions to tenants for tenants works (Cat B), or a combination of both, are becoming more common as landlords work more closely with tenants to assist them in obtaining early possession and/or to model space to suit their needs instead of tenants having to remodel the building. Landlord contributions are negotiated for commercial expediency and efficiency providing time, cost and environmental benefits.

1.3 Although the reverse premium exclusion provides an exemption for landlord to tenant payments for tenants' fit-out works, it is of limited and sometimes uncertain application. To fall within that exception, the relevant payment must be a pure 'inducement' in connection with a transaction being entered into by that person or a connected person eg in connection with a tenant entering into a lease.

HMRC's guidance for CIS purposes does not elaborate on the meaning of inducement for CIS purposes, but provides links to the Business Income Manual (BIM). For

¹ The policy aims were set out in the HM Revenue and Customs Research Report 106 'Evaluating the Construction Industry Scheme' in October 2010 – see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/344922/eval-cis.pdf

example, BIM41075 provides a number of examples of payments that HMRC considers to be inducements which are taxable reverse premiums. These will also be reverse premiums for CIS purposes. However, the BIM does not make it entirely clear, which payments can be reverse premiums for CIS purposes despite not being so for business income purposes. The most obvious example is at BIM41090 which does not cross refer back to the CIS Guidance explaining that the exclusions in the BIM are not relevant for CIS. This could lead a reader to assume that reverse premiums in these circumstances fall within CIS when in fact they may not.

- 1.4 As an educational charity, the CIOT's primary purpose is to promote education in 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. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2 Payments by a landlord to a tenant – CIS framework

- 2.1 The current legislative framework for CIS is in Part 3 Chapter 3 of Finance Act 2004 and the Income Tax (Construction Industry Scheme) Regulations 2005 SI 2005/2045 (as amended) ('the Regulations').
- 2.2 Payments fall within CIS if made under a construction contract defined in FA 2004 section 57 as a contract relating to construction operations (which is not a contract of employment) where one party is a subcontractor and the other is a contractor.
- 2.3 Where a tenant carries out work to premises and the landlord makes a contribution towards the tenant's expenditure, a landlord may be a contractor because the extended definition of a contractor in FA 2004 section 57 includes a business with average annual construction expenditure on construction operations that exceeds £1million or a specified public body such as a local authority as well as a mainstream contractor (someone whose business includes construction operations). In this context we note the guidance at CISR12080 stating HMRC's view that 'build to rent' investors may be contractors for these purposes thereby extending the ambit of the types of landlords potentially falling within these provisions.
- 2.4 Similarly the term 'subcontractor' is considerably wider than its normal usage in the construction industry. To fall within the definition of sub-contractor under FA 2004 section 58, it is sufficient that the tenant is merely 'under a duty' to do the works or procure that they are done or is 'answerable' to the landlord in respect of them.
- 2.5 The definition of 'construction operations' also extends beyond building structures and includes (as defined in FA 2004 section 74) not only altering and repairing buildings but also installing heating and lighting systems and painting or decorating the outside or inside of a building.
- 2.6 Where a contract includes some work that is within CIS and some that has nothing to do with construction, HMRC treat all payments made under the contract as falling within CIS.
- 2.7 It is irrelevant where the contractor and sub-contractor are resident or where payments are made.

- 2.8 If a payment or payments falls within the CIS, the landlord is required to withhold tax at the relevant percentage from the payment to the tenant unless the tenant is registered under the CIS to receive payments gross.

3 Reverse premiums – exclusion from the CIS

- 3.1 The reverse premium exclusion from CIS is a longstanding exception aimed at removing payments by a landlord to a tenant from the scope of CIS. However the exclusion (regulation 20 of the Regulations) is limited in its scope applying only where the payment to the tenant is treated as a reverse premium under Corporation Tax Act 2009 section 96 (previously Finance Act 1999 Schedule 6 now repealed ²) or ITTOIA 2005 section 99, subject to Reg 20(2).

For CIS purposes only, Reg 20(2) disapplies the cases which are excluded for corporation tax purposes by s97 CTA 2009 and for income tax purposes by s101 ITTOIA 2005.

- 3.2 A reverse premium for the purposes of CTA 2009 section 96 and ITTOIA 2005 section 99 is a payment that meets all the following conditions :
- The payment is received by way of inducement *in connection with* a transaction entered into by the recipient (or a connected person).
 - The transaction is one by which the recipient (or connected person) becomes entitled to an estate, interest or right in or over land.
 - The payment is paid by the person granting the estate, interest or right (or a connected person or nominee acting on the directions of either the recipient or the connected person).

As noted above, for CIS purposes, where payments are not taxed as reverse premiums because they are treated as contributions to expenditure on which the tenant would have been entitled to claim allowances (but for the restriction in the capital allowances rules on contributions), the exclusion from CIS can still apply (regulation (20(2)).

- 3.3 Where a payment is being made *in connection with the grant of a lease* and the tenant only carries out basic tenant fit out works, it should be possible to rely on the reverse premium exemption.

However, if the payment is for Cat A works that are the responsibility of the landlord or would otherwise have been carried out by the landlord (save for the express agreement with the tenant), it is not entirely clear if this could be or can never be a reverse premium. For example, that a tenant might be induced to enter a lease and the landlord might derive some benefit at the same time, does not appear mutually exclusive in the legislation. The legislation simply refers to payments by way of *an inducement in connection with* a transaction.

There are in fact numerous examples in landlord/tenant scenarios where it does not apply or where it is not clear whether or not it applies.

4 Problem areas – identification of works

². Regulation 20 should be updated to reflect the fact the relevant legislation is now at section 96 Corporation Tax Act 2009.

- 4.1 A common problem area is where the tenant's works are not clearly identifiable as basic tenant fit-out works. This difficulty arises from the requirement that, to be a reverse premium for tax purposes, the payment by the landlord must be an 'inducement' to the tenant to take a lease. BIM41075-41090 sets out HMRC's views on the meaning of this term in this context. BIM41085 indicates that HMRC regard a landlord's contribution to tenant fit-out costs as being a reverse premium. However, the guidance distinguishes between

- the cost of providing such fittings as are necessary to make a building ready to let (not a reverse premium) and
- the cost of meeting what are properly the tenant's expenses of fitting out (a reverse premium)

It is not always easy to make the distinction, and as noted above, neither is it clear that the legislation makes such a distinction. For example, tenants often install air conditioning systems within the building as part of their fit-out but would such works fall within the first or second category? Why does it matter and why cannot both parties derive some benefit?

The guidance provides two rules of thumb to assist in making the distinction:

It should usually be clear what expenditure procures a finished building and what represents tenant's fitting out costs. As a rule of thumb, the latter will not increase the value of the reversion, because it will be worthless to the landlord when the lease ends.

Another rule of thumb is that expenditure on fitting out costs will not fall to be taken into account in fixing market rent on a rent review.

These two rules mean that in effect if the landlord benefits beyond the tenant's agreement to enter into the lease, the contribution is not regarded as an inducement and it falls therefore within the scope of the CIS. A common example of a landlord's contribution is to the cost of carpets and floor boxes. While such a contribution might be seen as an inducement, where the lease imposes an obligation to yield up with the carpets or floor boxes in place, or contains rent review provisions that rentalise their presence, why should that preclude inducement status?

- 4.2 As a practical matter, It is common for tenants to combine tenant fit-out works with some more structural elements because it is simply not practical to have two different sets of contractors working on site simultaneously. Alternatively, tenants often prefer to have control over some elements that might more usually be carried out by or on behalf of the landlord.
- 4.3 Sometimes tenants themselves wish to make alterations to the building to suit their own purposes. In such cases the landlord may make a contribution but the works are being carried out at the instigation of and for the benefit of the tenant rather than the landlord.
- 4.4 To be a reverse premium, it is necessary that the payment is made in connection with a property transaction between the recipient (or a person connected with the recipient) and the landlord. In BIM41105 and BIM 41110, HMRC indicate that the inducement must be in connection with the grant of a lease. Therefore, contributions would not be within the reverse premium exemption if paid, for instance, in connection with a change of the terms of an existing lease (eg a variation to the rent) or if paid by the landlord to

an assignee (eg if the existing tenant becomes insolvent and the landlord wants to induce the assignee to step into the shoes of the tenant).

BIM41105 also explains that an inducement to buy a freehold is not a reverse premium because the payment must be made by the person by whom the estate interest or right is granted, and a freehold cannot be granted. The legislation refers at Condition C to the payment being made by the person by whom the estate (or interest or right) is or was granted. An interest or right clearly includes a leasehold, but if a freehold cannot be granted, what does the 'granting of an estate' mean where it is used in the legislation?

5 Business burdens

- 5.1 In our members' experience, where these issues arise, the question of the application of CIS may not be identified until a fairly late stage, if at all. For tenants who are, or could be, affected, obtaining a gross payment registration can take some time and is often impossible to achieve within the transactional timetable.
- 5.2 If the reverse premium exemption does not apply, it will be necessary to undertake detailed investigations to ascertain whether the landlord is or could be a deemed contractor and to identify the nature of works. Accordingly, landlords are forced into adopting an overly-cautious approach and apply CIS by default, at the expense of tenants because incorrect classification results in disputes with tenants and potentially significant tax liabilities and penalties.
- 5.3 Administratively, registering as a sub-contractor is a significant burden on tenants outside the construction industry in totally unrelated industries. One member notes that they deal with tenants that are mainly tech companies or in media and publishing. For such companies, registering as a subcontractor is time consuming and costly involving instructing advisers to apply on their behalf. Such tenants are not physically carrying out the works themselves but rather sub-contracting such works to a third party contractors. At that stage the rules operate as originally intended capturing construction operations. It is the application of the Scheme between tenant and landlord for the same works that seems outside the policy intent and operates to add costs and inhibit commercial arrangements.
- 5.4 Additionally, obtaining gross status is far more difficult if tenants are setting up business or expanding into the UK as they will not have a trading history. Similar difficulties may be encountered where single special purpose vehicles are used which are not within a group.
- 5.5 CIS also applies if one company in the group acts as developer under a development management agreement providing services to another group member. The company providing the services to another group member will have to register as a sub-contractor as above but additionally act as a deemed/mainstream contractor in respect of the contracts it operates with 'genuine' third party contractors. For the same reasons as above, it seems outside the policy intent that the rules should apply within a group because the group member registers in any case as a deemed/main contractor when dealing with the third party contractors. The application of CIS to the inter-group transaction is administratively burdensome.

6 Our suggestion

- 6.1 Given the wider policy intent of the Construction Industry Scheme, we suggest that consideration should be given to a wider exclusion to remove from CIS all contribution payments made by landlords to tenants in connection with the grant, variation or assignment of a lease whether for tenant's fit out or for landlord's works. In addition, consideration might be given to removing the administrative burden of operating CIS in a group context where one company in the group acts as developer under a development management agreement providing services to another group member (see 5.5 above).

7 Acknowledgement of submission

- 7.1 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.

8 The Chartered Institute of Taxation

- 8.1 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 18,000 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
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