● RESOURCE GUIDE · HERMIT BUSINESS SOLUTIONS

The Construction Industry Scheme (CIS)

*A guide for contractors and subcontractors based on **HMRC CIS 340 guidance (updated November 2018)***

Introduction to CIS

The Construction Industry Scheme (CIS) sets out the rules for how payments to subcontractors for construction work must be handled by contractors. Under the scheme, all payments from contractors to subcontractors must take account of the subcontractor's tax status as determined by HMRC. This may require the contractor to make a deduction which they then pay to HMRC from the part of the payment that does not represent the cost of materials.

Work covered by the scheme

- Site preparation, alterations, dismantling, construction, repairs, decorating, and demolition
- All work carried out in the UK, including territorial waters up to the 12-mile limit
- Work carried out by foreign businesses operating within the UK

Work not covered

- Private householders commissioning work on their own homes are not contractors
- Employees (PAYE workers): CIS only applies to self-employed subcontractors
- Construction work outside the UK

Mainstream contractors

A mainstream contractor is any business that pays subcontractors for construction work. This includes building firms, property developers, speculative builders, gang leaders organising labour and foreign businesses operating in the UK. All mainstream contractors must register with HMRC before paying their first subcontractor.

Deemed contractors

Some businesses outside the mainstream construction industry are deemed to be contractors when their average annual expenditure on construction operations exceeds £1 million over the preceding 3 years. Examples include large retailers, NHS trusts and local authorities who regularly commission refurbishment or building work.

Subcontractor payment status

Gross payment status requires a subcontractor to pass tests on turnover, compliance and bank account. HMRC gives 90 days' notice of any change to gross status and 35 days' notice to affected contractors.

Step 1: Establish the gross payment

Begin with the total invoice amount excluding VAT (if the subcontractor is registered for VAT). Travel expenses and subsistence paid by the contractor are included in the gross amount.

Step 2: Deduct allowable material costs

Subtract the costs the subcontractor actually paid for the following items used in the construction operations:

Allowable material costs

- Materials and consumable stores
- Fuel (excluding fuel used for travelling)
- Plant hire
- The cost of manufacture or prefabrication of materials

NOTE

If the subcontractor is not VAT-registered, VAT on materials is included in the deductible cost.

THE DEDUCTION FORMULA

Deduction = (Gross payment − Cost of materials) × Rate. Net payment to subcontractor = Gross payment − Deduction. The deduction is applied to the labour element only, materials are always paid in full.

Payment and deduction statement

When a deduction is made, the contractor must issue the subcontractor a written statement showing: the contractor's UTR, the subcontractor's UTR, the gross amount of the payment, the cost of materials, the deduction rate applied and the amount deducted. This statement is the subcontractor's evidence for offsetting the deduction against their own tax or NI liabilities.

The verification process

Before a contractor can make a payment to a new subcontractor, they may need to verify with HMRC. Verification is not required if the subcontractor appeared on the contractor's monthly returns in the current or previous two tax years.

When verification is required

- First time engaging the subcontractor
- Subcontractor last appeared on a return more than two tax years ago

How to verify

- Using the free HMRC CIS online service
- Using commercial CIS software

Verification outcomes

- Gross: pay in full, no deduction required
- Standard rate (20%): deduction required at 20%
- Higher rate (30%): HMRC cannot verify the subcontractor

Verification reference numbers

HMRC provides a verification reference number. For higher-rate cases, this reference must be shown on the subcontractor's payment and deduction statement and recorded on the monthly return.

Monthly returns

Each month contractors must file a return covering all payments made in the previous tax month. Returns must include: details of each subcontractor, payments made and deductions withheld, a declaration that employment status has been considered and a declaration that verification requirements have been met. A nil return must still be filed if no payments were made.

Deadlines and penalties

- Monthly return due by the 19th of each month: fixed £100 penalty for late filing
- Each additional month late may attract further penalties up to a maximum per return
- Records must be kept for at least three years after the end of the tax year they relate to

Companies setting off deductions

Limited company subcontractors can set CIS deductions suffered against their own PAYE, National Insurance, Student Loan repayments and CIS liabilities payable to HMRC. The set-off is shown on the Employer Payment Summary (EPS). Any excess remaining at year end is then set against the company's Corporation Tax bill and only if a surplus still remains after that will HMRC repay it.

Knowledge check: quiz

Test your understanding of the Construction Industry Scheme. The correct answer and explanation are shown for each question.

Q1. A business spends an average of £1.2m per year on construction work on its own premises. Under CIS, what is it classified as?

- A. Mainstream contractor
- B. Subcontractor
- C. ✓ Deemed contractor: non-construction businesses become deemed contractors when average annual construction spend exceeds £1 million over 3 years.
- D. Private householder

Q2. What deduction rate applies to a subcontractor who cannot be verified by HMRC?

- A. 0% (gross)
- B. 20% standard
- C. ✓ 30% higher: the higher rate of 30% applies when HMRC has no record of registration or cannot verify the subcontractor's details.
- D. 40% penalty

Q3. A sub invoices £4,000 ex-VAT, with £1,000 materials. They are on 20% standard rate. What is the CIS deduction?

- A. £800
- B. ✓ £600: labour = £4,000 − £1,000 = £3,000, so the deduction is 20% × £3,000 = £600.
- C. £400
- D. £300

Q4. When must a contractor verify a subcontractor before payment?

- A. Always, before every payment
- B. Only for the first payment ever
- C. ✓ Before first payment, unless the subcontractor appeared on a return in the current or previous 2 tax years: this is when verification is required.
- D. Only if paying more than £1,000

Q5. What is the deadline for a contractor's monthly CIS return?

- A. 5th of each month
- B. 14th of each month
- C. ✓ 19th of each month: monthly returns must be filed by the 19th, and a fixed penalty of £100 applies for late filing.
- D. Last day of each month

Q6. A limited company subcontractor has £5,000 of CIS deductions and £3,000 PAYE/NI to pay. What happens to the excess £2,000?

- A. It is lost
- B. ✓ It is set off against future payments in the same tax year: any remaining excess at year end may be refunded or set against Corporation Tax.
- C. It is repaid immediately
- D. It is added to their VAT bill