

Number 10

The Construction Industry Scheme: A Potential Minefield for Landlords

The Construction Industry Scheme (“CIS”) was introduced by the Inland Revenue to counteract the problems of tax avoidance in the building industry (where subcontractors received gross payments from contractors and then did not account for tax to the Revenue). What has transpired is that the CIS can also have a much wider impact outside the building industry, applying, if certain criteria are met, to any payments made by one party towards works to be carried out by or supervised by another party. One situation where this might happen is where a landlord agrees to make a contribution towards a tenant’s fitting out works as part of the negotiations for a new lease. The reality is that such a payment is often no more than an inducement to the tenant to take the lease. However, by expressing the inducement to be a payment for works in the agreement for lease or lease, the landlord can unwittingly fall foul of the CIS Rules and have to account for an additional tax liability to the Inland Revenue in addition to the payment that has already been made to the tenant.

To whom does the CIS apply?

Broadly, in Inland Revenue terms, the CIS applies to “contractors” who commission “construction operations” from “subcontractors” who carry out or supervise the works. There are thus three elements to the CIS:

- **Being a “contractor”.** Most non-construction businesses and individuals would, if unaware of the CIS Rules, almost certainly not consider themselves to be “contractors”. However, this is exactly where the problems begin, as, under CIS Rules, the word “contractor” is broadly defined and includes not just construction companies and building firms, but also any non-construction business (whether a company or individual) that has spent an average of £1 million per year over the past three years on “construction operations”. Contractors can be Crown and Government Departments, Local Authorities, Housing Corporations, property developers or any individual carrying on a business which includes “construction operations” and which pays others to carry out those works.
- **Employing a “subcontractor”.** A subcontractor can be any business or person that has agreed to carry out “construction operations” for another. The subcontractor does not necessarily have to carry out the operations itself. They may be carried out by its employees or by employing a third party. In such a way both the hats of “contractor” and “subcontractor” can be worn at the same time for CIS purposes.
- **For carrying out “construction operations”.** Construction operations are again broadly defined in the CIS rules and include works of construction, installation, decoration, alteration, repair and demolition.

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What is the effect of the CIS?

First, the CIS requires that any contractor be registered as such with the Revenue. It then imposes heavy administrative, record keeping and filing obligations on the contractor (recent proposed CIS reforms have sought to reduce this burden). More crucially, however, the CIS states that a contractor may not make any payment to a subcontractor unless the subcontractor holds either a valid Construction Tax Certificate (CIS5) or a Registration Card (CIS4). If neither is held, then the payment simply cannot be made. If the subcontractor is able to present a Certificate then the payment may be made gross. If only a Registration Card is held, then tax, currently at 18%, must be deducted from the payment by the contractor and accounted to the Revenue.

In theory, then, there would seem to be no problem. If the subcontractor did not already have a Certificate it could apply for one and the payment could be made gross. In practice, however, Certificates will generally only be issued to very large construction companies, as the requirements for obtaining a Certificate are stringent. A subcontractor would be more likely to be granted a Registration Card, but, if not already held, the application process would take at least a month, which is often impractical in terms of the timetable and the effort involved, particularly if the payment is essentially just an inducement to enter into a lease.

How can the CIS be circumvented by a landlord?

- Consider “repackaging” any inducements as a rent or service charge free period or a reverse premium. The reverse premium should not be tied to the carrying out of works by the tenant.
- As the CIS does not apply to the cost of actual materials, you could agree to pay for materials for the works alone.
- If the tenant does not hold documentation, consider agreeing that the tenant contracts with its builder as your agent. This creates the necessary contractual relationship between you and the builder so that payment may be made directly to the builder (who does hold documentation) or through the tenant. The problem with this is that you may not want this degree of involvement with the works and you will still have your own CIS responsibilities as contractor. Any building warranties may also need to be re-assigned to the tenant.

The watchword overall is proceed with extreme caution if you plan to make a contribution to fit out, consider the alternatives and take expert advice.

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Readers are advised to take specific advice before acting in reliance on the matters set out in this briefing.

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