



White paper: How to stay legal.



## How to stay legal

**HM Revenue & Customs (HMRC) charge penalties for all CIS returns not received by the 19th of every month. Any return not received from contractors by the due date will be liable to a fixed penalty of £100 and a further penalty for every additional month that the return remains outstanding.**

**Up to 43% of contractors are likely to be fined for:**

- **not informing HMRC of their nil returns**
- **not validating the status of subcontractors**
- **late monthly returns**

**This white paper from Pegasus Software looks at the rules and is designed to help you stay "fine-free".**

## What are the changes to the Construction Industry Scheme?

One of HMRC's aims, apart from increasing tax revenues from the construction industry, is to encourage companies to submit returns online. This is of benefit to HMRC but is likely to be a cost to a contractor because they will need to update their systems and software to generate the required information.

The main changes:

- CIS Cards and Certificates are no longer used; instead, contractors must verify any new subcontractor with HMRC. This can be actioned online.
- Subcontractors will still be paid net or gross of tax, but HMRC will specify which, as part of the verification process.
- There is a higher rate tax deduction of 30% that can be assigned to subcontractors if they cannot be matched to records on the HMRC system, as part of the verification process.
- Vouchers and Year-End returns are no longer required; these have been replaced with a CIS300 Monthly Return which can be filed online, on paper or as an electronic submission. This details payments and deductions made to all subcontractors. Even when no payments have been made to subcontractors in a month, nil returns must be made.
- The CIS300 Monthly Return requires a declaration to be signed that states the contractor has checked the employment status of each subcontractor, and that payments have not been made under contracts of employment.
- Most subcontractors that were registered under the old CIS rules were automatically transferred over to the new system and do not need to re-register.

Failure to submit the CIS300 Monthly Return on time will result in a penalty being charged based on the number of subcontractors on the late return. This penalty repeats for each month that the return is late. A late submission of a nil return automatically attracts a £100 penalty.

HMRC also states that if the return is received late, the contractor's own gross status as a subcontractor may also be at risk.

# Employment status

One of the first things that needs to be reviewed is the employment status of subcontractors. Can you tell the difference between one of your subcontractors and one of your employees?

It is necessary to decide whether a person works under a **contract of service** (employees) or under a **contract for services** (self-employed, independent contractor). There is no statutory definition of these terms; it is the relationship between the parties that matters.

The Employment Status Indicator (ESI) Tool from HMRC enables you to check the employment status online when a new worker starts with you. You can get all the information you need on employment status by visiting the HMRC website, [www.hmrc.gov.uk/calcs/esi.htm](http://www.hmrc.gov.uk/calcs/esi.htm).

This is important because under the new CIS system the contractor will be signing each monthly return to say that they have checked the employment status of all subcontractors on that return and that all are self-employed. The onus is on you to prove that the worker is not an employee but a self-employed subcontractor. Therefore, if you employ subcontractors continually on the same contract you should periodically check that any changes to working practices have not changed the workers' employment status with you. If the information you provide is incorrect, this could potentially put your company at risk of penalty for each return submitted.

It is important to note that you need to verify any subcontractor you engage if you have not previously used them. You must verify them before you pay them for the first time. The HMRC will issue you a unique verification number for that subcontractor.

The outcome of the verification process will either be:

- **Registered for gross payment:** no tax to deduct
- **Registered for net payment:** deduct tax from payments other than for the cost of materials at 20%
- **Not registered:** deduct tax from payments other than for the cost of materials at 30%.

If the tax status of a subcontractor that you have paid within the last 2 years changes, the HMRC will inform you in writing. They will let you know their new tax status and the date it is to be applied. It is irrelevant when the work was done, it is the payment date that counts.

You must then provide each subcontractor, liable to tax deduction, a payment advice slip which will show what they have been paid. This can be provided with each payment or as a summary for the payments made in the previous month. You may also want to provide this information to subcontractors who are gross paid in the form of a remittance advice.

The new scheme comes under Section 66(1) of the Finance Act 2004, supplemented by the Regulations included in Statutory Instrument 2005 No 2045. Section 66 says that HMRC may at any time raise a determination transferring a subcontractor from gross to net payment status if an officer believes that, were the subcontractor to apply for registration for gross payment at that time, he would be refused. In simple terms, this means that as soon as someone is in breach, their gross status is cancelled.

In October 2007, the HMRC announced the implementation of the Tax Treatment Qualification Test. Under this test, in the first month, one twelfth of gross registered subcontractors are selected at random for scrutiny. Their tax compliance over the previous 12 months is examined and if they have unacceptable breaches they receive a determination moving them to net status and a notice of their right to appeal. The following month, a further one eleventh of the remainder are checked and so on, until all gross registered subcontractors have been checked over the course of a year. The process then starts again with a random sample of one twelfth. So every gross registered subcontractor is looked at every year, but it is not necessarily a year between compliance checks: it can be anything from one month to two years. This means that nobody knows when they are being (or will be) checked.

The breaches of tax compliance can arise in almost any area except VAT, as the legislation was written when the Inland Revenue was still separate from Customs and Excise. The principle of the "minor and technical" default previously utilised to defend such breaches is still in existence, although it is not within the remit of the Commissioners. This is where the Regulations come in: Table 3 in Regulation 32 describes the circumstances under which a subcontractor will be regarded as compliant, even where there have been breaches.

These are also described in Fact Sheet 343, as follows:

"To pass the compliance test, you and any business partners (or your company and each of its directors) must, during the 12 months up to the date of the application, have done all of the following:

- Completed and returned all tax returns sent to you.
- Supplied any information to do with your tax that we may have requested.
- Paid by the due dates:
  - all tax due from yourself or the business
  - all your own National Insurance contributions (NICs)
  - any PAYE tax and NICs due from you as an employer
  - any deductions due from you as a contractor in the construction industry."

"When considering whether you have passed the compliance test, we will disregard, during the same 12-month period, any or all of the following:

- Three late submissions of the monthly return – up to 28 days late.
- Three late payments of CIS/PAYE deductions – up to 14 days late.
- One late payment of Self Assessment tax – up to 28 days late.
- Any employer's End-of-Year Return made late.
- Any late payments of Corporation Tax – up to 28 days late, including where any shortfall in the payment has incurred an interest charge but no penalty.
- Any Self Assessment return made late.
- Any failures classed as 'minor and technical' in relation to your obligations under the old Scheme, where these fall within the 12-month period up to your application."

The loss of gross payment status can have a disastrous impact on cashflow. The contractor may try to mitigate this by incorporating the business, provided that he has some staff or subcontractors of his own. In this case, the CIS tax suffered can be set off against CIS or PAYE/NIC due each month, thus eroding the loss of cashflow. For an unincorporated business no such set-off is possible as the tax suffered is set against the eventual liability for the year, so the contractor must wait for the credit. Any business facing making gross subcontractor payments out of net receipts is quite clearly in serious financial trouble. There is good evidence to suggest that this issue will become quite widespread as time goes on.

## Monthly Returns

It is critical to get the CIS300 Monthly Return in on time because of penalties for late returns. The return includes payments to all subcontractors whether paid net or gross and can be made on paper or online.

Contractors who miss the deadline will be charged an automatic £100 penalty. If the return shows more than 50 subcontractors paid in a month, there will be an additional £100 penalty for every 50 subcontractors. These penalties will be charged for each month that the return is late. Even a late nil return will incur a £100 penalty.

In addition to the penalty for a late return, there will also be a £3000 penalty for an incomplete or incorrect monthly return where the omission or error was caused by negligence or intent. This can include subcontractors or payments being omitted from the return, or incorrectly entered. There is also a requirement to provide net paid subcontractors with a statement of the deduction, either for each payment or on a monthly basis. Failure to produce these documents will also incur a £3000 penalty.

If a contractor receives gross payment for any work carried out as a subcontractor, then failure to adhere to the new CIS rules can put this gross status at risk. This compliance test is similar to the old system, but the gross status is now assessed annually, not every 36 months as previously.

There are no renewals of this application, but HMRC can cancel a company's registration for gross payment with only 90 days' notice. The reason for cancellation might include making more than two late monthly submissions or two late payments of PAYE/NICs/CIS deductions: a costly oversight!

It is worth noting that if you have made no payments to subcontractors in a particular month then you must provide a nil return, otherwise the same penalties will be charged.

## What should you do now?

Key decisions to make are:

- Decide who is going to be responsible for ensuring that the employment status of your subcontractors is correct and that there is no false self employment.
- Decide who will be responsible for signing the declaration section of the CIS300 Monthly Return.
- Evaluate software that can help with the management of your subcontractors and adheres to the new CIS rules.

It is fair to say that a lot of these requirements form part of both the old and the current CIS system. The main difference is that you will now have to handle two rates of tax that can be deducted from your net paid subcontractors. You must collate the data together and ensure that the new monthly return is submitted on time, plus you must sign a declaration stating that you have verified the employment status of all subcontractors paid that month and you need to produce payment certificates for each of those subcontractors.

## How can Pegasus CIS (Construction Industry Solutions) help?

Pegasus CIS (Construction Industry Solutions) comes with a Subcontractors module that allows you to set up subcontractors' details and assign their CIS status. When a Payment Application or invoice timesheet is recorded, the system will automatically calculate their tax liability based on this CIS status. Should you decide to certify and pay a subcontractor, Pegasus CIS will produce the payment certificate together with the cheque or BACS output.

When it comes to producing the CIS300 Monthly Return, Pegasus CIS will accurately give you all the details of the payments and deductions made to subcontractors in that month. This data can be submitted electronically to HMRC or you can take the figures and enter the information online or onto the paper return. You need never be late with this return when using Pegasus CIS!

However, Pegasus CIS offers much more than a Subcontractors Ledger; it is a contract costing system that has been specifically designed for the construction industry. Not only does it control all of the costs of a contract, it also controls all of the revenue so that you can see the financial performance of all your contracts. As part of the Contracts Sales Ledger, the system allows you to enter Payment Applications and print, certify and produce the associated invoices, handling both the retentions and main contractor discounts.

Pegasus CIS is a powerful contract costing system designed to give you complete management control over your contracts. It controls the whole process from Payment Applications and invoicing through to cost entries from subcontractors, purchases, stock, labour etc. Pegasus CIS comes with state-of-the-art data analysis and reporting tools to provide you with the information you need when you need it. What's more, it integrates with award-winning Pegasus XRL for real-time Excel-based data manipulation and reporting.

## Useful information

[www.hmrc.gov.uk/cis](http://www.hmrc.gov.uk/cis)

The HMRC have also produced a booklet, Booklet CIS 340, which is a guide to the scheme.

HMRC CIS helpline 0845 366 7899

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