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## **Fraud on provision of labour in construction sector: consultation on VAT and other policy options**

ICAEW welcomes the opportunity to comment on the *fraud on provision of labour in construction sector: consultation on VAT and other policy options* published by HM Revenue & Customs on 20 March 2017.

This response of 9 June 2017 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world.

We attended a meeting with the relevant HMRC and HM Treasury staff to discuss these provisions. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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## Major Points

1. ICAEW welcomes the opportunity to comment on the [fraud on provision of labour in construction sector: consultation on VAT and other policy options](#) published by HM Revenue & Customs on 20 March 2017.
2. Tax fraud is contrary to ICAEW's ethical rules and we support reasonable measures to counter it.
3. We note that the proposals contained in the consultation will have far-reaching implications for many businesses that operate within the construction industry and we question whether such wholesale changes are required to manage the issues identified, which are limited to a small proportion of contractors.
4. We have concerns that the proposals in this consultation, in particular the proposed changes to the CIS scheme, are likely to have been missed both by the industry itself and other bodies with an interest in construction (specifically because there was no mention of CIS in the title). We believe that there may be a need for further consultation, perhaps supported by a roundtable event, with the construction industry to explore the options further before any final decisions are taken.
5. Is a reverse charge the best solution? The proposed changes to reverse charge and CIS in order to address a small fraudulent minority will lead to 'winners' and 'losers' (for example in cash flow) in the compliant majority. We believe that further thought should be given in terms of how to address the fraud identified and whether the proposed options are the best way to achieve the policy objective. We would welcome the opportunity to meet with HMRC to better understand the issues and explore possible alternative courses of action.
6. There is always a danger with such measures that they do not tackle the root cause of the problem but merely impose further burdens and costs on the compliant majority. The majority of businesses in the construction industry are small, honest businesses with no intent to defraud HMRC. Any changes to the operation of VAT within the construction industry will need to be carefully targeted to minimise the impact on these compliant businesses of any additional burdens created by the proposed reverse charge.
7. Various rates of VAT apply within the construction industry, depending on the nature of the supply, and this will need to be considered carefully if a reverse charge is introduced. Thought will need to be given as to how construction services should be apportioned across projects with multiple rates of VAT. An alternative solution might be for any reverse charge on supplies involving mixed rates to be accounted for wholly at 20% throughout the supply chain up to the main contractor. The main contractor could then charge and account for VAT at the correct rates on supplies to the final customer using normal VAT accounting.
8. The construction industry is subject to specific tax rules already (the Construction Industry Scheme), and subcontractors are required to apply for gross payment status to ensure that payments made to them do not have tax deducted at source. Introducing further regulatory requirements is likely to deter some new businesses from entering the market, which does not appear to be the intended consequence of the proposals in the consultation document.

## **RESPONSES TO SPECIFIC QUESTIONS**

### **POTENTIAL SCOPE FOR A CONSTRUCTION SERVICES REVERSE CHARGE**

**Q1: Do you think the scope of a reverse charge for construction services should exclude supplies to final customer?**

1. We agree that to minimise complexity the scope of a reverse charge for construction services should exclude supplies to the final customer. It is clear from the consultation document that this is not where the identified fraud is taking place.
2. In addition, many final customers will be non-business customers and unable to operate the reverse charge. It would therefore seem sensible to exclude final customers from the proposed reverse charge system in the interests of simplicity and consistency.
3. Many final customers will be irregular users of construction services and unfamiliar with the VAT implications of their purchase, from both accounting and VAT liability perspectives. To expect such customers to account for a reverse charge on the purchase of construction services is therefore likely to be highly prone to errors.

**Q2: Do you think a labour/non-labour threshold for the application of the reverse charge should apply throughout the supply chain? If so, at what level should it be set?**

4. The use of a threshold will, in our opinion, cause unnecessary complexity and potentially lead to manipulation in the split of labour and non-labour supplies.
5. Construction contracts are often very complex, involving various project managers, contractors and subcontractors. In the event of work being completed in phases it could be difficult to ascertain the value of labour/non-labour supplies made and how that compares to any threshold set.
6. If HMRC wishes to pursue the idea of a labour/non-labour threshold we would recommend this being sufficiently high so as not to detriment the majority of businesses in the construction sector.

**Q3: Are there any implications we should consider if there is no designated main or principal contractor?**

7. It will be necessary for the legislation to set out where liability rests for the reverse charge if there is no designated main or principal contractor, and timely practical guidance (with examples) should be published in sufficient time to ensure businesses affected have time to plan their work accordingly.

**Q4: Can you think of reasons why architects, engineers or other similar types of businesses should not be treated as main contractors for reverse charge purposes? Are there other similar recipients of such supplies who should have the same treatment?**

8. We are not aware of any.

### **WHAT SORT OF SERVICES SHOULD A REVERSE CHARGE APPLY TO?**

**Q5: What are your views on using the CIS definition as the reverse charge definition? Are there other options that should be considered?**

9. We would encourage the consistent use of the CIS definition and believe the current definition should also be used for any future reverse charge definition. This would ensure the rules are not over-complicated and would allow for a single set of rules to apply across taxes. However, it will be important to have clear guidance to distinguish between construction operations and those who are main contractors for reverse charge purposes.

10. It would seem appropriate to review the current definition to ensure it is still fit for purpose and can also be used for VAT purposes. Any departures from the current definition for VAT purposes should be kept to a minimum and only made where absolutely necessary.

#### **SHOULD THERE BE A THRESHOLD?**

##### **Q6: Do you have any views on whether a narrower CIS definition or alternative qualifying criteria could be used to exclude small businesses instead of a sales based threshold?**

11. To ensure simplicity, we would suggest a sales based threshold is adopted to exempt small businesses rather than introduce an alternative CIS definition.
12. There would be a cash flow impact on affected small businesses buying materials, as they would have to pay VAT on their purchase, but would not receive payment of VAT on their onward sale. This negative cash flow impact should also be considered when setting a threshold.
13. We are concerned that the consultation suggests at paragraph 2.20 that “there will be a large number of small businesses that are not a fraud risk that will need to apply the reverse charge to their sales.” We recommend that the exemption is given sufficient consideration to keep the “honest majority of smaller businesses” referred to in paragraph 2.20 outside the scope of the proposed reverse charge system.

##### **Q7: Would setting a threshold by invoice value create uncertainty and lead to a confusing application of the reverse charge?**

14. We believe this would create confusion and uncertainty, especially where work in the construction industry is often by its nature completed over an extended period and invoice values vary from one period to another, resulting in differing VAT treatments.
15. We also see difficulties arising where invoices from previous periods need to be amended. This could result in the reverse charge retrospectively applying or vice versa, a complication which seems unnecessary and avoidable.
16. If a threshold were to be introduced at a contract or invoice level, we envisage that this would work along similar lines to the existing de minimis rule for mobile phones and computer chips. For example, any invoice below £10,000 could be excluded from the reverse charge provisions. We would suggest that any de minimis threshold be set sufficiently high to exclude most small companies for the need to operate the reverse charge.

##### **Q8: Are there contracts that do not lend themselves to the application of a threshold in this way and if so can you provide details please?**

17. As mentioned above invoice values fluctuate greatly in the construction sector which will result in variations to the contract value. This suggests that a threshold based on contract value would not offer a stable solution to combatting the fraud identified.
18. Again, this method could lead to manipulation of the contract value in order to avoid the reverse charge.

**Q9: If you think a threshold based on contract value would work, do you think it should be based on sales made monthly, annually or a combination?**

19. We do not support a threshold based on contract value.

## **SELF-BILLING AND APPLICATIONS FOR PAYMENT**

**Q10: If you disagree please can you explain why a reverse charge might affect self-billing or applications for payment arrangements?**

20. No comment.

## **THE VAT FLAT RATE SCHEME**

**Q11: Can you see problems with requiring the reverse charge to apply to services supplied by FRS users?**

21. Recent changes were made to the flat rate scheme in respect of limited cost traders and we understand that many small business will deregister for VAT as a result of this. The introduction of an additional requirement for affected FRS users to operate a reverse charge procedure would further complicate what is supposed to be a simplification measure. We would therefore recommend that FRS users be excluded from the requirement to operate the reverse charge.
22. When considering a possible de minimis threshold, the existing flat rate scheme entry threshold, which is set at no more than £150,000 per annum, should be taken into account. For example, if an annual threshold were to be applied to the reverse charge requirements that was above the FRS turnover limit, the problem would be resolved.
23. Various rates of VAT apply to construction industry supplies and so any labour/non-labour split would need to be categorised carefully into existing flat rate categories.

## **IMPLEMENTATION TIMETABLE**

**Q12: If a reverse charge was to be introduced, how long would you need to make the necessary IT and billings changes after any announcement? Does having a threshold significantly alter this?**

24. This will depend on the size of the business and the IT systems that it has in place. We think that businesses should be given a minimum of 12 months to change their systems. We do not believe that having a threshold would make any significant difference to the notice period required for the introduction of a reverse charge.
25. How the introduction of Making Tax Digital will interact with the proposals in this consultation are yet to be explored but will need to be considered in detail to ensure that any changes and burdens placed on businesses are minimised..
26. As with any significant change in the tax system we would encourage a soft landing for penalties in the first 12 months while businesses become familiar with the new rules.

## **THE CONSTRUCTION INDUSTRY SCHEME**

**Q13: Do you agree that any changes to the CIS should be restricted to companies?**

27. Yes, we agree that any changes to the CIS should be restricted to companies only, in particular as the consultation document cites at paragraph 3.10 that the "misuse of the CIS scheme is concentrated in the company sector."

**Q14: We are interested in views on whether changes to the turnover tests should only be applied to companies that have not traded before?**

28. The turnover test was recently reduced to £30,000 and we question whether further changes, particularly to increase the threshold, are necessary. Changing thresholds frequently can lead to uncertainty, something we would be keen to avoid.
29. We understand that applying the turnover tests to new entrants to the industry would act as a deterrent to those intending to engage in the types of fraud identified in the consultation document. However this will also target bona-fide companies seeking to begin in business.
30. Consideration would need to be given to existing companies in the construction industry and how the fraud can be prevented when a contractor acquires an existing company.

**Q15: If the threshold was to be increased, at what level do you think it should be set in order for it to be effective against fraud whilst not excluding too many legitimate businesses? Should the increased threshold apply if an applicant's controlling company already has GPS?**

31. If the controlling company already has GPS then it would seem appropriate for the existing threshold to apply rather than the increased threshold.

**Q16: What are your views on requiring customers to notify HMRC of changes of ownership or control of businesses supplying labour?**

32. A number of reporting requirements already exist for contractors and subcontractors under the CIS scheme. The introduction of any further compliance regulations could act as a barrier to businesses wishing to enter the sector and would place another administrative burden on existing businesses.
33. HMRC has the power to revoke the gross status of a non-compliant contractors in the CIS scheme and consequently we believe the compliance burden should rest with HMRC rather than the industry.
34. We therefore believe it is the responsibility of HMRC to use CIS to monitor and to an extent 'regulate' the industry. Accordingly, HMRC might wish to consider how they could work with Companies House to obtain this information, which contractors are already required to report and verify.

**Q17: Would it be feasible to define certain triggers after which contractors are required to determine whether control of subcontractors has changed? How much burden would that place on contractors?**

35. As above, we think this would cause a considerable amount of difficulty for contractors, not to mention a significant administrative burden, and it is probable that the size of the burden would exceed the size of the problem which HMRC has identified.
36. We understand that many contractors have difficulty ascertaining the split of labour and materials from certain subcontractors and to require them to seek additional information would appear to prove a challenge and impractical in many cases.
37. If contractors did become required to determine whether the control of subcontractors had changed there would need to be a defence mechanism in place should the subcontractor provide incorrect or false information.

**Q18: Should a different compliance test be set for those directors or shareholders who have not been previously required to fulfil obligations under the Taxes Act?**

38. This is another example of where we believe HMRC could work with Companies House. It could be possible for HMRC to identify those individuals that have been struck off as directors and/or have not complied with Companies House requirements.

**OTHER POLICY OPTIONS**

**Q19: Are there other options that we should consider for combatting this fraud?**

39. It is difficult to know without a clear understanding of the exact nature and extent of the fraud and who are its perpetrators. However we would welcome the opportunity to discuss the proposals in this consultation and consider whether there any alternative methods to combat the issues identified.

**ASSESSMENT OF IMPACTS**

**Q20: What impacts are the proposed changes likely to have on your business?**

40. No comment.

**Q21: Are there any specific impacts on small and micro businesses that are not covered in this chapter and chapters 2 and 3? If so, please provide details of the anticipated one-off and on-going costs and burdens.**

41. Administrative burdens and associated costs always impact disproportionately more on smaller businesses. Has HMRC worked with the relevant industry and construction bodies about this measure to help ensure it is properly targeted and that compliance burdens are minimised as far as possible.



## APPENDIX 1

### ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <http://www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx>).