TC01900

Appeal numbers: TC/2011/01493
TC/2011/08678

Income tax – construction industry scheme – deductions from payments to subcontractors – sums representing materials cost not to be subject to deduction – HMRC not accepting that materials cost amounts claimed could be justified – HMRC therefore considered under-deduction had taken place and issued determination under Reg 13 of CIS Regs to recover under-deduction – appellant argued that Reg 4 of CIS Regs only required that it should be "satisfied" as to such amounts, therefore HMRC had no right to require further records to support materials cost claimed – held that section 61 FA04 required deduction to be made from all payments except to the extent "shown to represent" the direct cost of materials – HMRC had used their best judgment in determining the amount underpaid under Reg 13 of CIS Regs, so burden lay on the appellant to show their determination was wrong – in the absence of appropriate evidence, that burden was not discharged – Reg 4 only relevant to content of returns, did not qualify the primary obligation to deduct under section 61(1) or place a limit on the records which HMRC could reasonably require to see to confirm accuracy of return – appeal dismissed. Related appeal against cancellation of gross payment status also dismissed

FIRST-TIER TRIBUNAL TAX CHAMBER

FLEMMING & SON CONSTRUCTION (WEST MIDLANDS) LIMITED — **Appellant**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS — **Respondents**

JUDGE KEVIN POOLE
TRIBUNAL: BEVERLEY TANNER

Sitting in public at Temple Court, 35 Bull Street, Birmingham on 27 February 2012

Martyn Arthur of Martyn F Arthur Specialist Forensic Accountant Limited for the Appellant

Ros Shields, Presenting Officer of HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. These two appeals are concerned with the Construction Industry Scheme ("CIS").

2. The first appeal relates to a determination issued by HMRC under Regulation 13 of the Income Tax (Construction Industry Scheme) Regulations 2005 ("the CIS Regulations"). HMRC had reached the view that the appellant had failed to make proper deductions from the payments it had made to its subcontractors under CIS. Specifically (in relation to most of the amount claimed), it considered that the amounts of the materials cost claimed in such payments had been overstated, so that the appellant had operated deductions on too small a proportion of the overall payments to its subcontractors.

3. The amounts involved totalled £32,923.45.

4. The second appeal relates to HMRC's cancellation of the appellant's registration for gross payment under CIS, by reason of the non-compliances (including the under-deductions the subject of the first appeal) which HMRC claimed to have identified in the course of their review.

5. The parties both confirmed that our decision in the first appeal would determine our decision in the second – ie that if we agreed the appellant had been guilty of under-deductions under CIS then it was accepted that its gross payment status should be cancelled, and if we did not so agree, then its gross payment status should be maintained. The appellant had initially suggested that it might wish to argue the second appeal independently even if it failed in the first appeal, but it changed its mind at the last minute and decided that it wished the second appeal effectively to be determined by the outcome of the first appeal.

The facts

6. We heard evidence from Mrs Fiona Guy, a CIS compliance officer with HMRC, in support of the bundle of documentary evidence compiled and submitted by HMRC. No evidence was given on behalf of the appellant, though a number of its officers were present at the hearing and we did double check with Mr Arthur that he was quite sure he did not wish us to hear any evidence from them.

7. From the evidence before us, the following facts emerged.

8. The appellant has at all material times carried on business as a building contractor and has been registered under the CIS. It is (and at all material times has been) registered for gross payment, ie no sums need be deducted from payments made to it by other contractors who employ it.

9. Following a review of the appellant's monthly CIS returns, HMRC noticed that the appellant appeared to have under-deducted from a number of payments to its subcontractors. They wrote on 27 March 2009, listing the discrepancies that concerned them and asking for an explanation and, if appropriate, an analysis of all such failures that had occurred since 6 April 2007.

10. There followed a lengthy correspondence and one meeting to address HMRC's concerns about this and other matters.

11. The details of the correspondence and meeting are not relevant for present purposes. The key point arising from them is that the reasons for the discrepancies related largely to the appellant's view as to the amount of the materials cost included in the payments it was making to its subcontractors. It was deducting tax from the payments it made based on what HMRC considered to be an over-generous assessment of the extent to which those payments represented materials cost.

12. HMRC sought further information and evidence from the appellant to support its view of the appropriate materials cost figures. Some further information and evidence was forthcoming but in relation to the remainder of the payments, the appellant's stance was that its contract managers would know if the materials cost amounts included in the payments to the subcontractors were excessive.

13. The end result was that HMRC were not satisfied by the information (or, more accurately, the lack of information) provided by the appellant or its advisers. Eventually on 31 January 2011 they issued determinations under Regulation 13 of the CIS Regulations, assessing the appellant to a total of £115,900.65 in respect of the tax they considered to have been under-deducted. After further correspondence and provision of information, this was reduced to £32,923.45 in a letter dated 21 December 2011.

14. The appellants have not disputed any of the individual items included in HMRC's analysis, and we heard no evidence on behalf of the appellant in support of the correctness of the deductions.

The law

15. Section 61(1) Finance Act 2004 ("FA 04") is the section which requires contractors to deduct tax from payments it makes to their subcontractors. It reads as follows:

> "(1) On making a contract payment the contractor (see section 57(3)) must deduct from it a sum equal to the relevant percentage of so much of the payment as is not shown to represent the direct cost to any other person of materials used or to be used in carrying out the construction operations to which the contract under which the payment is to be made relates."

16. The appellant did not dispute that it was a "contractor" for these purposes, or that it had made "contract payments".

17. Regulation 13 of the CIS Regulations reads, so far as relevant, as follows:

> "**13** (1) This regulation applies if –
>
> ….
>
> (b) an officer of Revenue and Customs has reason to believe, as a result of an inspection under regulation 51 or otherwise, that there may be an amount payable for a tax year under these Regulations by a contractor that has not been paid to them, or
>
> (c) an officer of Revenue and Customs considers it necessary in the circumstances.
>
> (2) An officer of Revenue and Customs may determine the amount which to the best of his judgment a contractor is liable to pay under these Regulations, and serve notice of his determination on the contractor.
>
> ….
>
> (5) A determination under this regulation is subject to Parts 4, 5 and 6 of TMA (assessment, appeals, collection and recovery) as if –
>
> (a) the determination were an assessment, and
>
> (b) the amount determined were income tax charged on the contractor,
>
> and those Parts of that Act apply accordingly with any necessary modifications, except that the amount determined is due and payable 14 days after the determination is made."

18. Regulation 51 of the CIS Regulations, so far as relevant, provides as follows:

> "(1) Whenever required to do so by a person nominated by the Commissioners for Her Majesty's Revenue and Customs, a contractor must produce to that person all contractor records, or such contractor records as may be specified by that person, for inspection at the prescribed place and at such time as that person may reasonably require.
>
> (2) "Contractor records" means all documents and records relating to –
>
> (a) the calculation and payment of sums paid by the contractor to sub-contractors (or their nominees) under contracts relating to construction operations, and
>
> (b) the deductions made from such sums required under section 61 of the Act, in the tax years or tax periods specified by the nominated person."

19. Finally, Regulation 4 of the CIS Regulations (headed "Monthly Return"), so far as relevant, provides as follows:

"(1) A return must be made to the Commissioners for Her Majesty's Revenue and Customs in a document or format provided or approved by the Commissioners –

(a) not later than 14 days after the end of every tax month, by a contractor making contract payments…..

….

(2) The return under paragraph (1) must contain the following information –

…..

(d) in respect of each sub-contractor to whom, or to whose nominee, payments under construction contracts were made by the contractor during that month, -

….

(iii) the information specified in paragraph (3).

(3) The information specified is –

….

(b) if the sub-contractor is registered for payment under deduction –

….

(ii) the total amount of contract payments made by the contractor to the sub-contractor during the month,

(iii) the total amount included in those payments which the contractor is satisfied represents the direct cost to any person other than the contractor of materials used or to be used in carrying out the construction contract to which the payment relates, and

(iv) the total amount deducted from the payments mentioned in pargraph (3)(b)(ii) under section 61 of the Act (deduction on account of tax from contract payments);

….

(7) The contractor must make and keep such records as will enable him to comply with this regulation."

Appellant's submissions

20. The appellant maintained that it had made the appropriate deductions, having satisfied itself that the materials cost element of the payments was correct. In relation to the outstanding payments (in respect of which HMRC had imposed the £32,923.45 determination), the appellant had no further evidence beyond an assertion of its own satisfaction that the materials cost figures it had used were appropriate.

21. Mr Arthur pointed out that Regulation 4(3)(b)(iii) of the CIS Regulations only required (see above) that the monthly returns should set out "the total amount included in those payments *[ie payments to subcontractors]* **which the contractor is satisfied represents** the direct cost… of materials". From this, he inferred that the only requirement which was imposed on a contractor was to be "satisfied" as to the correctness of the materials cost amounts. No requirements were, he said, laid down as to how a contractor must satisfy himself. It followed, he submitted, that if a contractor was so satisfied, HMRC had no power to enquire any further and certainly had no power to call for further information or documents from the contractor to verify the amounts which the contractor had already "satisfied" itself were correct.

22. As to section 61(1) FA 04, Mr Arthur submitted that the word "shown" (in the context "so much of the payment as is not **shown** to represent the direct cost… of materials") should be interpreted as meaning "shown to the contractor" (by the subcontractor). This might be on invoices or it might be by discussion or any other means.

23. The essence of his submissions could therefore be summarised as follows:

(1) Section 61(1) FA 04 removed from the deduction obligation any part of the payment which was shown by the subcontractor to the contractor to represent the cost of materials.

(2) The contractor was entitled to satisfy itself in whatever way it wished as to the amount of materials cost involved in any payment. Breakdowns on invoices from subcontractors would be one way to satisfy itself, but a general knowledge of the nature of the contract works and a view of how the agreed payments actually broke down between materials cost and other items (mainly labour) would be another way. In other words, the opinion of the relevant contract manager within the appellant that the materials cost element of any particular payment was not overstated would be sufficient.

(3) The obligation in Regulation 4(7) of the CIS Regulations only required a contractor to keep whatever records were necessary for the purposes of Regulation 4, and certainly did not impose an entirely unnecessary and inappropriate obligation to keep documentary evidence to justify every item of materials cost, when all that the legislation required was that the contractor be "satisfied" as to those amounts.

24. Mr Arthur maintained that the appellant had deducted the appropriate percentage (20% in most cases) from the relevant proportion of the contract payments it had made, and it was beyond HMRC's powers to impose a deduction from a payment which the appellant had satisfied itself was properly attributable to materials cost.

HMRC's submissions

25. Miss Shields on behalf of HMRC argued for a different interpretation of subsection 61(1) FA 04. In her submission, the word "shown" in that subsection should have its ordinary meaning. To follow her submission to its natural conclusion, for a payment to be "shown to represent" a materials cost, the means of "showing" must be accessible to third parties (specifically HMRC and the Tribunal), it could not just be a private matter between the contractor and the subcontractor.

26. To hold otherwise would mean that a contractor and a subcontractor would be free to agree whatever artificial value they wanted for the "materials cost" element of a payment without any possibility of that artificial value being attacked by HMRC. The result of this would be to drive a coach and horses through the whole system of deductions as contractors and subcontractors agreed artificially inflated values for materials costs, thereby taking the bulk of subcontractor payments outside the deductions regime altogether.

27. Miss Shields argued that HMRC had acted in good faith in seeking explanations for what they considered to be the unrealistically high materials cost figures in the returns supplied to them. They had required the appellant to supply its supporting records, as provided by Regulation 51 of the CIS Regulations. When the appellant had failed to produce what HMRC regarded as satisfactory records or other explanations of what HMRC regarded as the unrealistically high materials cost figures, they had formed the reasonable belief, under Regulation 13 of the CIS Regulations, that tax had been underpaid by the appellant. She gave as examples two of the invoices in question which were for groundworks at a new-build residential site and which totalled £30,000. They were supposedly comprised entirely of materials cost. She said that "any contractor would want to know the breakdown of the costs involved" to ensure that they were justified in paying without deduction, yet no justification or further information had been supplied to HMRC.

28. It was therefore open to them to raise the "best judgment" determinations which they had raised under Regulation 13. It was then up to the appellant to displace those determinations on appeal. The burden lay on the appellant to produce evidence or argument to displace the determinations, otherwise they would stand good (see section 50(6) Taxes Management Act 1970).

29. She submitted that no evidence had been produced at all by the appellants to the effect that the determinations were wrong. The argument they had formulated was incorrect and accordingly there was no basis on which the determinations could be discharged.

Discussion and decision

30. We agree largely with the submissions of Miss Shields.

31. It is clear that section 61(1) FA 04 requires a deduction to be made from all payments made to subcontractors, subject only to one exception. The exception only applies to any part of the payment which is **shown** to represent the materials cost.

32. We consider that the word "shown" in this context connotes the satisfactory demonstration by appropriate evidence of the relevant facts, in a way which can be properly evaluated not just by the contractor but also by HMRC and, if necessary, the Tribunal.

33. We do not consider that an assertion that the contractor is "satisfied" as to those facts, without demonstrating a reasonable basis for that satisfaction, can meet the requirements of subsection 61(1).

34. Clearly the best means of meeting those requirements is by appropriate documentary evidence which might include, for example, breakdowns of costs agreed in good faith as part of the negotiation of the contract price. It would still be possible (though less persuasive) to provide oral evidence to "show" how much of a payment represents materials cost. Arbitrary apportionments with no supporting commercial rationale would not suffice, otherwise there would be an open invitation to unscrupulous parties to evade the deductions regime altogether by simply agreeing wholly artificial apportionments of the contract price.

35. Thus a contractor who wishes to deduct from less than the full amount of any contract payment must be prepared to produce evidence, capable of standing up to proper scrutiny, that any amount which it has treated as being payment for materials cost does indeed truly represent that cost. A contractor would be well advised to consider carefully the terms of its contractual relationships with its subcontractors with this obligation in mind.

36. We consider that HMRC were fully entitled, given the concerns they had raised, to seek explanations from the appellant for what appeared at first sight to be under-deductions. When no satisfactory explanations were forthcoming, we consider they acted within their powers under Regulation 13 of the CIS Regulations in issuing the determinations dated 31 January 2011. When further explanations and information were eventually forthcoming, they again acted reasonably in reducing the initial determinations.

37. We do not consider there is any force in Mr Arthur's argument on Regulation 4(3)(b)(iii) of the CIS Regulations. This regulation is concerned with the content of contractors' monthly returns and it cannot in our view be regarded as qualifying or overriding the clear wording of subsection 61(1) FA 04, which is the primary provision requiring the deduction to be made.

38. Mr Arthur chose to produce no evidence (beyond that which was already included in the bundle submitted by HMRC) with a view to displacing the determinations raised by HMRC. It may be that he had no material evidence to offer, but the Tribunal cannot second guess that decision. The simple fact is that once a determination has been made by HMRC of the amounts which they consider to have

been under-deducted and that determination is shown to have been made to their best judgment, the burden then shifts to the appellant to displace that determination. In this case, no evidence has been put before us to discharge that burden and we do not accept Mr Arthur's legal submission that no such evidence is required.

39. It follows that we must dismiss the first appeal and confirm the determinations raised by HMRC on 31 January 2011 (as amended and reduced in their letter dated 21 December 2011).

The second appeal

40. The second appeal was made out of time. We heard submissions from both parties and decided on the basis of those submissions to entertain the second appeal, even though it had been made out of time.

41. Both parties have confirmed to the Tribunal that if the first appeal fails, the second appeal must also fail.

42. Having reached the conclusion that we have in relation to the first appeal, we therefore must also dismiss the second appeal.

43. Having done so, we do not consider it is necessary to set out our reasons for allowing the appeal to be entertained even though it had been made late. We would however wish to make it clear that the "normal rule" is that time limits should be observed and they will only be overridden where there are clear reasons to do so.

44. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

KEVIN POOLE
TRIBUNAL JUDGE
RELEASE DATE: 09 March 2012