All’s well that ends badly

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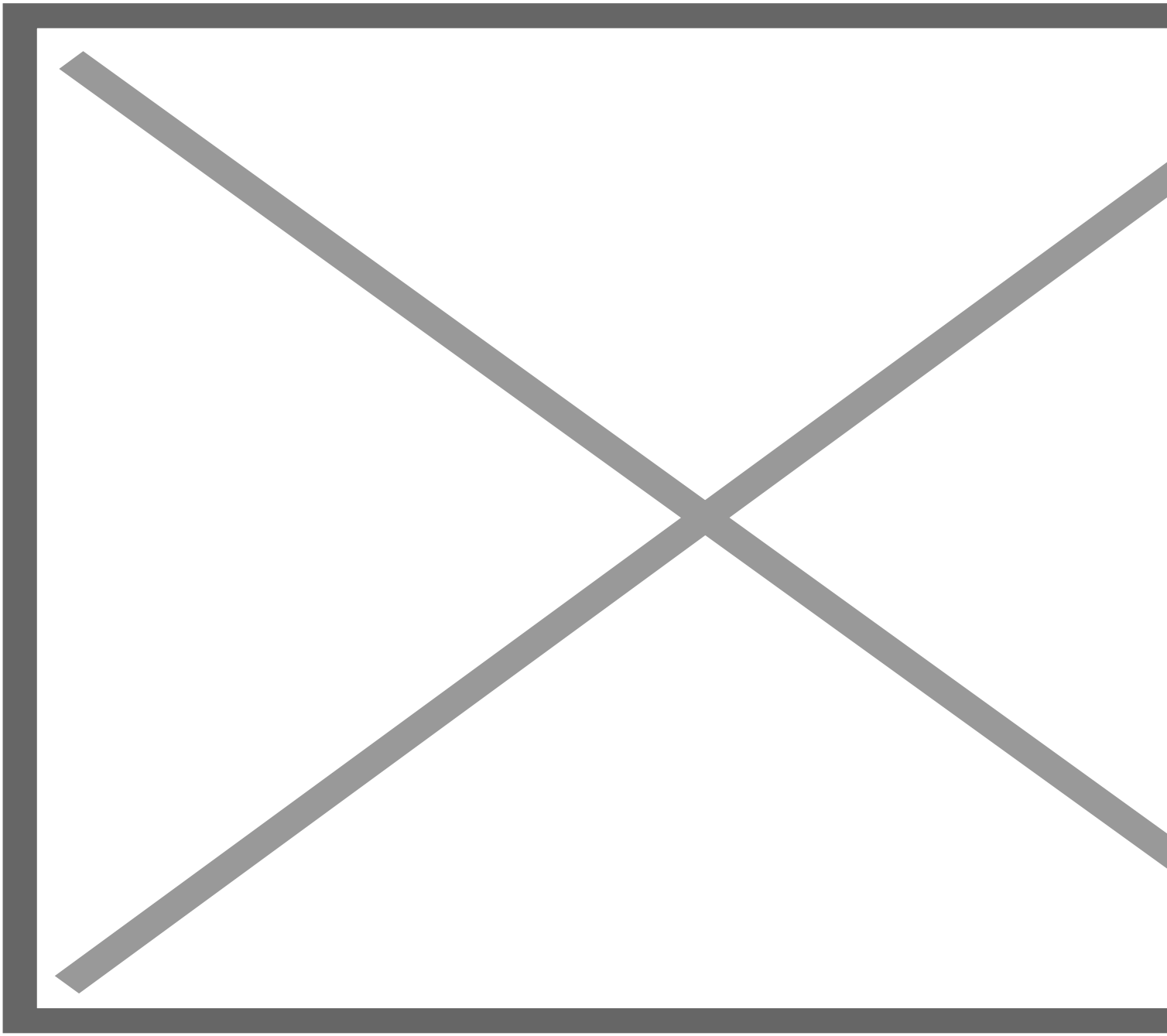

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Keith Gordon provides an update on the Construction Industry Scheme case of *JP Whitter (Waterwell Engineers) Ltd v HMRC*

Key Points

What is the issue?

The CIS was introduced in the 1970s to reduce the risk of tax evasion (and/or other non-compliance) which was then particularly widespread in the construction industry.

What does it mean to me?

The company's appeal was defeated on the fact that, when exercising their discretion, HMRC were not obliged to consider the wider impact of any decision to remove the company's gross payment status.

What can I take away?

Perhaps it is now time for a root and branch overhaul of the CIS rules so that this essential industry is subject to a regime that properly imposes burdens that match the risks to the Exchequer.

In my April 2013 article in Tax Adviser 'Much Ado about Something', I wrote about the appeal by JP Whitter (Waterwell Engineers) Ltd ('the company') against HMRC's decision to cancel its gross payment status under the Construction Industry Scheme ('the CIS'). The case has since progressed to the Court of Appeal whose decision is reported at [2016] EWCA Civ 1160.

Background to the case

As most readers will recognise, the CIS was introduced in the 1970s to reduce the risk of tax evasion (and/or other non-compliance) which was then particularly widespread in the construction industry. As a default, the CIS requires payments to subcontractors to be subject to a flat-rate deduction of tax, thereby ensuring that (at least on average), over the course of the tax year, subcontractors will in fact have paid the correct amount of tax. Businesses with a good tax compliance record, however, are entitled to register for gross payment status, meaning (as the name suggests) that they can receive their fee income without this deduction in precisely the same way as most other businesses.

As well as being advantageous from a cash-flow perspective, gross payment status has a major commercial advantage: large construction companies will rarely engage labour without gross payment status. They do not want (or need) the aggravation of the additional paperwork that the CIS involves. Those larger construction businesses also gain the knowledge that their labour is tax-compliant, something which is becoming increasingly important these days.

HMRC regularly review the compliance record of businesses subject to gross payment status and, where there has been a material failing, may remove that status. It was confirmed by the First-tier Tribunal in *Scofield v HMRC* [2011] UKFTT 199 (TC) that HMRC may not remove gross payment status automatically – they must exercise their discretion before doing so – and HMRC's procedures have been modified somewhat to reflect the Scofield decision. What the present case considers is how that discretion should be exercised.

Facts of the case

The company was subject to a decision by HMRC to have its gross payment status removed. This was not the first time that the company had suffered this sanction although, on the two previous occasions, HMRC relented,

giving the company a further chance to get its house in order.

On the third occasion, HMRC identified seven (out of twelve) late payments of PAYE during the relevant twelve-month period which HMRC may consider when deciding whether or not gross payment status may be retained. The company accepted that the payments had been made late and did not argue that it had a reasonable excuse for the delays. However, it argued that the loss of gross payment status would inevitably lead to a loss of its major contracts, with a consequential impact on its continued ability to employ so many workers. The company's appeal was based on the fact that, when exercising their discretion, HMRC were obliged to consider the wider impact of any decision to remove the company's gross payment status.

The Court's decision

In the Court of Appeal, the case was heard by Lord Justices Jackson, Christopher Clarke and Henderson. Henderson LJ gave the main judgment with which Jackson and Christopher Clarke LJJ concurred.

In his analysis of the statutory code, Henderson LJ emphasised (thereby confirming the *Scofield* decision) that HMRC have a power (and not the obligation) under FA 2004 s 66(1) to remove gross payment status, subject to the case coming within one of the three scenarios set out in that subsection.

He continued by noting that, in addition to the discretionary nature of the power, taxpayers have four additional safeguards within the legislation. First, HMRC are required to set out their reasons for removing gross payment status and, secondly, the taxpayer has the statutory right of appeal. The third additional safeguard is the fact that a taxpayer may reapply for gross payment status after a year. Finally, the code excuses taxpayers from any sanction if their non-compliance is down to reasonable excuse.

Given what the Judge called a 'tightly constructed statutory scheme', he said that it was unlikely that the exercise of the statutory discretion should go more widely than cover the various areas which are dealt with by the scheme itself, in other words, the discretion should not consider what the Judge called 'matters extraneous to the CIS regime'. Thus, as the FA 2004 code makes no reference to the financial impact of a subcontractor's status, it should fall outside the list of considerations that HMRC are required to consider.

It appears that the Judge raised this viewpoint (then being no more than a preliminary view) in the course of the hearing because the judgment records the response to it from the taxpayer's Counsel. In short, Counsel argued that if the exercise of the discretion were limited to the matters set out in the statute then there cannot be much of a discretion as either there has been a relevant compliance failure or there hasn't. However, the Judge's reply was that there could still be a discretion exercised in these areas: effectively where there has been a technical failure but of a relatively minor nature.

The Judge then considered additional arguments raised on behalf of the company. He accepted that HMRC are bound by the common law and that there are many contexts in which the common law will require proportionality between the ends and the means to be observed by a public body in the exercise of its functions. However, he considered that the common law requirement of proportionality is satisfied by consideration of the matters within the statutory code itself.

Similarly, the Judge dismissed the arguments based on human rights. He accepted that the consequences of losing gross payment status might appear harsh. However, harshness is not sufficient for mounting a human rights challenge. Nevertheless, the Judge did not rule out 'the possibility of exceptional circumstances justifying a wide proportionality review' in another case. The company's circumstances, he held, came nowhere near to that situation.

The company’s appeal was therefore dismissed.

Commentary

As is usual with judgments by Henderson LJ, this judgment is a model of clarity and makes persuasive reading. Furthermore, one can see a parallel (although not expressed in the judgment itself) with the underlying discretion that HMRC have before making an assessment – it is not widely argued that HMRC officers must consider the likely impact on the taxpayer before making any assessment to recover tax that is believed to be underpaid. In short, there is certainly considerable merit in the argument that any discretion is to be narrowly construed. However, I am not sure that I agree that it is to be exercised solely by reference to the factors laid down by the statute as comprising compliance failures. As the taxpayer’s Counsel argued, that appears to bring the statute back into the previous incarnation of the rules where ‘minor and technical breaches’ were often forgiven.

Furthermore, the CIS is not the same as a general assessing power applicable to all taxpayers. It is a special regime for a small selection of the taxpaying public because of perceived evasion by others in the same industry (45 years previously). There is no doubt some correlation between a taxpayer’s compliance with routine matters (such as PAYE) and the taxpayer’s overall reliability as regards paying the right amount of tax on his/her/its trading profits. But is it really reasonable to destroy a business which has built up to 25 employees and an annual profit of about £180,000 simply because its PAYE was paid late on a few occasions (especially since late payment attracts additional charges in any event)?

Perhaps the company’s downfall in this case was that the PAYE failures were not isolated (there being seven in the year under review) and, indeed, the company (having been forgiven twice by HMRC) was clearly in the last-chance saloon. In the circumstances, it is not difficult to see why the company might not have attracted a great deal of sympathy – it knew what it had to do and continued to fail. Taking on an additional member of staff, solely tasked with the routine tax compliance, would have saved the company a lot of money in the long run. But it is easy to say that with the benefit of hindsight.

All I can do is repeat the concerns I expressed four years ago and ask whether it is now time for a root and branch overhaul of the CIS rules so that this essential industry is subject to a regime that properly imposes burdens that match the risks to the Exchequer.