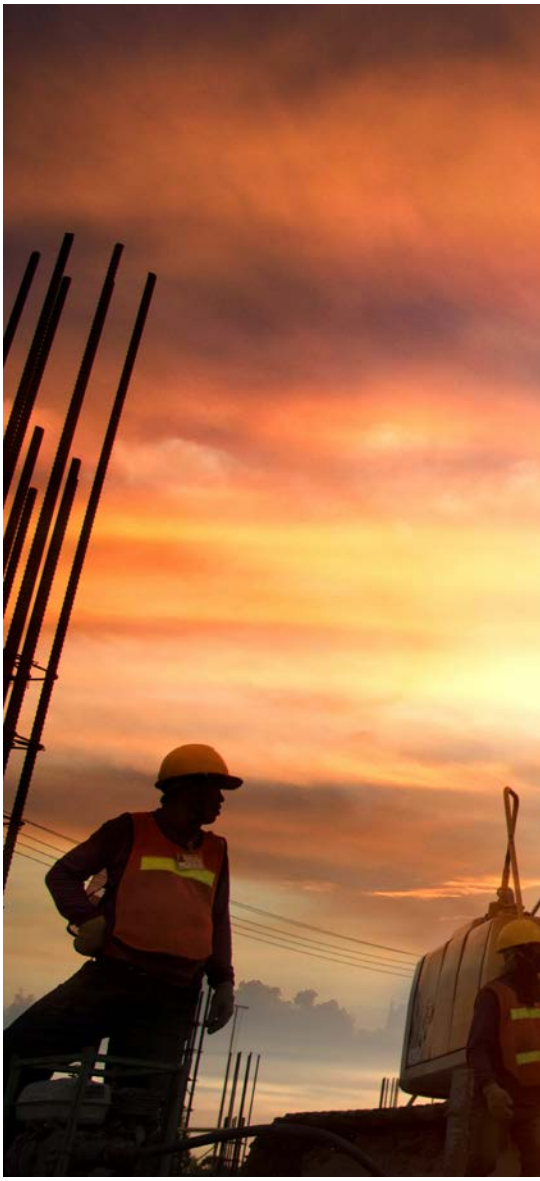
CIS fraud rules: the 'should have known' standard

Barbara Bento explains recent changes to the CIS, and assesses what impact they will have



HMRC's strengthened Construction Industry Scheme (CIS) powers are now live. Under the new rules, HMRC can immediately cancel Gross Payment Status (GPS) where a business knew, or should have known, that it was involved in a transaction connected to tax fraud, including cases where suspicions existed within the supply chain but were not acted upon.

This mirrors HMRC's long established VAT approach under the Kittel principle, under which input VAT may be denied where a taxpayer knew, or ought reasonably to have known, that its transactions were linked to fraud.

Should HMRC consider that fraud took place in the supply chain, businesses will be made liable for the tax lost along with a potential penalty up to of 30%. There is also scope for these penalties to be extended to directors and persons connected to the business.

Although the legislation is new, HMRC's approach is not entirely unfamiliar, and recent HMRC investigations suggest this shift has been developing for some time. From our experience advising on CIS investigations specifically, HMRC has been moving steadily away from treating CIS as a box ticking exercise. The focus is now firmly on behaviour, judgement and whether contractors took reasonable steps to identify and respond to risk within their supply chains.

From box ticking to behavioural risk

Historically, CIS compliance was largely seen as procedural: verify subcontractors, apply the correct deduction rate and submit returns on time. Those basics remain essential, but under the new rules they are no longer sufficient on their own.

HMRC is now asking a different question: was it reasonable for the contractor not to realise something was wrong? This is where the 'should have known' test becomes critical and risky.

In practice, HMRC enquiries increasingly focus on issues such as:

- how subcontractors are onboarded and verified.
- whether discrepancies in HMRC systems were understood or questioned.
- how contractors identified and dealt with anomalies.
- whether commercial arrangements made sense.

In some cases, contractors have chosen to override CIS software results showing subcontractors as 'unmatched' with HMRC records, relying instead on assurances from

subcontractors who expected to be paid gross. Although this may be understandable in the context of long-established commercial relationships, HMRC investigations have shown that, in certain cases, subcontractors had misrepresented their position to obtain the benefit of gross payment.

HMRC's view is that contractors still need to understand why a subcontractor appears as 'unmatched' in HMRC's records and whether any further checks are needed before making payment. Under the current rules, relying on automated systems and the word of subcontractors alone, without appropriate review and follow up, can quickly lead to compliance issues.

The real risk: loss of Gross Payment Status

The withdrawal of GPS remains one of HMRC's most powerful tools, and one of the most damaging for businesses. Loss of GPS can have an immediate impact on cashflow, strain commercial relationships and cause reputational harm.

Previously, GPS withdrawal was typically the outcome of a compliance check, and businesses could usually reapply within one year. Under the new rules, businesses will only be able to reapply after five years, materially increasing the commercial and cash flow risks faced by contractors, even where no deliberate wrongdoing is alleged.

In our experience, HMRC increasingly uses the threat of GPS withdrawal as leverage during CIS enquiries, particularly where it believes behavioural concerns exist. This makes early engagement and a clear evidential trail of reasonable care more important than ever.

'Knew or should have known': a difficult standard

The new CIS fraud rules introduce an objective knew or should have known test, meaning HMRC does not need to prove deliberate wrongdoing. It is enough for HMRC to conclude that, based on the surrounding circumstances, a contractor ought reasonably to have recognised that a transaction was connected to fraud.

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In the construction industry this is a challenging standard. Contractors often operate at scale, manage multiple subcontractors across complex labour supply chains and face intense commercial pressure to deliver projects on time. Decisions are frequently made quickly, based on partial information and longstanding commercial relationships. Against that backdrop, HMRC's expectation that warning signs should have been identified and escalated will inevitably be tested.

The real difficulty for businesses is that HMRC's assessment is typically retrospective and influenced by hindsight. Investigations often take place years after the relevant transactions, when HMRC has access to information that was not available or obvious at the time. Assertions that a contractor should have known are, therefore, difficult to rebut unless there is clear, contemporaneous evidence of risk assessment and follow up.

In practice, disputes will turn less on whether a business acted honestly, and more on whether it can prove what checks were carried out, what concerns were identified, and how those concerns were addressed at the time. Where processes were informal, undocumented or overly reliant on software outputs, contractors may struggle to defend their position.

When genuine mistakes carry consequences

Prior to the April 2026 changes, we frequently saw HMRC scrutiny in cases where businesses had expanded rapidly, particularly where growth was not supported by robust CIS procedures. In a number of cases we handled

HMRC identified substantial subcontractor payments on which CIS deductions had been operated incorrectly. Although there was no allegation of deliberate wrongdoing, incomplete records – including missing UTRs, National Insurance numbers or inadequate separation between labour and materials – significantly weakened the contractor's position and limited the scope for relief under Regulation 9 of the CIS Regulations.

Had those same facts arisen under the new regime HMRC would be far more likely to pursue a deeper, behavioural investigation. Rather than treating the issues primarily as procedural failures, HMRC could now examine whether the scale and nature of the record keeping failures meant the business knew or should have known there were wider compliance issues within its supply chain.

What contractors should be doing now

Under the new regime, contractors will need to focus on being able to evidence reasonable judgement, not just basic compliance. Practical steps include:

- strengthening subcontractor onboarding and verification beyond minimum CIS checks.
- understanding and investigating 'unmatched' or anomalous CIS verification results.
- training operational staff to recognise and escalate red flags, not just process payments.
- documenting commercial decisions, follow-up actions and risk assessments.
- avoiding over reliance on CIS software without human review.
- addressing issues at the time, rather than attempting to explain them retrospectively.

Ultimately, the battleground with HMRC will be factual: what the contractor knew, what it should reasonably have known, and critically, what it can prove it did in response.

A delicate balance

HMRC's objective of tackling fraud within the construction sector is entirely justified. However, experience from current CIS investigations shows how easily compliant businesses can find themselves exposed where systems, processes or records fall short.

As the new rules are tested through enforcement, proportionality will be critical. Clear guidance from HMRC and consistent decision making will be essential to ensure the measures target fraud effectively without penalising businesses acting in good faith.

For now, the message is clear: under the new CIS rules HMRC is not just checking compliance, it is judging businesses decision-making processes and whether they should have known better.

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