



An Outline Guide to the Construction Sector VAT Reverse Charge

The Principle

The introductory date for this major change to VAT accounting in the construction sector is 1 October 2019, when a new domestic reverse charge will be introduced in the UK. This will cover supplies between contractors of most construction and/or building services, although it excludes the manufacture and delivery of materials to site without installation; signwriting; installation of seating, blinds, shutters, alarms and CCTV systems; the supply of labour by labour agencies; and a few rather more obscure services. The services of professionals, such as architects and surveyors, not being construction services as such, are also excluded.

Reverse charge provisions have existed for some time in a number of other, much narrower sectors in the UK economy, as a fraud elimination measure. To counter fraud and other forms of tax loss in the construction sector, reverse charge provisions will be extended to positive-rated supplies between contractors of construction services. Unlike other sectors where there is a domestic reverse charge, however, there will be no requirement for reverse charge sales lists to be completed by contractors, reporting all relevant sales to HMRC along with the customers' VAT numbers.

HMRC's reasonably comprehensive guidance of June 2019, including a flowchart for deciding when it applies, can be found here: <https://www.gov.uk/guidance/vat-domestic-reverse-charge-for-building-and-construction-services> (avoid the November 2018 guidance, which is still online). This also includes a more detailed list of services which are and are not covered by the reverse charge provisions.

Contractors charging other contractors for services covered by the reverse charge will no longer be required to charge VAT on their invoices or collect it from their customers. Instead, they will notify the customer of the rate and amount of VAT that they would have charged and add a narrative informing the customer that they are liable to account for VAT on the supply received. HMRC provide a number of suggested narratives for this, although anything which adequately communicates the same thing will be permissible.

HMRC's options are:

- reverse charge: VAT Act 1994 Section 55A applies
- reverse charge: S55A VATA 94 applies
- reverse charge: customer to pay the VAT to HMRC

The customer will be obliged to account for the VAT shown as output tax in box 1 of their VAT return, claiming this back in box 4, subject to the normal rules. Although in principle it could be that the output tax accounted for is not deductible as input tax, this would seem a highly unlikely scenario for any contractor in the construction sector. A couple of suggested invoice formats appear in the annex to this note.

It should be emphasised that, unlike the cross-border reverse charge, the domestic reverse charge does not shift the liability to the customer to account for the sale as well as the tax due on the sale. All that shifts to the customer is the requirement to account to HMRC for the output tax. The supplier therefore continues to account for the net value of the sale in box 6 of their VAT return.

Some accounting packages have codes for implementing the domestic reverse charge. Sage, for example, has set aside T20 for this purpose, which can be used for both sales and purchases covered by the rules.

The Practice

These new provisions will only apply where the customer of one contractor is another contractor, so it is not used when a contractor deals directly with the party owning a property, whether they are a business such as a property developer or a private individual; here, VAT will continue to be charged in the normal way. In most cases it will be clear to a contractor when they are dealing with a customer who is not another contractor and in such circumstances they should not apply the reverse charge procedure. HMRC's flowchart suggests that the contractor should obtain confirmation from their customer that they are not a contractor, but their guidance allows for this to be assumed in many cases.

There are a number of conditions to be met before the reverse charge applies. There can be considered in any order, so what follows is one approach to considering them:

1. Both parties to the transaction are VAT-registered. If the supplier is not registered there is no tax to shift. If the customer is not VAT-registered, they have no means of accounting for the VAT.
2. The supply is standard-rated or reduced-rated for VAT purposes. If the supply is zero-rated there is no tax to shift. (This renders the reverse charge largely irrelevant in the house-building sector.)
3. The transaction falls in whole or part within CIS. If it does not, the reverse charge does not apply. Many will see this as a governing principle in determining when to apply the reverse charge or not. The mention of being partly within and partly outside CIS refers principally to the situation where materials are excluded but labour is covered by CIS. In such cases, the whole supply is within the reverse charge regime.
4. The supply is not to an end user. An end user is any person who will not be selling the services on to a further customer (but also includes any person connected with an end user). In many cases – potentially the majority of cases – this condition will not need to be considered, since the potential use of the reverse charge will have been eliminated by the fact that the transaction is not within CIS.

The fourth condition will need to be considered in two situations. The first of these is where the customer is a deemed contractor for CIS purposes, but nonetheless an end user. Various bodies, such as local authorities, may be deemed contractors of this kind, as will the larger property developers. In the main a contractor working for such a customer will be aware they are an end user notwithstanding their CIS status and may charge VAT as before, possibly requesting token confirmation from the customer that they are indeed an end user.

The second situation is where the customer is connected with an end user. Such a customer is likely to be another contractor, but by virtue of being part of the same corporate group as the actual end user, is an end user for the purposes of these provisions. An example would be where a group of development companies have a captive construction company. By virtue of its connection with the actual end user, this construction company is also to be seen under the legislation as an end user itself. Potentially the only way in which a supplier may become aware of that end-user status is if the customer provides some kind of declaration.

The definition of a party “connected” to an end user is either a company which is part of the same corporate group or undertaking as an actual end user, using the definition in section 1161 of the Companies Act 2006, or (although this will be rare) having a share in the ownership of the land where the construction works are taking place. In these circumstances the customer is what might be called a deemed end user (not HMRC’s term).

HMRC’s guidance puts the onus on both supplier and customer to ensure that the reverse charge provisions are not applied to relevant transactions. They suggest that contractors should check the status of their customer if there is any doubt (often of course it will be obvious and no checking will be required). They also indicate that end users (and, perhaps more significantly construction companies connected with end users) should make some form of declaration to contractors working for them that they are an end user for these purposes, also refusing reverse charge invoices if these have been issued in error by the supplier through ignorance of the customer’s status.

Where self-billing or authenticated receipts are in use, the customer must replicate the same processes, endorsing the document with a declaration which is the opposite of that of a supplier issuing their own invoices, such as

- reverse charge: we will account for and pay the output tax due to HMRC
- reverse charge: as the UK customer we will pay the VAT due to HMRC

The Problems

The reverse charge is mandatory. Customers receiving invoices on which VAT has been charged in the normal way for transactions covered by the reverse charge must refuse them. They are not valid VAT invoices as the VAT purportedly charged is not deductible as input tax. It is as important for the customer that the rules are correctly applied as it is for the supplier.

Accounting systems and invoicing procedures will need to be adapted to implement the new provisions. This will need to include a decision-making process to determine each time an invoice is raised whether or not it falls under the new rules. In this respect, things will be easier for subcontractors who work exclusively under CIS for other contractors (not connected to end users), where they will have only one method of invoicing rather than two, albeit different from that which they have been using before.

The manner of accounting for VAT will result in significant mismatches between net sales and output VAT on many contractors' VAT returns.

This new provision potentially brings about a cash-flow saving for contractors (especially main contractors) receiving services from subcontractors, although, depending on the circumstances, this may be outweighed by the cash-flow disadvantage arising from issuing reverse charge invoices. The point here is that contractors supplying other contractors will no longer be collecting VAT from customers and holding it until the VAT return becomes due, depriving them of the temporary use of those funds, whereas recipients of such services will no longer have to pay out VAT to suppliers and wait to reclaim it from HMRC.

In many cases contractors will continue to have input tax to claim but have much reduced amounts of output tax of their own to account for. Any reverse charge output tax declared by a contractor who is a customer will be mirrored by an input tax claim and therefore not result in an actual liability to HMRC. Many contractors will therefore end up in a repayment position and may wish to opt for monthly VAT returns.

The effect on flat rate scheme users will be variable, depending on the extent to which their supplies fall under the reverse charge. If all, or nearly all, their work is covered, they will become repayment traders and the FRS will no longer be of benefit. If they undertake a mixture of work, some under and some not under the reverse charge, they may benefit from a reduced FRS liability. This results from the fact that reverse charge transactions are excluded from the FRS calculation, but also do not attract a liability to account for output tax on the part of the supplier. The impact on FRS traders will need to be considered on a case-by-case basis.

Supplies made under the reverse charge are not eligible for cash accounting treatment, although businesses may continue to use cash accounting for the remainder of their activities if it is still of benefit. Supplies received subject to the reverse charge may be accounted for by the customer on either an invoice basis or a cash basis.

Another problem which will be faced by many contractors, especially those at the lower end of the sector, is the fact that potentially only some of their sales will come under the reverse charge and others will not. Work for private householders or directly for (probably small and/or local) developers will call for the normal method of invoicing, for example, whereas work under CIS for other contractors will come under the reverse charge. This will complicate invoicing and accounting generally.

These rules could have eliminated the risk of VAT being charged by a subcontractor at a rate greater than that permissible in the legislation, since it is the customer who actually accounts for the VAT through their return and who could have been given responsibility for determining the rate and amount of VAT to account for. However, this is not the case, as the provisions make it entirely clear that the supplier must identify both rate and amount to the customer. It is not at all uncommon of course for subcontractors to charge VAT at 20% where the correct rate would be 5%, and for HMRC to assess the difference as overclaimed if the contractor paying the subcontractor recovers all of it as input tax rather than requesting the subcontractor to correct the rate accordingly. HMRC do not directly address the question of the wrong rate of VAT being stated on the reverse charge invoice, but where this does happen, it is clear that the customer must challenge the rate and amount stated and arrange for it to be reduced before accepting and processing the invoice.

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Annex

There is no single permissible format to be used. HMRC have indicated that there is significant flexibility. Here are two of many possible options, illustrating the key features.

XYZ Construction Company
High Street, Anytown, Countyshire BC1 2DE

Construction Customer
Something House
Somewhere Street
Sometown
PQ5 6RS

Invoice no: 7934

Invoice date: 31 January 2020

To the provision of electrical services in connection with the conversion of Old Farm Barn to a dwelling

Labour and materials	£2,402.00
VAT at 5% (reverse charge applies)	£120.10
Total payable to XYZ	£2,402.00

Reverse charge: Customer to pay the VAT to HMRC

VAT Registration Number: 123 4567 89

XYZ Construction Company
High Street, Anytown, Countyshire BC1 2DE

Construction Sector Business
Something House
Somewhere Street
Sometown
PQ5 6RS

Invoice no: 7934

Invoice date: 31 January 2020

To the provision of carpentry work and plastering in connection with the refurbishment of an office building

Labour and materials for January	£10,000.00
Total payable to XYZ	£10,000.00

Rate of VAT due: 20%

Amount of VAT due: £2,000.00

Reverse charge applies: Customer to pay the VAT to HMRC

VAT Registration Number: 123 4567 89