

Construction Sector VAT Reverse Charge

The Principle

The introductory date for this major change to VAT accounting in the construction sector is 1 March 2021, when a new domestic reverse charge will be introduced in the UK. This will cover many supplies made by building contractors of most construction and/or building services.

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, reverse charge provisions will be extended to a range of positive-rated supplies of construction services made by contractors. Unlike other domestic reverse charges, however, there will be no requirement for reverse charge sales lists, reporting all relevant sales to HMRC along with the customers' VAT numbers.

HMRC produced some reasonably comprehensive guidance in June 2019, which has since been updated a number of times, and also a "technical guide", released on 24 September 2020, including links to two flowcharts for deciding when the reverse charge applies. An alternative flowchart appears as an annex to this note.

The term construction services must be understood to mean supplies of labour only (other than by labour agencies) and of labour and materials (supply and fit). The following are seen as falling under this heading:

- construction, alteration, repair, extension, demolition and dismantling of buildings, etc;
- installation of heating, lighting, air-conditioning, utilities, sanitation or fire protection;
- internal cleaning as part of any of the above;
- painting and decorating, internal or external;
- services integral to any of the above.

The following services are not covered:

- when supplied alone, signwriting, erection of signboards, etc; installation of alarm systems, CCTV and sound systems; installation of seating, blinds, shutters, sculptures and murals;
- supplies of labour by labour agencies (which are supplies of staff not of construction services, since the agency takes no responsibility for the work done);
- materials delivered to site without installation even if designed specifically for the building concerned;
- professional services, such as those of architects and surveyors.

Contractors charging other contractors, and in certain circumstances some other customers, 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.

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 customer we will pay the VAT due to HMRC

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

The original intention of the new provisions was that they should apply where the customer of one contractor was another contractor, and not when a contractor dealt directly with an “end user” (meaning any person who has an interest in the land or is a company in a corporate group with a company that has an interest in the land), where VAT would continue to be charged in the normal way.

However, changes over time to the legislation and guidance mean that, where a supply to an end user is reportable under CIS (usually because the end user is a deemed contractor for CIS purposes) VAT will be charged in the normal way only if they have confirmed their status as an end user in writing to the contractor(s) working for them. Thus, where no written confirmation of end-user status is provided by a customer to a contractor, and the other conditions are met, the reverse charge provisions should be applied.

A further late addition to the provisions excluded from the reverse charge procedures supplies where 5% or less by value of the supply or contract falls with the parameters for its application. This is known as the “5% disregard”.

The Conditions

There are a number of conditions to be met before the reverse charge applies. These 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, unless the positive-rated proportion of the overall supply is no more than 5%. If the supply is zero-rated there is no tax to shift, which renders the reverse charge largely irrelevant in the housebuilding sector.
3. The transaction falls in whole or part within CIS, unless the part covered by CIS is no more than 5% of the total value. If it does not fall within CIS, the reverse charge does not apply. Many will see this as a governing principle in determining whether 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, unless the labour is 5% or less of the total value.
4. The supply is not to a person who has confirmed in writing that they are an end user.

The fourth condition will only need to be considered if all the other conditions have been fulfilled. If the supply is not covered by the CIS, for example, then the customer’s status as an end user (or not) will be irrelevant and there will be no need to consider whether or not written confirmation of end-user status has been made.

The reverse charge is largely but not wholly irrelevant in the housebuilding sector, since most construction services are zero-rated and there is no tax to shift. Subject to the 5% disregard, contractors working on residential development sites will need to take account of the reverse charge only if there is a positive-rated element to their work, say because there is a school or community hall on which they are working as well as the dwellings, or an existing building is being converted to dwellings and the reduced rate applies. There will be no requirement to apply the reverse charge to the standard-rated items sometimes installed by builders in new dwellings (carpets, fitted furniture other than kitchen units, certain appliances, etc), even if they exceed the 5% disregard limit, since VAT is chargeable only on the goods – the installation services remain zero-rated – and so in this respect there is no positive-rated construction service.

The Problems

The reverse charge is mandatory. Suppliers do not have a choice of whether or not to apply it if the conditions for its application have been met.

However, if the conditions are not met, a normal VAT invoice must be raised; issuing a reverse charge invoice in such circumstances gives rise to an underpayment of VAT to HMRC and the risk of an assessment from them if the error is discovered later. The same is true for customers receiving invoices on which VAT has been charged in the normal way, who must refuse them if they relate to transactions covered by the reverse charge. They are not valid VAT invoices if 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.

This new provision has profound cash-flow implications for businesses in the construction sector. It is cash-flow disadvantageous for suppliers and cash-flow advantageous for customers. Most contractors will suffer a net cash-flow disadvantage, and main contractors working for end users who declare their status will receive a significant benefit. This cash-flow situation will also act as a major disincentive to end users declaring their status in writing; if they deliberately do not do so (and there is no legal obligation on them whatsoever to do so), they will end up with a cash-flow saving. Conversely, contractors supplying end users will be keen to receive written notification of their customers' status, in order not to be disadvantaged from a cash-flow point of view. Some such suppliers may wish to put in their terms of business that they will assume that their customers are end users unless they are advised to the contrary, but this will only be effective in confirming end-user status if the relevant customers agree to those terms in writing.

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, where they will have only one method of invoicing rather than two, albeit different from that which they have been using before. For others invoicing procedures and record-keeping will become more complicated.

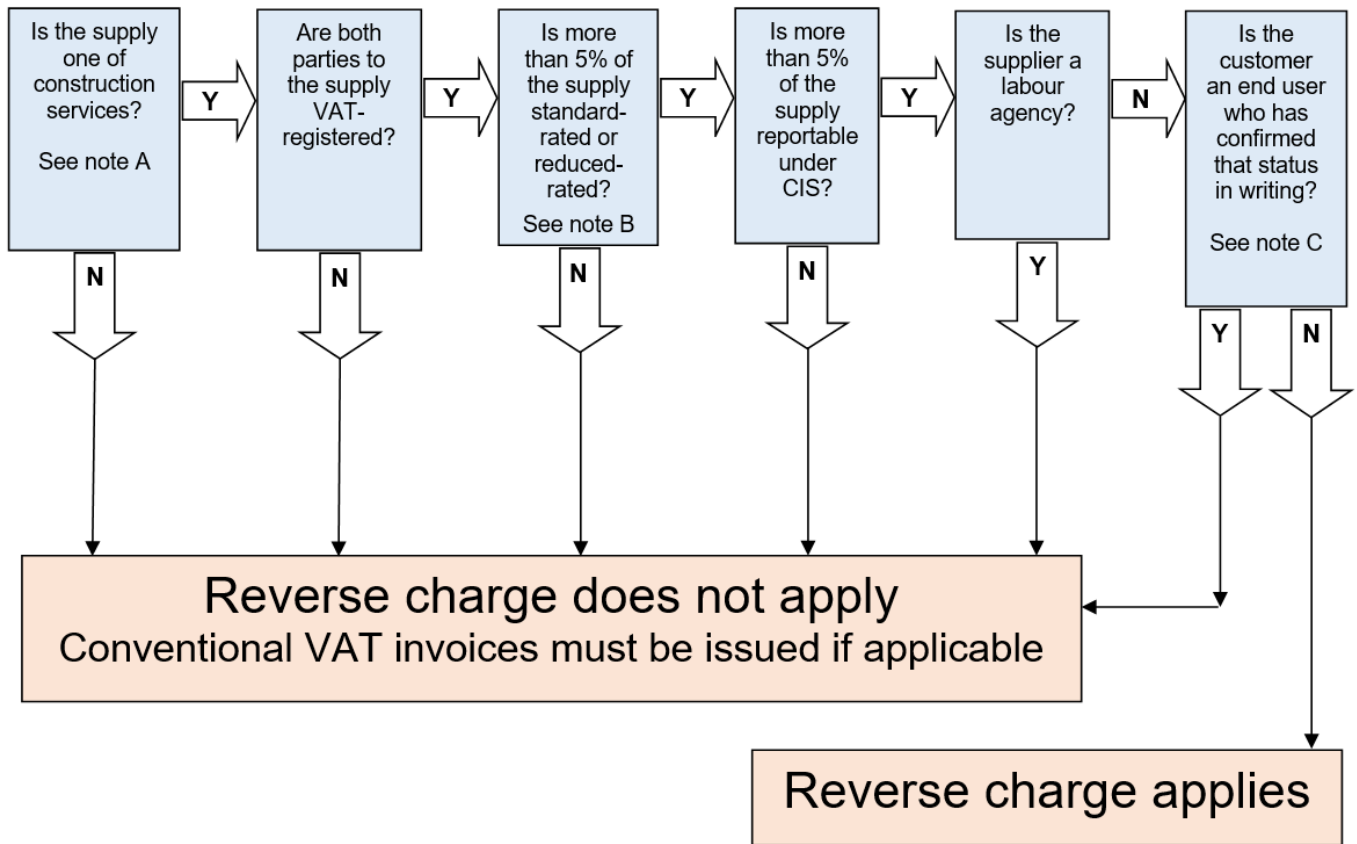
The manner of accounting for VAT will result in significant mismatches between net sales and output VAT on many contractors' VAT returns.

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.

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.

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 value to them. If they undertake a mixture of work, some under and some not under the reverse charge, this will result in a reduced FRS liability, but also a reduced benefit from use of the scheme. This results from the fact that reverse charge transactions are excluded from the FRS turnover 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.

Annex: Construction sector reverse charge: deciding when it applies



Notes

A: Construction services mean any of the following: constructing, altering, repairing, extending, demolishing or dismantling buildings or structures (whether permanent or not), including offshore installation services; constructing, altering, repairing, extending, demolishing of any works forming, or planned to form, part of the land, including (in particular) walls, roadworks, power lines, electronic communications equipment, aircraft runways, railways, inland waterways, docks and harbours, pipelines, reservoirs, water mains, wells, sewers, industrial plant and installations for purposes of land drainage, coast protection or defence; installing heating, lighting, air-conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection systems in any building or structure; internal cleaning of buildings and structures, so far as carried out in the course of their construction, alteration, repair, extension or restoration; painting or decorating the inside or the external surfaces of any building or structure; services which form an integral part of, or are part of the preparation or completion of the services described above - including site clearance, earth-moving, excavation, tunnelling and boring, laying of foundations, erection of scaffolding, site restoration, landscaping and the provision of roadways and other access works.

B: The standard-rated items included in a zero-rated residential construction project (carpets, fitted furniture other than kitchen units, certain appliances, etc.) should be disregarded when answering this question.

C: An end user is a person having an interest in the land where the works are taking place or a company connected to the end user by virtue of section 1161 of the Companies Act 2006, namely within the same “corporate group or undertaking”.