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THE CONSTRUCTION INDUSTRY AND VAT: ANALYSING THE CHANGES



The VAT domestic reverse charge for building and construction services comes into effect from 1 October 2019. Given the scale of the changes, it would be appropriate for businesses to plan for the reverse charge now.

THE REVERSE CHARGE: AN OVERVIEW

The reverse charge represents part of a government clamp-down on VAT fraud. Large amounts of VAT are lost through ‘missing trader’ fraud. As part of this type of fraud, VAT is charged by a supplier, who then disappears, along with the output tax. The VAT is thus lost to HMRC. Construction is considered a particularly high-risk sector because of the potential to make supplies with minimal input tax but considerable output tax.

The reverse charge does not change the VAT liability: it changes the way that VAT is accounted for. In future the recipient of the services, rather than the supplier, will account for VAT on specified building and construction services. This is called a ‘reverse charge’.

The reverse charge is a business-to-business charge, applying to VAT-registered businesses where payments are required to be reported through the Construction Industry Scheme (CIS). It will be used through the CIS supply chain, up to the point where the recipient is no longer a business making supplies of specified construction services. The rules refer to this as the ‘end user’.

Broadly then, the reverse charge means that a contractor receiving a supply of specified construction services has to account for the output VAT due – rather than the subcontractor supplying the services. The contractor then also has to deduct the VAT due on the supply as input VAT, subject to the normal rules. In most cases, no net tax on the transaction will be payable to HMRC.

The charge affects only supplies at standard or reduced rates where payments are required to be reported via CIS and not to:

- zero-rated supplies;
- services supplied to ‘end users’ or ‘intermediary suppliers’.

Under the scheme a VAT-registered business, receiving a supply of specified services from another VAT-registered business, for onward sale, on or after 1 October 2019:

- should account for the output VAT on supplies received through its VAT return
- does not pay the output VAT to its supplier on supplies received from them
- can reclaim the VAT on supplies received as input tax, subject to normal VAT rules.

The supplier should issue a VAT invoice, indicating the supplies are subject to the reverse charge.

An end user should notify its end user status, so the supplier can charge VAT in the usual way.

Example

Safe as Houses Ltd is a VAT-registered contractor. It uses Brickyard Bill, who is also VAT-registered. Brickyard Bill tells Safe as Houses that the reverse charge applies.

Safe as Houses does not pay VAT to Brickyard Bill. It accounts for the VAT on its own VAT return, entering it as both output and input tax. It enters the value of the purchase from Brickyard Bill as part of its inputs. It does not include the value in its outputs.

Their VAT returns will look like this:

- Brickyard Bill puts the value of the sales in box 6 of the VAT return, but no output tax in box 1
- Safe as Houses uses box 1 to declare the output tax on the services from Brickyard Bill to which the charge applies. It doesn’t include the value of the transaction as an output in box 6. It reclaims the input tax on reverse charge purchases in box 4 and includes the value of purchases in box 7.

CONSEQUENCES FOR BUSINESSES

Details of the charge have changed since it was first announced. Originally, the charge was to apply to 'labour-only' supplies. Now however, the charge applies to construction services, including materials. With the domestic reverse charge, the value of reverse charge supplies will not count towards the VAT registration threshold of the recipient business.

For many construction businesses, the change is likely to have far-reaching consequences. Processes will need to be in place to ensure VAT accounting systems are compliant with the unusual requirements of the reverse charge. The rules require a number of verification checks to ascertain VAT status of customers, CIS registration (in some circumstances) and end user or intermediary supplier status. Given that output VAT currently provides many businesses with a positive cashflow advantage, the impact on cashflow and liquidity will also need appraisal. Changing to a monthly VAT return cycle to accelerate payments due from HMRC may be of benefit. The VAT Flat Rate Scheme (FRS) may no longer be of benefit, and reverse charge transactions cannot be dealt with through the Cash Accounting Scheme.

SPECIFIED SERVICES

Construction services covered by the reverse charge are those falling within the category of 'construction operations' for the CIS, and include the construction, alteration, repair, extension, demolition or dismantling of buildings or structures, including offshore installations. Works forming part of the land are also included, such as walls; pipe and power lines. So too are preparatory services such as site clearance and scaffold erection; the installation of systems of heating and lighting; and painting and decorating. The reverse charge includes goods, where supplied with specified services.

Supplies excluded from the charge, where these are supplied on their own, include the services of architects, surveyors and some consultants; and the manufacture of building or engineering components, materials or plant.

SERVICES WITH REVERSE CHARGE AND EXCLUDED ELEMENTS

Where excluded services are supplied with services subject to the reverse charge the whole supply is subject to the reverse charge. As it can be difficult to determine in some situations whether the reverse charge applies, if there has already been a reverse charge supply on a construction site, any subsequent supplies on that site between the same parties may be treated as reverse charge supplies, if both parties agree. Where there is any doubt, HMRC recommends reverse charging, if the recipient is VAT-registered and payments are subject to the CIS.

CONSIDERING END USERS

The domestic reverse charge applies to VAT-registered businesses throughout the CIS supply chain, but is designed not to apply to 'end users' or 'intermediary suppliers'. 'End users' are VAT-registered businesses receiving supplies of specified services which are not sold on as construction services. Examples could be a construction firm selling an interest in land as a newly built office, or a large retail business having trading premises built for its own use. Intermediary suppliers are VAT and CIS registered businesses that are connected or linked to end users. Examples could be landlords and tenants, or recharges of building and construction services within a group of companies.

Businesses will need to know when they are dealing with an end user or intermediary supplier, so they can invoice appropriately. The end user or intermediary supplier should inform the supplier of their status so that VAT can be charged as normal. If the end user does not provide confirmation of status, the supplier should issue a reverse charge invoice. Businesses dealing frequently with end users may wish to include a statement, in business terms and conditions, to the effect that it is assumed that the customer is an end user, unless they indicate otherwise.

EFFECTIVE INVOICING

To invoice correctly under the new rules, suppliers should mark the invoice to the effect that the domestic reverse charge applies, and that the customer must account for VAT. The amount of VAT due under the charge should be clearly stated on the invoice. It should not be included in the amount shown as total VAT charged.

The rules require that when the customer is liable for VAT, an invoice should include the reference 'reverse charge'. Any of these are acceptable:

- Reverse charge: VAT Act 1994 Section 55A applies
- Reverse charge: S55A VATA 94 applies
- Reverse charge: Customer to pay the VAT to HMRC.

Where invoices are created with an IT system that cannot show the amount to be accounted for, HMRC refers suppliers to VAT Notice 735, 'Domestic reverse charge procedure' [bit.ly/20sGJWK](https://www.gov.uk/guidance/domestic-reverse-charge-procedure).

HMRC'S POLICY

HMRC has issued technical guidance [bit.ly/2WHQ5R2](https://www.gov.uk/guidance/technical-guidance-domestic-reverse-charge). There will be a 'light touch' approach to genuine mistakes and penalties for six months from October where businesses are aiming to comply and act in good faith. Businesses knowingly claiming end user status when the reverse charge should have applied, however, will be liable for the tax due and may be liable for penalties.

HOW WILL THE CHANGES AFFECT YOU?

The new rules will have a significant effect on VAT compliance and cashflow. Key questions to consider include:

- is the reverse charge likely to apply to supplies to and from other VAT-registered contractors and subcontractors you deal with?
- how will your accounting systems calculate and report reverse charge supplies?
- how will you check on an ongoing basis that supplies and purchases are treated correctly?
- will your cashflow suffer if you no longer hold output tax, and would changing to monthly VAT returns help?
- if you use the VAT Flat Rate Scheme, how will the charge impact you?

Overall, the change may mean that the construction sector is likely to be subject to considerable HMRC scrutiny in the foreseeable future. Under the rules, for example, some subcontractors, with VAT to reclaim on inputs but no VAT to charge on outputs, will regularly receive VAT refunds. A regular repayment position could trigger a VAT inspection. For these reasons, we would recommend taking stock of VAT and CIS compliance across the board.

How we can help

In this factsheet we have only been able to touch on some of the key issues. Please contact us for an in-depth discussion on the matter.