



VAT REVERSE CHARGE

Levine House
233 Wigan Road,
Ashton-in-Makerfield • Wigan
Lancashire • WN4 9SL

T: (01942) 203255
E: info@fpsaccountants.com
W: www.fpsaccountants.com

Directors

Emma J. Thacker att
Amanda J. Kershaw fcca



chartered certified accountants

New VAT rules for construction

In this brief guide we look at the 'Domestic Reverse Charge' (DRC) that is to be introduced for VAT on construction services from 1 March 2021. This was announced in a consultation in early 2018, with the intention that it should be introduced on 1 October 2019. It was delayed for a year because of Brexit, then delayed another 5 months because of the pandemic. As far as we can tell, Brexit and the pandemic will still be with us on 1 March 2021, but we have to be prepared for the new rules to be introduced without a third delay. There are links to HMRC's detailed website guidance at the end of the newsletter.

What's it all about?

HMRC has lost a great deal of money over the last 20 years to 'missing trader fraud'. Someone charges VAT to a customer, receives payment, and disappears without paying anything to HMRC; the customer then claims the VAT back as input tax from HMRC, who may pay out the claim before they realise they have not collected the money from the supplier. Some frauds involve international transactions, but there has been an increasing problem in the UK construction industry (as well as other sectors).

To deal with this, the normal rules of VAT are being set aside. VAT is normally based on the principle that the final consumer bears the cost of the tax, but it is collected by everyone who has contributed in the supply chain.

Example

W sells something to X for £1,000 plus VAT. X sells it to Y for £1,500 plus VAT. Y sells it to Z, a consumer, for £3,600.

Z bears the total VAT of £600 (one sixth of £3,600). It is paid to HMRC in stages by W (£200), X (£300 output tax less £200 input tax, £100) and Y (£600 output tax less £300 input tax, £300).

The benefit to the government of charging VAT at every stage is that it makes the tax hard to avoid: all traders have to charge it on all transactions. However, it gives W an excuse to charge £1,200 for something that is only worth £1,000; X may pay the gross amount in good faith, believing that the cost will only be £1,000, and then end up arguing with HMRC if W has disappeared with the £200.

How does this help?

A 'reverse charge' system means that the supplier does not add output tax to a sales invoice. Instead, the customer reports the tax in Box 1 of their VAT return, and claims it back in Box 4. Only the last stage in the chain is charged to VAT in the normal way.

Example

Taking the above figures, Z still bears the total VAT of £600 (one sixth of £3,600). W charges £1,000 with no VAT to X. X puts £200 in Box 1 and Box 4 of the VAT return, and charges £1,500 with no VAT to Y. Y puts £300 in Box 1 and Box 4 of the VAT return in respect of the purchase, as well as £600 in Box 1 in respect of the sale; Y charges £3,600 to Z and pays £600 to HMRC.

Because all the VAT is accounted for only at the final stage, W and X have no opportunity to charge VAT and disappear with it. Although it is not explicitly stated in the rules, it is probably true that Y and Z are less of a risk for HMRC:



in the construction industry, Y is likely to be a main contractor and Z either owns or has just bought a building. They are less likely to disappear than the suppliers at the beginning of the chain (although it is still possible).

The Construction Industry Scheme (CIS)

The reason that the new VAT rules are particularly complicated is that there is already an anti-fraud system in place in the construction industry, and the DRC has been developed to operate alongside it. As a general rule, a transaction will either be within both or outside both – HMRC appears to have listened to representations that making them widely different would cause huge confusion. However, they are not exactly the same, and there will be plenty of opportunity for mistakes at the borders. Businesses that are familiar with CIS should not make assumptions about how the new VAT rules will operate.

The CIS is aimed at a different type of tax fraud – paying builders in cash that they do not declare to HMRC as income, thereby evading income tax and National Insurance Contributions (if they are self-employed) or corporation tax (if a company). In very brief outline, under the CIS:

- people who provide construction services are 'subcontractors', who are allocated a tax status by HMRC – if they meet certain conditions they can be paid gross, or may be subject to deductions of 20% tax from their invoices, but will be subject to deductions at 30% if they have not applied for more favourable status;
- a 'contractor' is required to check the tax status of a 'subcontractor' and make deductions as required from all payments, handing the money over to HMRC;
- the subcontractor can offset CIS deductions against various types of payment to HMRC.

The 'big idea' of CIS is that those who can be paid gross have satisfied HMRC that they will account for their income honestly; those who suffer 20% or 30% deductions from their turnover, without allowing for any expenses, are likely to need to file returns in order to claim back an overpayment.

Cash flow

The effect of CIS deductions on cash flow can create problems for subcontractors; the introduction of the DRC is likely to make those problems worse.

Example

M Ltd is subject to 20% CIS deductions. On an invoice for £10,000 + 20% VAT, the company will be paid £10,000 by the customer (80% of the net £10,000, plus all the VAT). The £2,000 CIS deduction can be offset against PAYE liabilities or, in due course, against corporation tax. The £2,000 VAT has to be paid to HMRC a month after the end of the VAT quarter.

Once the DRC is introduced, the customer will only pay M Ltd £8,000. The VAT will not be received and paid over – it will not enter M Ltd's bank account at all.

Construction businesses that have in the past been net payers of VAT to HMRC may become 'repayment traders' – with no VAT on their sales, but input tax on purchases of materials and on overheads. HMRC's guide suggests that such traders may wish to move to making their VAT returns monthly, in order to accelerate repayments. Filing 12 returns a year rather than 4 will require more frequent attention, but should not be too difficult for those using a software package.

Deemed contractors

One important difference between CIS and DRC is the existence of 'deemed contractors' within the CIS – businesses that would not normally be considered to be 'building contractors' but which spend on average £1 million a year on construction work over 3 years. Such businesses are required to make deductions from businesses who supply them with construction work.

By contrast, a CIS 'deemed contractor' is likely to be 'the last stage in the chain' for DRC – the person who is supposed to pay all the VAT to their supplier, who pays it all to HMRC. So a supply to a 'deemed contractor' is subject to the CIS but is intended not to be subject to the DRC. However, the rules on 'end users' appear to allow the customer – the end user – to choose whether or not the DRC applies to their purchases (explained below).

Checking status

Another important difference between the CIS (which is familiar to construction businesses) and the DRC (which is not) is the responsibility for checking. The obligations under CIS fall on the customer – checking the supplier's status and making the appropriate deductions. The obligations under DRC fall mainly on the supplier – considering whether to charge VAT or to apply the DRC. Some of the questions appear to be similar, but they are asked by a different person for a different reason.

When the reverse charge applies

The DRC applies to construction supplies with a tax point on or after 1 March 2021. Fortunately, there are no rules to apportion an invoice raised from that date where the work was done beforehand – it is all within the new rule. Similarly, invoices raised before that date are all within the 'normal' VAT rules.

From 1 March 2021, a supply must be accounted for using the DRC when the following apply:

- the customer is registered for VAT in the UK;
- payment for the supply is reported within the CIS;
- the services are standard (20%) or reduced rated (5%);
- the supplier is not an employment business (see below) supplying either staff or workers, or both;
- the customer has not given written confirmation that they are an end user or intermediary supplier (see below).

These details therefore have to be checked by the supplier before raising an invoice, and preferably before taking on the work. Often these details will have been known in the past, but now there must be a procedure in place to check them. Note in particular that:

- the requirement for the customer to be VAT-registered is because the VAT will be accounted for on the customer's VAT return – they have to be a person who files one;
- traditionally, CIS checking has been the responsibility of the customer, but now the supplier has to confirm that the customer is a CIS contractor before raising an invoice;
- the DRC sensibly does not apply to zero-rated supplies (e.g. house construction) because there would be no entry in Box 1 or Box 4 in any case;
- the status of 'employment businesses' (who must charge VAT on their sales) and 'end users or intermediary suppliers' (who must be charged VAT on their purchases) are areas where the DRC and CIS rules differ, and are therefore likely to cause confusion.

Employment businesses



HMRC's technical guide on the DRC says: 'Employment businesses are treated differently for the purpose of the reverse charge. Supplies by employment businesses are not subject to the reverse charge, even if those supplies are within the scope of CIS. Employment businesses supplying construction workers are, for VAT purposes, treated as supplying staff rather than building and construction services. For VAT purposes, such activities of workers are supplies of staff by their employer and not supplies by the workers themselves. The supplier makes a supply of staff for VAT purposes if it provides another person with the use of an individual who is:

- contractually employed or otherwise engaged by the employment business;
- a director of the employment business.

On the other hand, services provided by 'labour only subcontractors', who are responsible for the works carried out, are within the DRC. The technical guide says that 'the simplest way to tell the difference' is:

- labour only construction services – the business supplying the labour will be responsible for overseeing the completion of the work carried out by the workers;
- staff – the customer that receives the workers will be responsible for overseeing the completion of the work carried out.

One possible problem is that some missing trader frauds have been carried out by employment businesses charging VAT on supplies of workers and disappearing. If they are excluded from the DRC, they are still entitled to charge VAT, and the opportunity for this fraud is therefore still present. It is not clear why they have been excluded 'even if those supplies are within the scope of CIS', because it appears to be a substantial loophole.

If a contractor buys in supplies of workers from an employment business, paying VAT as required by the rules, the contractor will be at risk if the supplier goes missing. HMRC may refuse to give credit for the VAT as input tax while the matter is investigated; if the contractor has failed to carry out adequate due diligence to be satisfied of the good faith of the supplier, that denial of credit may become permanent on the grounds that the business 'knew or ought to have known' that the supplier intended to carry out a fraud.

End users and intermediary suppliers

For DRC purposes, an 'end user' is someone who does not make onward supplies of the building and construction services supplied to them. They are the last person in the chain, who is supposed to pay all the VAT to their supplier.

They must be a CIS contractor – if they were not, the DRC would not apply in any case. Examples would be a substantial property investor spending over £1 million a year on properties rented to tenants, or a developer paying for the construction of a building with the intention of selling it.

The VAT charge is moved further back down the chain where there is an 'intermediary supplier' – a CIS-registered business that is connected to the end user. So if a construction business supplies services to a company in the same corporate group as the end user, which will supply the building or services on to the end user, VAT is supposed to apply.

The regulations state that the DRC must be applied unless the supplier has written notification from the customer that the customer is an end user or an intermediary supplier within the meaning of the rules. This notification can be made on paper and sent by post, or electronically in an e-mail, or can be included within the building contract.

The curious point about this rule is that it does not impose an explicit requirement on the customer to issue the notification if it applies, nor does it require the supplier to consider whether the customer ought to issue a notification. If there is no notification, the supplier is required to use the DRC, and the (unnotified) end user will have to account for the output tax in Box 1 of the VAT return and claim it back in Box 4 to the extent that the building is used for taxable purposes.

It is strange that HMRC has left this important point – the identification of the last link in the chain – apparently to be policed entirely by suppliers, and apparently subject to the customer's choice. If the customer chooses not to give the notification, it appears that the supplier is required to charge no VAT. Suppliers may prefer to encourage their customers to give the notification if it appears to apply to the situation, but there is no legal requirement to do so. It may be that HMRC regards this end of the supply chain as very low risk – after all, for the question to arise, the customer is VAT-registered and CIS-registered, and has probably just bought a building. They are unlikely to become a missing trader.

HMRC's technical guidance says 'If you often deal with end users or intermediary suppliers, you can include a statement in your terms and conditions to say you'll assume that your customer is an end user or intermediary supplier unless they say they're not. This places a responsibility on the customer to respond if this is not the case.'

Detailed requirements

HMRC's guidance gives the following lists of supplies that are 'in DRC' and 'outside DRC':

You **must use** the reverse charge for the following services:

- 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.

Do not use the reverse charge for the following services, when supplied on their own:

- drilling for, or extracting, oil or natural gas;
- extracting minerals (using underground or surface working) and tunnelling, boring, or construction of underground works, for this purpose;
- manufacturing building or engineering components or equipment, materials, plant or machinery, or delivering any of these to site;
- manufacturing components for heating, lighting, air-conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection systems, or delivering any of these to site;
- the professional work of architects or surveyors, or of building, engineering, interior or exterior decoration and landscape consultants;
- making, installing and repairing art works such as sculptures, murals and other items that are purely artistic signwriting and erecting, installing and repairing signboards and advertisements;
- installing seating, blinds and shutters;
- installing security systems, including burglar alarms, closed circuit television and public address systems.

There are detailed rules on the following situations, where the HMRC guidance should be referred to for more information.

Mixed supplies – where some of the supply is within the scope of DRC and some is not, the general rule is that the DRC will apply to everything. This includes a supply of services with materials, where the materials element is not subject to a CIS deduction. But if the DRC element is only 5% or less, it can be ignored and VAT applied to the whole supply.

Change of VAT treatment during a contract – if the customer's status changes (e.g. becomes or ceases to be VAT-registered or CIS-registered), the customer must notify the supplier to enable the correct VAT treatment to be applied.

Paperwork

Invoices and credit notes are still required to show all the information that should be on a VAT invoice, and should:

- make a note on the invoice to make it clear that the domestic reverse charge applies and that the customer is required to account for the VAT (for example 'reverse charge: VATA 1994 section 55A applies');
- clearly state how much VAT is due under the reverse charge, or the rate of VAT if the VAT amount cannot be shown, but the VAT should not be included in the amount charged to the customer.

Accounting

VAT returns should, of course, now be submitted using Making Tax Digital. Accounting software packages should be designed to cope with reverse charges, but any change of system requires care and attention, training and practice, to make sure that the programmed functions are used correctly in an unfamiliar situation.

People who use spreadsheets and bridging software

to comply with MTD will have to take extra care. For a supplier, a DRC sale can be accounted for in much the same way as a zero rated supply. There is simply no VAT; the sale appears in revenue and in Box 6 of the VAT return. The customer's position is more complicated. The problem is that a reverse charge appears on the customer's VAT return as a sale and a purchase, affecting Boxes 1, 4 and 7. However, for the accounts it is only a purchase - it would be wrong to inflate revenues and costs in the financial accounts. A software package should deal with this correctly, but a spreadsheet will have to be adapted.

Flat rate scheme for small businesses (FRS)

Reverse charge supplies are not to be accounted for under the FRS. FRS users who receive reverse charge supplies will have to account for the VAT due to HMRC and recover it simultaneously on the same VAT return.

A business that makes a significant proportion of supplies subject to DRC is likely to be disadvantaged by using FRS. Even within the FRS, it will not be necessary to account for FRS VAT on supplies on which no VAT has been collected from the customer; however, the difference between the FRS VAT and VAT charged to customers is intended to compensate the FRS trader for not being entitled to any input tax deduction, and not charging output tax to customers means that compensation is not received. A builder making supplies under the DRC is likely to be better off using the normal rules of VAT to reclaim input tax on costs. It is possible to apply to leave the FRS and use the normal rules with effect from a particular date – 28 February 2021 would be the natural choice if this applies.

A light touch?

HMRC's technical guidance includes the following message:

'HMRC understands that implementing the reverse charge may cause some difficulties and will apply a light touch in dealing with any errors made in the first 6 months of the new legislation, as long as you are trying to comply with the new legislation and have acted in good faith.'

Any errors should be corrected as soon as possible, as the longer under-declared or overcharged sums remain outstanding the more difficult it may be to correct or recover them.'

HMRC officers may assess for errors during the light touch period, but penalties will only be considered if you are deliberately taking advantage of the measure by not accounting for it correctly.'

The promise that 'only the VAT' will be collected and penalties will 'probably not be considered' is not very reassuring when such a major change is being made to the system. It is likely that HMRC officers will also have some difficulties getting used to the new rules. The most important thing is to have thought through the effects well in advance: we have had two delays that have given all those affected time to make preparations, and – in spite of Brexit and the pandemic – HMRC will expect everyone to be ready.

References:

www.gov.uk/government/publications/construction-industry-scheme-cis-340/construction-industry-scheme-a-guide-for-contractors-and-subcontractors-cis-340

www.gov.uk/guidance/vat-reverse-charge-technical-guide

www.gov.uk/guidance/how-to-use-the-vat-reverse-charge-if-you-supply-building-and-construction-services

www.gov.uk/guidance/how-to-use-the-vat-reverse-charge-if-you-buy-building-and-construction-services