

## The new VAT reverse charge mechanism for construction services

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From 1 March 2021, after a year and a half delay, a domestic 'reverse charge' will be introduced for specified construction services. Under the new legislation, the recipient of services supplied in the construction industry will be required to account directly to HMRC for VAT due on payments for services, rather than paying the supplier for both fees and VAT (ie gross).

The government predict that this change in legislation will affect around 150,000 businesses in the construction sector.

### Why is this change happening?

The aim of this new legislation is to combat the tax revenue lost as a result of so-called 'missing trader fraud' whereby suppliers are paid VAT but do not pay it over to HMRC. The construction industry is seen as one in which VAT fraud is prevalent both domestically and via exploitation of cross border rules (see more detail on this below). The new rules will apply in circumstances where the Construction Industry Scheme (CIS) also operates. The change was initially supposed to come into force on 1 October 2019 but was delayed for a year and a half due to industry concerns that some businesses were not ready to implement the required changes.

### The context

In a standard VAT supply chain, a VAT registered construction company accounts for VAT in two ways when buying and selling services:



1. Charging VAT to customers when the customer buys goods or services from the company (**output tax**)
2. Being charged VAT by a supplier when the company buys goods or services from the supplier (**input tax**).

At the end of every quarter, the company will submit a VAT return to HMRC giving details of their output tax and input tax. If output tax exceeds input tax, the company is only required to pay the value of output tax less the value of any input tax, ie the net amount of the VAT it collects. If the opposite is true and the input tax exceeds the output tax, the company can claim a refund directly from HMRC for the excess tax (a 'repayment position').

## What is missing trader fraud?

VAT fraudsters take advantage of the VAT collection system by avoiding payment of VAT (where output tax exceeds input tax as explained above) or by fraudulently claiming repayments (where input tax exceeds output tax).

A simple example would be a fraudster acquiring goods from the EU without VAT (under EU rules) and then charging VAT to its UK customer. Shortly after the VAT has been collected, the fraudster then disappears without declaring or paying over that VAT to HMRC. As a result of missing trader and similar types of fraud, it is estimated that the government loses around £100m a year.

## Which services will the new reverse charge apply to?

The reverse charge will apply to individuals or businesses supplying or receiving 'specified services', these being defined as 'construction operations' for the purposes of the CIS. This will include a wide range of services such as construction, alterations, repairs, extensions, demolition, civil engineering, the installation of heating, air-conditioning and lighting, as well as painting and decorating.

The reverse charge will apply to supplies between VAT registered businesses where the recipient of the services will make an onward supply of those 'specified services' (ie transactions in the chain of supply of construction services). If the recipient purchases the services for any purpose other than making an onward supply (for example, if they are a land owner who will be granting leases of new constructed properties), they will be defined as an 'end user' and the reverse charge will not apply. Similarly, if a supplier buys construction services and re-supplies them to a customer, without making any material alterations to the supplies, this supplier will be classed as an 'intermediary supplier' and treated as if they're an end user. In both of these circumstances, VAT will apply as usual.

It is possible for a design and build contractor to be classed as an intermediary supplier if the necessary conditions are met. Under a design and build contract, the contractor will buy services from multiple consultants and contractors and then provide a single supply to the client of the designed and built project. So far as the D&B contractor does not carry out material alterations to the services it buys in, the VAT reverse charge will not apply.

In order to confirm the reverse charge will not apply to the services being supplied to 'end users', the supplier must ask the customer (or end user) to confirm that they are not intending to make an onwards supply by written notification. The supplier should also ask the customer to confirm their VAT and CIS status, as well as providing their VAT number.

## How will it affect my business?

If you receive construction services within the reverse charge scheme, you will now have to pay the VAT charged on those services directly to HMRC, rather than paying the supplier. The invoice from the supplier will record



the VAT payable, but it will be detailed as a 'reverse charge'. You will claim the VAT accounted for as input tax in the same return. Essentially, money paid as VAT for the specified services will no longer pass between businesses, it will be paid directly from the customer to the government.

From an operational point of view, VAT invoicing and VAT accounting for supplies of specified construction services will significantly change. If your supplies of services are subject to the reverse charge, you will most likely need to update your accounting systems, software and procedures, and train relevant personnel to use them. This reconfiguration is likely to carry a one-off cost as well as possible disruption of everyday business while the transition happens. There may well be ongoing costs too, including familiarising staff with reverse charge calculations and recording them, ensuring supplies are correctly treated if the reverse charge applies, and reporting reverse charge supplies on VAT returns.

Whilst some services in a composite supply may not fall within the scope, the reverse charge has been designed in such a way that if there is a reverse charge element in a supply of services, the whole supply will be subject to the reverse charge at domestic rates. Similarly, if the original services are not subject to the reverse charge, but subsequent services fall within the scope, the VAT treatment of that entire project will have to change to introduce the reverse charge. Companies will therefore be required to carry out ongoing reviews of the VAT position throughout a construction project, which could be administratively burdensome. Staff will also have to be trained to regularly monitor a project's VAT position.

Secondly, if you are currently using your output VAT to support cash flow in your business (ie the VAT you retain prior to paying it over to HMRC), you will need to consider the potential impact of no longer holding this cash. Whether this will be an issue for your business will be case-specific and dependent on your company's financial structure and sources of working capital. However, given the recognised cash flow challenge faced by many subcontractors in our industry, the VAT changes may present a significant commercial risk for some.

Unlike the first attempt at introducing this new legislation, HMRC has acknowledged that implementing the reverse charge may cause difficulties for some companies and has confirmed that they will apply a 'light touch' in dealing with errors made in the first 6 months of the new legislation (as long as the company can show they acted in good faith and were trying to comply).

## How can you minimise the impact on your business?

Most importantly, prepare for the impact ahead of time. As a business in the construction sector, we encourage you to review supplies received from and made to other VAT registered businesses to establish whether they are subject to a reverse charge. If you are a contractor, you will need to review contracts with clients to decide if the reverse charge will apply to those supplies. In most cases, the client will be an end user, but you should obtain confirmation from the client that they do not intend to make an onwards supply. As a contractor, supplies made to you from sub-contracts will most likely be subject to the reverse charge regime so you will need to ensure the invoices sent to you and your VAT accounting are correct.

If you are a sub-contractor, it is likely that your supplies will fall within the scope of the reverse charge as a main contractor will not usually be an end user. Despite this, it is still worth checking if your customers intend to make an onwards supply.

To ensure that the exclusion applies where supplies are made to 'end users', ask that customer to confirm their end user status, their CIS status and their VAT number.

Once you have identified which of your services will be affected by the reverse charge, you can begin to prepare for 1 March by updating your accounting systems and software and training relevant staff.



If your business relies on VAT collected to provide some working capital in the interim period before remittance to HMRC, you will probably suffer some loss of cash flow. In these circumstances, we advise reviewing the payment terms in your contracts to see if your existing contractual provisions will be sustainable after the legislative change. Furthermore, as a result of the reverse charge, you may find that your VAT return changes from being a net payment to HMRC to being a net claim. In these circumstances it may be worth considering moving to monthly accounting to improve cash flow.

With less than two months until this legislation comes into force, it is vital to be proactive in managing and mitigating the potential impact of the reverse charge. Consider any adaption required to your accounting systems and necessary training ahead of time. Preparation will be key to avoiding disruption in your day-to-day operations after 1 March.

## How we can help

From developers, investors and contractors to high net worth individuals, our construction lawyers provide a wealth of expertise and ensure construction contracts are well drafted and watertight. We can also assist with construction disputes. To find out more, please contact our [construction team](#).