

VAT: domestic reverse charge in the construction industry

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2019 promises to be a year full of challenges for VAT compliance. 1 April 2019 sees the introduction of the new rules around Making Tax Digital ("MTD"); six months later, on 1 October, the Construction Services Domestic Reverse Charge ("CSDRC") is introduced.

The first thing to understand is that, despite its name, the CSDRC is nothing to do with private households. It is "domestic" only in the sense that it applies to transactions wholly within the UK. Like similar rules that have applied for some time to supplies of certain high-risk goods such as mobile phones and computer chips (albeit with important differences of detail) the new regulations are intended to counter "missing trader fraud"—that is, where a trader reclaims as input tax on purchases an amount of VAT that the supplier has no intention of ever paying over to HMRC.

What are the key points?

- With effect from 1 October 2019, a person supplying certain construction industry services to a VAT-registered customer will no longer be required to account for VAT. Instead the customer will account for VAT under a "reverse charge" arrangement. That is, the customer will account for VAT as if he had himself made the supply (to himself) and will also, if and to the extent appropriate, recover the same VAT as input tax. The effect is, of course, to remove any risk that there may be deducted as input tax an amount which has never been paid over as output tax.
- The CSDRC applies only to supplies which would otherwise be subject to VAT at the standard or reduced rate. It does not, for example, apply to zero-rated supplies or supplies made by someone who is neither registered nor required to be registered for VAT (for example, where the supplier is below the VAT registration limit).
- The list of services to which the CSDRC applies ("construction services") has a familiar ring—they are the same services as those to which the Income Tax Construction Industry Scheme ("CIS") applies. They thus extend not only to construction but to alteration or repair of buildings, some types of electrical and plumbing work, site clearance etc. The CSDRC also extends to any goods or materials supplied in conjunction with "construction services".

- The CSDRC applies only to services that are made to a contractor: it does not apply to an “end-user” customer. However, there may be situations when this rule may be relaxed where both parties agree. Further guidance is due to be published by HMRC in the coming months which will shed light on this.
- Unlike some other “reverse charge” schemes, amounts accounted for under the CSDRC will not count towards the VAT registration limit. This means that if a customer is not already required to be registered for VAT, the CSDRC “deemed self-supplies” will not make him so.

What does this mean for you?

The interaction of both MTD and CSDRC may cause confusion over when a business is required to comply with the MTD rules (i.e. 1 April or 1 October 2019), but also over whether the software used for complying with the reverse charge is MTD compliant.

Subcontractors may need to consider the loss of cashflow. The (legitimate) opportunity to use VAT to fund cashflow between the time it is received from the customer and the time it has to be paid over to HMRC will no longer exist. By the same token, however, **contractors** will no longer suffer a delay between paying out VAT and recovering it, since both will now be dealt with on the same VAT return. Construction services may be charged VAT at different rates dependent upon what work is being undertaken i.e. 20% / 5% / 0%. The onus will now be on the contractor, to verify the correct rate to be used for the reverse charge (or if is to be used at all).

Before agreeing not to charge VAT on a taxable supply, a supplier of “construction services” will need to be satisfied that the supply falls within the CSDRC (and in particular that the customer is a VAT-registered contractor not an end-user). It remains to be seen what steps a supplier will be expected to take to verify this or what the position will be should he get it wrong.

Finally, additional clarity is required from HMRC in the coming months on:

- The treatment for construction works which may have been supplied or contracted for before 1 October 2019, but paid for afterwards
- What happens if a customer either ceases to be, or becomes, an end user during a contract

We will pass on an update as and when this is provided.

Background to the CSDRC

A technical consultation on the CSDRC took place in June and July 2017. Like the Domestic Reverse Charge that is currently in place for the sale of computer chips, emissions allowances and mobile phones it aims to prevent “missing trader” fraud.

Ordinarily, a supplier making taxable supplies in excess of the VAT registration limit (currently £85,000 annually) is required to account to HMRC for VAT at the appropriate rate on the value of those supplies. Depending on the nature of the supplies (and in some cases, the nature of the customer) VAT may be chargeable at the standard rate of 20% or at a reduced or zero rate. Where the customer is registered for VAT and receives the supply

for the purposes of making its own taxable supplies, the customer is entitled to recover the VAT charged on the supply (“input VAT”) on its own VAT return. The system ensures that the burden of VAT is effectively borne by the ultimate non-VAT-registered consumer – typically a private individual or a VAT-exempt business.

However, one obvious way in which the system is susceptible to fraud is where a supplier charges VAT on the services provided, is paid VAT by its customer but then goes “missing” before paying it to HMRC. Where this happens, HMRC are left out of pocket to the value of the “missing” VAT.

This can, of course, happen in any industry. But where it has been found to be particularly prevalent, HMRC have taken steps to modify the normal operation of VAT by introducing a “reverse charge” regime. This applies to specified goods and services and has applied to:

- mobile phones (from 1 June 2007)
- computer chips (from 1 June 2007)
- wholesale gas (from 1 July 2014)
- wholesale electricity (from 1 July 2014)
- emission allowances (from 1 November 2010)
- wholesale telecommunications (from 1 February 2016)

The scheme will be extended to “construction services” from 1 October 2019, though some of the more onerous of the existing rules will not apply to the extension.

HMRC’s approach

Fundamentally, “missing trader” fraud is countered by shifting the responsibility to account for VAT from the supplier (i.e., in the context of construction services, the subcontractor) to the customer (i.e., the contractor).

Thus, instead of paying VAT to the supplier, the customer becomes liable to account on its VAT return for VAT at the appropriate rate on the supply. The customer may recover that VAT amount as input tax, subject to the normal rules – where the customer is a fully taxable business as will usually be the case, this would result in a nil net tax position with no VAT being due to HMRC. But, crucially, the risk that HMRC will give credit for VAT that they have never actually received is removed.

The CSDRC will apply to VAT registered businesses which supply certain services to other VAT registered businesses, but only where the recipient business then makes an onward supply of the same construction services. The supplier will be required to issue a VAT invoice stating that the services are subject to the CSDRC.

Which supplies are affected by the DRC?

The CSDRC applies to “construction services”. The definition is the same as that used in the long-established Construction Industry Scheme (“CIS”) and so will be familiar to most

businesses operating in the industry. Thus, the supplies which will be covered include (but will not be limited to):

- Construction, extension, demolition, alteration or repair of buildings or of any works forming part of the land
- Installation in any building (whether or not in the course of construction) of a heating, lighting, air conditioning, power, water, drainage etc system
- Internal cleaning of buildings (so far as carried out in the course of construction, extension, etc)
- Painting or decorating the internal or external surfaces of any building

It also applies to those services which form an integral part of any of the services described above or are preparatory to them or for rendering them complete.

Which supplies are excluded?

Supplies which are excluded from the definition of construction services where supplied on their own include (but will not be limited to):

- Manufacture of components for systems of heating, lighting, air conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection
- Professional services of architects or surveyors, building consultants etc
- Installation of seating, blinds and shutters
- Installation of security systems such as burglar alarms, closed circuit television and public-address systems

Where a supply is zero-rated for VAT purposes (as for example most services related to housebuilding) there is obviously no risk to the Exchequer from “missing trader” fraud and such supplies are not within the CSDRC. In addition, there is a *de minimis* limit: where in any month the value of CSDRC supplies made to a particular customer does not exceed £1,000, those supplies fall outside the scheme.

Additional points

Certain additional points of interest have arisen from recently published HMRC guidance. These include:

Registration limit

Ordinarily, where a business receives “reverse chargeable” services, these are considered when looking at the VAT registration limit. However, the legislation update confirms that the value of supplies within the CSDRC scheme does not count towards the VAT registration threshold for the customer. This is good news especially for smaller businesses which are trading just below the £85,000 limit.

Reverse Charge Sales List

The provisions which require an online return to be made of “reverse charge” goods do not apply to services, so are of no relevance to the CSDRC.

‘Labour only’ services

HMRC initially proposed that the CSDRC would apply only to ‘labour only’ supplies of construction services. However, it is now intended that it will cover the provision of construction services that includes materials and will therefore catch many more businesses than initially thought.

Mixed supplies

The legislation is designed so that if there is a “reverse charge” element in a mixed supply then the whole supply will be subject to the CSDRC. This is to make it simpler for both the supplier and customer, and to avoid the need to apportion or split out the supply.

‘End user’

Importantly, the CSDRC applies only to services which are required to be included in a return of payments under the CIS. These returns are made mainly by contractors, but also extend to “deemed contractors”—businesses that are not contractors, but which spend more than £1m a year on construction operations. However, the CSDRC excludes “end users”—businesses buying construction services for their own use rather than to sell on—so supplies made to CIS “deemed contractors” will usually be outside the scope of the CSDRC.

Further, the CSDRC does not apply (except in special circumstances and only then by election) where the services are supplied to an “intermediary supplier” whose onward supply is either to a connected person (such as a company in the same group) or is between landlord and tenant.

Importance of status

It will be important both for suppliers and customers to be aware of their responsibilities under the CSDRC. **Suppliers** will need to be confident, before agreeing not to charge VAT, that a customer is in fact a contractor and not an “end user”. **Customers** will need to ensure that a supplier does not incorrectly charge VAT on supplies that ought to fall within the scheme, for such VAT will not be recoverable as input tax. In each case, robust systems will need to be in place to give the necessary confirmations.

How will HMRC be enforcing the CSDRC?

In the first six months following implementation, HMRC will apply a light touch in dealing with errors, where businesses are genuinely trying to comply with the new legislation. However, where businesses knowingly fail to account for the reverse charge when it should have been due, penalties may be due.