

Reverse charge for construction services

(Lecture B1130 – 13.13 minutes)

Background

The starting point with any transaction is that the supplier charges VAT on a taxable supply of goods or services made in the UK and accounts for output tax on a VAT return – and hopefully pays this output tax to HMRC.

HMRC has identified that certain supplies have been prone to Missing Trader Fraud, where the supplier charges VAT to a customer and disappears. These supplies are often linked to transactions where there is little input tax sacrificed by the fraudulent business i.e. the “stolen VAT” becomes a sales tax rather than a margin tax. HMRC has identified that there has been a big tax loss with businesses involved selling certain construction services.

Reverse charge

With effect from 1 October 2019, the VAT position will change as far as transactions concerning certain supplies of construction services is concerned. From this date, the customer will account for the VAT by doing the reverse charge on his own VAT return. This means that the supplier neither charges VAT to nor collects VAT from his customer. The reverse charge will apply to the following transactions:

- The legislation refers to ‘specified services’ but these do not apply to services supplied to non-construction businesses, such as a high street retailer having his premises improved or any other end user customer or building owner;
- The reverse charge will also apply to any goods supplied by the builder as part of his work;
- Supplies between landlords and tenants are excluded from the reverse charge as well as supplies involving connected parties. In such cases, the supplier will continue to charge VAT as happens now;
- The reverse charge will be based on the VAT rate applying for the work in question, but only supplies subject to either 5% or 20% VAT i.e. excluding zero-rated sales.

Example

Mike is an electrician, VAT registered as a sole trader. He is doing some work on an office block, invoicing the main contractor Steve for his work, and Steve will then invoice the building owner.

Mike will not charge VAT to Steve because Steve will deal with the VAT on his own return by doing the reverse charge. This will be a ‘nil’ outcome for Steve because his onward supply to the building owner is taxable (20% VAT) so he gets input tax recovery in Box 4 when he does the reverse charge entry. Steve will charge 20% VAT on his sales invoice to the building owner because his client is not in the construction industry i.e. the normal rules apply.

VAT return boxes

Going back to the previous example, if Mike charged VAT on his supply, let's say for £5,000 + VAT, then the following entries would be made on his VAT return:

Box 1 – output tax - £1,000

Box 6 – outputs - £5,000

Steve's VAT return would be recorded as follows:

Box 4 – input tax - £1,000

Box 7 – inputs - £5,000

The overall figures are unchanged with the reverse charge legislation – all that happens is that the Box 1 entry recorded by Mike will instead be included on Steve's return – so Mike will only record the net value of the sale in Box 6 i.e. £5,000.

Other issues

There is a precedence of certain supplies of goods and services being subject to the reverse charge as an anti-fraud measure, particularly mobile phones and computer chips if the value of the supply exceeds £5,000. A few other points to consider:

Checks should be applied to ensure that building contractor clients being invoiced under the new rules are properly registered for VAT and are bona fide – see VAT Notice 735, section 9.

Sales invoices should include a reference to 'reverse charge' i.e. so that the customer knows he must account for output tax with the appropriate calculation.

The amount of VAT relevant to the calculation should also be shown on the invoice (usually 20% of the net invoice amount or 5% in some cases) but it must be very clear that the supplier is not charging this VAT.

HMRC suggests that if there are any doubts about the credentials of a customer, then a deposit equal to the amount of output tax not being charged should be collected from the customer e.g. if he has applied for but not received his VAT number.

VAT Notice 735, para 9.3.1 gives examples of customer checks that should be considered.

Flat rate scheme

In most cases, the new changes will only affect the cash flow of a business. This could be important if suppliers have used VAT money in the past to temporarily provide working capital to their business e.g. collecting VAT from a customer in, say, early January, but not paying it to HMRC until the March VAT return is paid in early May. But there is a potential impact on net profit for a construction business that uses the flat rate scheme (FRS), and benefits from the lower rate of 9.5% that applies if at least 10% of the turnover of a supplier relates to materials.

Example

Pete the Plumber has annual sales on £140,000 plus VAT so is eligible to use the flat rate scheme (the annual joining threshold is £150,000 excluding VAT). All of his work is for VAT registered construction businesses and standard rated and because his turnover from materials is £18,000 plus VAT (i.e. greater than 10% of total sales), he can adopt the 9.5% FRS rate for 'general building or construction services'. His total input tax on expenses is £5,000, so his VAT payment with normal accounting would be £23,000 – but with the FRS it is only $£168,000 \times 9.5\% = £15,960$ (gross income X Relevant FRS percentage).

Reverse charge supplies are excluded from the FRS (VAT Notice 735, para 10.8.1), so Pete's VAT returns after 1 October 2019 will be nil returns. It would therefore be sensible for him to withdraw from the FRS in order to claim input tax on his expenses i.e. £5,000 in total. But he will still be £7,040 worse off each year (£23,000 minus £15,960) because he is no longer making a profit with the FRS.

Contributed by Neil Warren