Reverse charge accounting: when is it relevant?

Indirect Tax



19 March 2024

The use of the ‘reverse charge’ has become an important part of the VAT legislation and is relevant to both domestic and international supplies. We explore when and how it is applied.

Key Points

What is the issue?

The reverse charge is an important part of HMRC’s anti-fraud strategy. It was extended to include many supplies in the construction industry from 1 March 2021 and it also applies to sales and purchases of ‘specified goods and services’ between VAT registered suppliers and customers. The article gives practical examples of how the reverse charge works in practice.

What does it mean to me?

It is sensible for UK importers to have an EORI number from HMRC and elect for postponed VAT accounting on all imports. It is a cash flow winner to not pay VAT in the first place – and account for the reverse charge – rather than pay VAT and wait up to three months to claim input tax.

What can I take away?

If a business is not registered for VAT because its sales are exempt from VAT or its taxable sales are less than compulsory registration threshold, it must include the values of services purchased from abroad as part of its taxable turnover figure.

Many advisers will agree that a fundamental weakness of the VAT system is that 5% or 20% tax will be charged by some suppliers who will not declare or pay it on a return submitted to HMRC. However, VAT registered customers will still pay the invoice and reclaim input tax, meaning that HMRC is out of pocket. A big tax leakage has taken place. It is therefore logical to adopt an alternative system for some supplies, so that VAT is not charged by suppliers in the first place to those businesses or organisations that can claim input tax. Welcome to the reverse charge!

In this article, I will consider the main situations when reverse charge accounting must be adopted by a business and the boxes that must be completed on VAT returns in each case.

How does it work?

The reverse charge works as follows:

- It is only relevant to supplies that are subject to 5% or 20% VAT.
- Instead of the supplier charging VAT and accounting for output tax in box 1 of their next return, the customer makes the box 1 entry instead and therefore the supplier does not charge VAT on their sales invoice(s).
- The customer will reclaim the same amount of input tax in box 4, subject to the usual rules for input tax deduction; i.e. adjusting for any exempt, private or non-business use.
- The benefit to HMRC is that the risk of VAT being charged by a supplier and never declared or paid on a return is removed.

Note: The only time that a reverse charge type entry is made in box 2 of a VAT return – rather than box 1 – is for a Northern Ireland based business that accounts for acquisition tax on goods purchased from suppliers based in EU countries. Box 2 is no longer relevant to a business in Great Britain.

Imported goods

A major VAT change took place on 1 January 2021 – the day after the UK's final departure from the EU – which means that the reverse charge now applies to all imports of goods into Great Britain from abroad if the importer elects for this option and instructs its customs agent or freight forwarder accordingly. A business based in Northern Ireland can use it for non-EU imports.

The use of postponed VAT accounting is a 'win win' scenario. It is better to not pay VAT in the first place and carry out a reverse charge entry than pay VAT to HMRC and wait up to three months to claim input tax on a return. It is a cash flow winner!

To use postponed VAT accounting, an importer must be registered for VAT and also have an Economic Operator Registration and Identification (EORI) number. An importer that does not meet these conditions must pay VAT when the goods arrive at the border.

In terms of VAT accounting, the reverse charge will produce entries for output tax and input tax in boxes 1 and 4 of each return (which depends on the VAT rate for the goods in question) and the total cost of the import is recorded in box 7, the inputs box.

Buying services from abroad

If a business buys services from abroad, it will not be charged VAT by the overseas supplier in most cases because the supplier will not be registered for UK VAT. An overseas supplier must usually have a UK fixed or business establishment before it can get a VAT number. See VAT Notice 741A s 3. However, the place of supply for most business to business services will still be the UK, where the buyer is based, so the reverse charge will be carried out on the buyer's next return. See ***Services purchased from abroad: reverse charge accounting.***

The entry that often gets forgotten by accounting staff is the outputs declaration in box 6 – because it seems illogical to make a payment to a supplier and then record it in an income box. However, this is because if an overseas supplier registered for UK VAT, it would charge 20% VAT and make entries in boxes 1 and 6 of its next return; with the reverse charge, the buyer takes over the responsibility to make entries in those boxes. Job done!

Services purchased from abroad: reverse charge accounting

Marie is VAT registered from her hairdressing salon in Manchester and completes calendar quarter returns. She uses the services of two overseas suppliers: a software business based in India; and a hairdressing consultant in France.

She has received:

- a purchase invoice for £5,000 from the Indian supplier (dated 23 February 2024); and
- a purchase invoice for £10,000 from the French consultant (dated 21 March 2024).

Marie paid both invoices in April 2024.

The relevant date for reverse charge accounting is the invoice rather than payment date, even if Marie uses the cash accounting scheme. She will include both invoices on her March 2024 return:

- **Box 1:** £5,000 + £10,000 x 20% = £3,000
- **Box 4:** Input tax is claimed for the same amount because her business is fully taxable and not partially exempt. There is no private or non-business use with these expenses that would also require an input tax restriction.
- **Box 6:** outputs less £15,000
- **Box 7:** inputs less £15,000

Note: This example highlights the fact that the reverse charge applies to services purchased from abroad and not just the EU. That outcome also applied before the UK left the EU.

VAT registration trap

There is a quirk in the legislation about buying services from abroad that has caught out many small businesses over the years – and also some big entities that only make exempt supplies. This is the need to treat purchases of services from abroad as taxable turnover as far as the registration threshold is concerned.

If the value of VATable services purchased from abroad – plus income from UK taxable sales – exceeds £90,000 in any rolling 12 month period, or will exceed £90,000 in the next 30 days (£85,000 in both cases until 31 March 2024), the UK business has a liability to register for VAT. See ***Education provider: compulsory VAT registration.***

Education provider: compulsory VAT registation

Averitus Ltd has annual turnover of £3 million from vocation training fees which are exempt from VAT. Its only VATable income is £60,000 per annum earned from food and drink sales in a staff canteen, which is below the annual threshold of £90,000 (it was £85,000 in both cases until 31 March 2024), so the company is not registered for VAT.

The directors have agreed a deal to use an overseas auditor in the future that will charge an annual fee of £40,000. Annual taxable turnover will be £100,000 so the company will need to register for VAT at some point in the future.

Note: The best way for Averitus to avoid a VAT problem is to continue to use a UK based auditor. The UK company will charge 20% VAT but this will avoid a registration problem because annual taxable sales are now £60,000.

Reverse charge for builders

Reverse charge accounting was introduced for certain supplies in the construction industry as an anti-fraud measure on 1 March 2021. The *raison d'etre* for the legislation is to prevent builders charging VAT and failing to pay output tax to HMRC, the exact scenario I considered in my opening paragraph.

The end result is that some supplies between builders will not be subject to a VAT charge by the supplier because the customer will do the reverse charge instead:

- The services must come within the Construction Industry Scheme (CIS) and the buyer will be registered for both VAT and the CIS.
- The supplier is registered for VAT and their services are subject to either 5% or 20% VAT rather than zero-rated.
- The buyer sells on the construction services in question; i.e. they are not classed as an ‘end user’.
- The reverse charge applies to both labour and materials provided by a builder on a job by job basis.

In terms of accounting for VAT, the relevant boxes for the buyer doing the reverse charge are boxes 1,4 and 7. There is no box 6 entry, as there are with services purchased from abroad, because the builder selling the services will make a box 6 entry instead. Entries are again based on invoice rather than payment dates, even if the buyer or seller uses the cash accounting scheme. See ***Joiner John: reverse charge for builders.***

Joiner John: reverse charge for builders

Subcontractor John is VAT registered and doing joinery work for Contractor Mike on two jobs:

- The first relates to work on the premises of a hotel, where Mike is working for the hotel.
- The second job relates to work on a house that Mike owns and rents out to tenants on a buy-to-let basis.

Mike is registered for both VAT and CIS.

The reverse charge will apply to the hotel job because Mike is selling on the construction services supplied by John. However, John will charge 20% VAT for the house work because Mike is an ‘end user’; i.e. he is not selling on the services.

Note: Mike must tell John in writing that he is an end user for the house job and that John should charge 20% VAT on his invoice(s).

Other reverse charge supplies

The other reverse charge scenarios also relate to anti-fraud strategies and are explained in HMRC’s well written VAT Notice 735. The notice gives clear advice on when it applies to certain domestic sales, described in the notice as ‘specified goods and services’. For example, the reverse charge will apply to any business that sells mobile phones or computer chips to a VAT registered customer where the sales invoice value exceeds £5,000 excluding VAT. It also applies to supplies of wholesale gas and electricity between VAT registered entities.

The specified services are:

- emission allowances;
- wholesale telecommunications; and
- renewable energy certificates.

There is no de minimis threshold for these supplies or the wholesale supplies of gas and electricity.

Note: The word ‘wholesale’ takes its everyday meaning. i.e. supplies are B2B and the buyer intends to sell on the goods or services in question.

© Getty images/iStockphoto