

Reverse charge procedures: some common pitfalls

Indirect Tax

Property Tax



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The reverse charge procedures for the construction industry were introduced four years ago. We explain the basic rules and some common problems that have arisen.

Key Points

What is the issue?

VAT registered buyers and sellers of construction services must be clear about when the reverse charge applies to a supply; i.e. when the customer, rather than the supplier, must declare the VAT. HMRC has the power to issue an assessment where the accounting treatment is incorrect.

What does it mean to me?

If a buyer notifies their supplier that they are an 'end user' in a particular deal because they are not selling on the building services in question, the supplier will still charge VAT in the normal way. The article highlights the fact that end user notifications by buyers are optional.

What can I take away?

Ensure that your clients buying and selling construction services are applying the same accounting treatment to both labour and materials on a particular deal. If a builder issues separate sales invoices for materials, they will still be subject to the reverse charge if it applies to the labour; it is the fact that a contract is for both labour and materials that counts.

Where has the time gone? Somewhat incredibly, it is almost exactly four years since the reverse charge rules for the construction industry were introduced on 1 March 2021.

The aim of the change was to reduce VAT fraud in the building trade; namely, situations where output tax was charged on a supply made by a builder but output tax was not declared and paid on a return. The reverse charge process removes this risk because the VAT registered customer accounts for the output tax instead of the supplier. The customer will usually claim the same amount of VAT as input tax on the same return, meaning there is a neutral cash flow.

I am a massive fan of reverse charge accounting and think it should be extended to other industries. As Del Boy from the hit programme *Only Fools and Horses* might say: 'You know it makes sense, Rodney.'

In this article, I will review the basic rules and highlight some common errors.

How does it work?

As mentioned above, the aim of reverse charge accounting is to reduce fraud in the construction industry. Here is a typical transaction:

- Builder Bob is VAT registered and has done some work for Oberon Builders, charging £10,000 plus VAT. The supply is standard rated and is subject to the

reverse charge rules, so Bob issues a sales invoice for £10,000 and no VAT.

- Bob must note his invoice along the lines of: 'No VAT charged, reverse charge to be accounted for by customer.'
- Oberon will apply the reverse charge and account for output tax of £2,000 in Box 1 of their next return, claiming the same amount as input tax in Box 4. The latter entry assumes there is no input tax block for Oberon with either private, exempt or non-business use.
- Bob will record the sales value of £10,000 in Box 6 of his return (the outputs box) and Oberon will enter £10,000 as an expense in Box 7 (the inputs box).

Here are two common errors:

- Some buyers of construction services think they must include the value of the supply in Box 6 of their return as well as Box 7. This outcome is relevant if a UK business buys certain services from abroad but not supplies in the construction industry. This is because the Box 6 entry is always made by the supplier.
- The supplier must show the amount of VAT that their customer must declare on their return with the reverse charge or the rate of VAT that applies to the job. The answer will usually be 20% but the rules also apply to jobs that are subject to 5% VAT, such as the conversion of a commercial property into dwellings.

Scope of the reverse charge

The reverse charge only applies to builder-to-builder suppliers where both the supplier and customer are registered for VAT and the customer makes an onward supply of services to their own customer. Materials supplied by builders as part of their work are also subject to the reverse charge.

Builders supplying services must be clear about supplies when VAT must still be charged; HMRC can issue an assessment to correct errors. See ***Reverse charge: checklist for suppliers of construction services***.

Buyers of services must ensure that they are not charged VAT incorrectly by their supplier. HMRC will allow input tax to be claimed in such cases but has the power to assess output tax; in other words, HMRC can issue an assessment to achieve the same outcome as a correct reverse charge entry. The buyer must request a VAT credit from the supplier to balance the books. see ***Reverse charge: checklist for***

builders that buy construction services.

Reverse charge: checklist for suppliers of construction services

A supplier will apply the reverse charge if there is a 'yes' answer to the first two questions and 'no' to the final question:

1. Is your customer registered for VAT and the Construction Industry Scheme (CIS)?
2. Does the work fall within the scope of the CIS and is subject to 5% or 20% VAT?
3. Has your customer notified you that they are an 'end user' or 'intermediary supplier' for any of the work?

Note: See the main article for definition of an end user. Intermediary suppliers are VAT and CIS registered businesses that are connected or linked to end users.

Reverse charge: checklist for builders that buy construction services

The reverse charge will apply if you are VAT and CIS registered and answer 'yes' to the first two questions and 'no' to the third and fourth questions.

1. Will the payment for the supply be reported within the CIS?
 2. Does the supply relate to services subject to either 5% or 20% VAT?
 3. Are you hiring staff or workers; e.g. from an employment business?
 4. Have you notified your supplier that the end user or intermediary exclusions apply?
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End user status

My only disappointment with the reverse charge procedures when they were introduced in 2021 was the complications caused by the phrase 'end user'. This issue is probably only relevant to 0.1% of all transactions - but it was certainly responsible for more than 0.1% of the sleepless nights for advisers as we approached the introduction date!

First, we should start with what is meant by the term 'end user'. It applies when services supplied to a VAT and CIS registered builder do not relate to an onward

supply of construction services made by that builder; e.g. the work might relate to repair work carried out at the builder's head office. VAT will be charged in the normal way on these jobs.

An important fact is that the **buyer** of construction services must tell their builders if they are an 'end user' for some or all of the work and that VAT should be charged. However, the notification of enduser status is optional for the buyer. For example, a builder might think that their customer is an end user but not be notified as such, so the reverse charge will continue to apply, assuming the customer is both VAT and CIS registered.

To quote HMRC's technical manual: 'Only once the notification is made can the supplier stop applying the reverse charge and charge VAT under normal rules. It is optional so there is no legal obligation to be treated as an end user.'

Some horror stories

My first horror story was caused by the fact that the contractor buying subcontractor services misunderstood the rules. He told his subcontractors that he was an end user for certain supplies - and should therefore be charged VAT - because the jobs in question were for domestic customers who were not registered for VAT. This is incorrect: the contractor is still selling on construction services that he has purchased from subcontractors; the VAT registered status of his customers is irrelevant. It took some time untangling that one!

The other tale relates to attempts made by subcontractors to issue separate invoices for labour and materials, thinking they can charge 20% VAT on the invoices for materials. Some builders like to boost their cash flow by collecting VAT up to four months before it is declared on a return, hence the motive for the split on reverse charge supplies. In a nutshell, it doesn't work!

A job involving the supply of both labour and materials is classed as a single supply of construction services. To quote from HMRC's guidance: 'If a customer places a single supply and fix order within the scope of the CIS with a supplier, the reverse charge will apply to the full value of the order even if the supplier issues separate invoices for the supply and fix elements.'

What happens if builders raise separate orders for labour and materials? The guidance is clear: 'If the works are to be provided at the same time and on the same site ... they comprise a single supply for VAT purposes.'

HMRC technical guidance

As part of my research work for this article, I re-read the technical guidance published by HMRC to see if there were any important updates. A few issues came to light...

Snagging works

HMRC recently issued Revenue and Customs Brief 03/2024 about the VAT issues for developers and builders as far as remedial repair work is concerned on cladding affected dwellings.

In some cases, contractors will carry out snagging works on a building where they originally supplied construction services but will not charge the developer for this extra work. However, the reverse charge will still apply to subcontractor invoices because the contractor would have charged for supplies of labour and material on the original contract with the developer.

Employment business

Supplies of labour made by an employment business are subject to VAT even if those supplies are within the scope of the CIS. HMRC's technical guidance is very clear about the difference between an employment business and a labour only builder. The key issue is whether a worker is being provided – being paid on a time basis and working under the control of the contractor paying the employment business – or a builder who is charging, say, £500 for each room that they decorate.

Conclusion

The introduction of the reverse charge rules was delayed twice in 2020/21 but they have now been with us for four years and – based on the number of queries I have received from clients and accountants – my view is that they have worked very well.

I hope that HMRC can verify that tax fraud has been significantly reduced: if so, perhaps the department could consider an extension of the reverse charge principles for other supplies? As a suggestion, how about extending it to services supplied to local authorities for their non-business expenses where they recover VAT anyway by submitting a 'section 35' claim to HMRC? I'll leave that idea with you...

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