Construction sector – VAT domestic reverse charge

Indirect Tax

01 July 2017

The CIOT has responded to HMRC proposals to explore a domestic VAT reverse charge for the provision of construction sector services.

Announced at Spring Budget 2017, HMRC have published a call for evidence on ' Fraud on provision of labour in construction sector: consultation on VAT and other policy options' to explore a domestic VAT reverse charge to the provision of labour services in the construction sector. The proposals also look at changing the rules around gross payment status within the Construction Industry Scheme.

What is the issue?

HMRC reports they are aware of organised crime groups artificially extending supply chains within this sector with the intention of failing to pay VAT and making incorrect income tax deductions. HMRC considers the domestic reverse charge has been effective at tackling VAT fraud in the telecoms and energy sectors and now wishes to extend the regime to the construction sector.

What is the reverse charge mechanism?

The effect of the reverse charge is to ensure the supplier of goods or services is not involved in the payment of VAT to HMRC; shifting liability for VAT payments to the customer. The customer declares the VAT due as output tax on its own VAT return. Typically, the same amount is recovered as input tax on the same VAT return (subject to the normal partial exemption rules). This means that for most transactions the VAT is simply netted off and is no more than an accounting entry.

The reverse charge mechanism derogates from the general principles of the EU's VAT system (laid down by the Principal VAT Directive 2006/112/EC). For construction services, there is specific vires under Article 199 that requires the UK to inform the VAT committee, rather than apply for a derogation.

Key issues from the CIOT response

We support HMRC taking action to combat fraud in this area. In principle, the reverse charge is a relatively straightforward concept, which could offer an effective way of combatting VAT loss. However, as HMRC acknowledge, this would be the first time the reverse charge would apply to an area dealing with different VAT liabilities; with the potential for much greater complexity than we have previously seen.

We feel strongly that HMRC should exclude the final supply from the reverse charge requirements; limiting it to just within the construction supply chain. This would prevent final customers from having to deal with the potential complexity of different VAT rates and ensure that the fraud prevention measures are targeted at the right businesses.

Because of the complexity of the rules around VAT and construction, the issues raised in this consultation add weight to our view that the VAT rules concerning property and construction would greatly benefit from simplification.

Determining how to define and apportion construction services across a multi-rate project (and identify these elements on domestic invoices) will be challenging; clear legislation and timely, accurate guidance will be essential to guide both taxpayers and HMRC staff. Given the acknowledged long-standing problems with out-of-date HMRC guidance, particularly in land and construction, we recommend that this be prioritised and adequately resourced in any implementation of the proposed reverse charge.

We support the inclusion of an annual sales-based threshold to exclude smaller businesses from this measure. We consider this would be simpler to administer and would utilise information that is commonly required to be collected by contractors as part of the procurement process. We are of the view that introducing an invoice or per contract-based threshold would create unnecessary complication and uncertainty, whilst leaving the sector open to risk of fraudulent behaviour.

We agree, in principle, that any changes to the Construction Industry Scheme should be restricted to companies, subject to the existing exceptions being retained. However, we consider the proposal to require contractors to notify changes of ownership of labour suppliers to HMRC would be excessively burdensome for businesses. In any event, we think that HMRC is better placed to obtain this information for itself.

We would expect there to be a light touch in relation to any penalties until the new rules are fully embedded. The focus on penalties should be to encourage good compliance and not merely to raise revenue – in accordance with HMRC's five penalty principles.

What happens next?

This consultation is being carried out at 'stages 1 and 2' of the consultation process. The next stage of the process is normally the production of draft legislation. We cautioned HMRC against rushing into the implementation of new measures before there has been adequate consultation and discussion. We encouraged HMRC to consult thoroughly and widely before drafting the proposed legislation, particularly as (recognised by HMRC) this measure could affect up to 250,000 businesses. This is especially relevant because stakeholder consultation meetings were cancelled due to election purdah.

We have called on HMRC to meet with us to explore further the type of fraud identified and the options and issues raised in this consultation.

You can read the full response on the CIOT website.