

Insight

Insight provides practical information on topical issues affecting the building, engineering and energy sectors.

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2019: Are you prepared?



2019: ARE YOU PREPARED?

In our first *Insight* of 2019, we pause briefly to reflect on how 2018 concluded and consider what challenges will be faced by the construction industry in 2019. We focus, in particular, on the VAT reverse charge due to come into force on 1 October, as there are concerns that the construction industry is not prepared for this change and the impact it may have.

Alasdair Reisner, Chief Executive of the Civil Engineering Contractors Association (CECA) says of this change in law, "The new rules on reverse charge VAT are a timebomb for the industry with an increasingly short fuse. We are concerned that many businesses are still not aware that they will have to be compliant with the new rules this autumn, and that when they do have to change they will find that the new model will mean that suppliers take a negative hit on cashflow, right at the time when they are struggling with a potential post-Brexit slowdown in the sector"

It appears, on its face therefore, that 2019 will be the most challenging year for the construction industry in quite some time. That said, quite what will happen over the coming weeks as the Brexit date draws closer remains entirely uncertain. Although, such is the state of flux in the UK at present, that this statement may be out of date within days.

2018: A review

Overview

The construction industry enters 2019 a bit battered and bruised.

The effects of the demise of Carillion still ripple through the industry, and other major players at main contractor level are ensuring that anxiety levels are higher than normal.

The budget issues and delayed completion of the Crossrail project has brought public sector spending on major infrastructure projects under renewed scrutiny. This is entirely understandable, but incredibly unfortunate as the Elizabeth Line, once opened, will be a fantastic addition to the transport network of London, and the links it will provide for the west and east of the city.

Against this backdrop, there are continuing concerns about precisely what the impact of Brexit will be.

New contracts

The year 2018 saw a number of standard form construction contracts being published by industry bodies,

such as RIBA's professional services contracts and building contracts, NEC4's alliance contract, and ICC's design and construct contract and target cost contracts.

We are already seeing NEC4 being used, which is reassuring as this revision added some clarity to common issues encountered by users of NEC3.

New legislation

Amendment to the VAT Act 1994: VAT Reverse Charge for construction services

In November 2018 a draft Order, the "VAT Reverse Charge for Construction Services", was issued under section 55A of the VAT Act 1994. This will result in new law introducing a VAT "reverse charge" to certain specified construction services, meaning that the end-user (the ultimate customer or client) will be responsible for paying the relevant VAT, not the supplier.

The new regime will "go live" on 1 October 2019, but there is a concern within industry bodies that the construction industry is neither ready for the logistical requirements of this change, nor the practical commercial consequences, as is discussed in more

detail below.

Disclosure Pilot Scheme

As of 1 January 2019, a new mandatory Disclosure Pilot Scheme (DPS), a two-year pilot, has commenced in the Business and Property Courts, including the Technology and Construction Court. The aim of the DPS is to facilitate and influence a change in the approach to disclosure of documents as part of the litigation process.

The DPS's aim is to ensure that parties to a litigation focus on the key "Issues for Disclosure" rather than on every issue pleaded. It also promotes cooperation between the parties and the greater use of technology. The judiciary has a more central role in the process with greater oversight and case management. Full details can be found in the Practice Direction to the Civil Procedure Rules, PD51U.

Building Regulations

Building Regulations (in England) were amended on 21 December 2018, part of which resulted in the ban of the use of combustible materials in all new residential buildings above 18 metres. This regulation already applied in Scotland.

Politically this change was unavoidable. However, there will be an impact on the industry. For example, the use of only non-combustible cladding (in particular the ban of cross-laminated timber) will require the need for alternative/additional insulation, with likely increased costs and the potential requirement for less compact insulation to be used, reducing the interior space within tall buildings, and therefore the available space for units within such buildings.

2019: A look forward

New contracts

The year 2019 appears relatively quiet on this front. FIDIC's Emerald Book (focusing on tunnelling works), and the NEC's new public sector Z clauses to complement their NEC4 suite, are expected.

New legislation

Brexit

Precisely how Brexit will look when, or if, it is concluded by the exit date of 29 March, is still being "debated" in Parliament. As to this, depending on who you are (or listen to), the outcome is becoming either less, or more, predictable.

Nonetheless, contracts continue to be "Brexit-proofed" as best they can.

Beyond this, any kind of coherent or conclusive analysis is impossible at this time. The main hope has to be certainty, and quickly, as it is certainty that allows all businesses to understand the baseline from which they must react and plan; whatever that baseline is.

VAT: the Reverse Charge¹

Background

The introduction of the reverse charge VAT to construction services this year is something which construction companies should be preparing for now. Anecdotal evidence suggests

that this is not the case. It is for this reason that this topic is the primary focus of this edition of *Insight*.

This new legislation has been introduced to combat tax related fraud. Over a number of years, an increasingly common swindle has seen fraudsters "steal" VAT revenue from the Government.

This has been achieved by the fraudsters by either setting up shell companies, or taking over trading companies, and charging VAT to customers in addition to the services provided in the normal way. However, rather than flow the VAT money through the system such that this money is eventually received by HMRC, they keep it. As a result, HMRC are deprived of significant sums of tax.

This is not a problem specific to construction; indeed, the figures show that the construction industry is a relatively minor percentage of the wider problem.

The Government's solution to this tax evasion, however, is one that is likely to have significant ramifications for companies across the construction industry.

What is a reverse charge?

From 1 October 2019,² for suppliers of certain construction "specified services",³ the ultimate client/customer, defined in the legislation as the "end user"⁴, will be the party liable to pay VAT to HMRC in respect of the services provided rather than the supplier(s).

In layman's terms a company that is in receipt of "specified services" will not pay VAT to its supplier, rather it will account for the appropriate amount of VAT on its VAT return. For the supplier this means that it should not include, and should not receive payment for, VAT in its invoice. If an invoice wrongly adds VAT to the relevant amount due, it will have to be reversed (as will any monies paid).

The result?

Money paid for the VAT element of invoices will no longer flow between businesses. With each qualifying transaction, VAT will be calculated as a paper exercise and registered on the invoice as a "reverse charge". It will be the responsibility of the "end user" at the top of the supply chain to pay the tax.

The Government has estimated this will impact up to 150,000 construction-sector businesses and admits that the administrative burden is likely to be significant.

The official guidance is that the reverse charge will not apply to all contractors, only applying to "specified services". However, the definition of "specified services" mirrors those services defined as "construction operations" in the 'Construction Act'.⁵ Thus, it will affect most construction companies to some extent.

If a supply contains a mix of specified and other construction services it will be classed as a single supply of "specified services" and the domestic reverse charge will apply.

The services not covered by the reverse charge mirror those not considered "construction operations" under the Construction Act. Particular additional exclusions to note being:

- Where the end-users of construction services are not making an onward supply of construction services (for example, businesses commissioning the services to build an office, or a main contractor that sells a newly completed building to a customer) they will not be impacted.
- Zero-rated supplies such as for the construction of new-build housing.
- The supplier and recipient are landlord and tenant or vice versa.

Normal VAT rules will apply to the excluded services.

Cost

There will, of course, be one-off costs to affected companies, including familiarisation with the new rules and adapting VAT accounting systems and processes to enable reverse charge supplies to be calculated and reported.

There will also be ongoing costs which include: calculating the reverse charge; keeping records of all reverse charge supplies; checking the reverse charge is correctly applied; reporting reverse charge supplies on VAT returns; and, crucially, obtaining evidence as to whether or not a customer is an end-user.

Planning for this should be expedited, if not already commenced.

In addition to the more predictable costs outlined above, the practical consequences of this new regime poses a high risk with potentially significant consequences to construction companies.

Risk 1: the entire construction industry will require to reconfigure its accountancy practices and procedures. Such a significant change to accounting processes will always carry a heavy practical risk.

Risk 2: many construction businesses will no longer be able to rely on VAT money for cash flow. Whilst it is true this money should not be used in this way, it has been, and remains, common practice throughout the supply chain. Preparation for this loss of cash flow requires to be properly considered by all companies well in advance of 1 October.

Risk 3: at the top of the chain, main contractors, if they fall under the definition of "end-user", as they often do, will require to pay a significant VAT bill, for all "specified services" provided through the supply chain below. With narrow margins, and a squeeze in the market continuing for such

companies, this is a material risk to the industry as a whole.

Risk 4: where there is a defined term there is often (not far behind) a legal argument about the interpretation of that term. This is a distinct possibility with the term "end user", particularly with the responsibility falling on such parties to pay significant amounts of money payment of potentially. Further, how will a sub-contractor know if the contractor it is supplying services to is the "end user" and what will be needed to evidence this? Current guidance from HMRC is unclear on such issues.

The above risks have the potential to result in catastrophic consequences for companies that are not properly prepared this change. Specialist tax advice should be sought on this issue and preparations for 1 October should commence immediately, if not already in progress.

Conclusion

It would seem, therefore, that 2019 is set up as a "the perfect storm" for the industry.

In such uncertain economic conditions construction companies must ensure, more than ever, that best practice construction management principles (for example effective contract management; efficient and productive working methods; and ensuring cash flow), so often a failing within the industry, are adhered to.

One key opportunity for construction companies to improve productivity and margins is to continue to embrace the exciting advancements in technology that are evident across the industry. Technology in construction will be the focus of our next edition of *Insight*.

It seems that the industry is as prepared as it can be for Brexit, but the message we have received from industry leaders appears to be that the reverse charge (and its potential impact) is somewhat under the radar and may be a bigger risk event to

construction companies this year than Brexit.

This is possibly a bold statement given the current predictions of impending disaster after 29 March. However, companies have prepared and continue to prepare for Brexit the best they can. It is not clear that the same can be said in respect of the VAT reverse charge.

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Footnotes

1. An amendment to the Value Added Tax Act 1994 aimed specifically at services supplied in construction activities.
2. By virtue of Statutory Instrument published in November 2018, The Value Added Tax (Section 55A) (Specified Services and Excepted Supplies) Order 2019 (the "SI").
3. As detailed in article 4 of the SI.
4. Defined in the issued SI as "a taxable person who is a recipient of specified services, and uses those services for any purpose other than making further supplies of specified services".
5. The Housing Grants, Construction and Regeneration Act 1996, "construction operations" being defined at section 105.