

Application of Recent Tax Changes in Contract Administration of Construction Contracts

1. General Details

Government has recently announced various tax changes and some of them are already affective. These tax changes should be contractually managed in the payment certifications of the construction contracts.

In many standard forms of contracts there is a provision to administer such changes under “*Adjustment for Changes in Legislation*”. Please refer Conditions of Contract; Sub Clause 13.6 in CIDA / SBD / 02 and Sub Clause 13.7 of FIDIC First Edition 1999 for details.

The above Sub Clauses in;

CIDA / SBD / 02, Second Edition January 2007 stipulates,

“The Contract Price shall be adjusted taking into account any increase or decrease in Cost resulting from Change in Law in Sri Lanka, during the period commencing 28 Days prior to the closing date of Bids and ending on the date of issuance of the Certification of Completion or termination pursuant to clause 15 and 16 and which affect the Contractor's performance of contractual obligations”. Whereas,

FIDIC Conditions of Contract, First Edition 1999, stipulates,

“The Contract Price shall be adjusted to take account of any increase or decrease in Cost resulting from a change in the Laws of the Country (including the introduction of new Laws and the repeal or modification of existing Laws) or in the judicial or official governmental interpretation of such Laws, made after the Base Date, which affect the Contractor in the performance of obligations under the Contract”.

Accordingly, it is necessary to refer the definitions of “Laws” and “Base Date” to understand the above provisions. The respective definitions are stated as follows in above contract forms.

“Base Date” means the date 28 days prior to the latest date for submission of the Bid.

Above is as per CIDA / SBD / 02, Second Edition January 2007 and in FIDIC, First Edition 1999 it is the same definition except that, instead of term “Bid” it uses the term “Tender”.

The definition of “Laws” is almost similar in both forms of contracts as stated below.

FIDIC, First Edition 1999

“Laws” means all national (or state) legislation, statutes, ordinances and other laws, and regulations and by-laws of any legally constituted public authority.

CIDA / SBD / 02, Second Edition January 2007

“Laws” means all legislation, statutes, ordinances and other laws, and regulations and by-laws of any legally constituted public authority.

Types of Taxes and Concerns

2. VAT

Changes applicable to contract administration are;

1. Reduction in VAT percentage from 15% to 8% with effect from 1st December 2019, and
2. Increase in VAT registration threshold from Rs. 1 million to 25 million per month from 1st January 2020.

The application of reduced VAT percentage in Item 01 above from VAT registered entities is fairly a simple calculation changing the percentage to 8% from the effective date. However, there will be a large number of Small and Medium level contractors and subcontractors who will lose their VAT registrations in January 2020 of not being able to meet the turnover criterion in Item 2 above. Most of the consultants too will be out from VAT registration.

Currently Performing Contracts and Contracts with Base Date prior to 1st January 2020

There can be many scenarios and combinations;

1. Contractor and some Subcontractors / suppliers lose the VAT registration,
2. Contractor doesn't lose but all or some Subcontractors / suppliers or design consultants lose the VAT registration,
3. Subcontractor and some suppliers doesn't lose but Contractor loses the VAT registration,
4. Employer loses the VAT registration, and
5. Employer had no VAT registration before etc.

VAT input means the VAT payments are made to the seller / supplier in buying the inputs required for the products and services by the buyer. VAT output is the VAT received from the customer or client in the transaction of selling the outputs made using the inputs. The difference between output VAT received and input VAT paid goes to the government. VAT invoices showing VAT amount separately are issued by the VAT registered parties. Hence, the rates and prices or do not include VAT or they are net of VAT, the specified VAT percentage is separately added to the value or price of sale in VAT invoices. VAT un-registered parties will include all input VAT component in their rates and prices as part of costing and they cannot issue VAT invoices showing VAT separately. Thus, VAT un-registered parties do not go into VAT input and output calculations to remit the difference but VAT is included in the rates and prices. In other words, if a seller or buyer (Employer, Contractor, Subcontractor, Supplier etc) is not VAT registered VAT becomes a cost to them. (Readers may get an accountant to advise them on this subject further and the writer is not qualified in accountancy)

The VAT input costs for construction contractors and subcontractors are mainly from formal industries' processed materials such as cement, ready mix concrete, pre-cast concrete items, steel reinforcements, structural steel, aluminium products, steel pipes, valves, metal roofing, bitumen, sanitary fittings, tiles, applicable equipment etc. Raw materials used or cottage industry materials such as sand, earth, rubble etc. and labour may not include VAT. In other words, they are not VAT applied inputs.

If VAT registration is repealed from 1st January 2020 of the contractors and subcontractors, the input VAT will have to be included in the rates and prices as mentioned above. However, in the performing contracts or in contracts with Base Date on or before 31st December 2019 rates and prices are net of VAT as they had a VAT registration prior to 1st January 2020. Hence, all input VAT after 1st January 2020 of such cases would be claimed as additional cost claims. The additional cost will not be 8% of the payment due but reduced amount to the extent of VAT applicable inputs in the value of works done. Thus, there will be additional cost claims from subcontractors to contractors and directly from contractors, due to deregistration in VAT which will then be passed on to the Employer or client at the end.

If the Employer is a VAT registered entity the input VAT in the rates of all VAT un-registered parties used in the process will become an additional cost. This may be passed on to the end user or customer. If all parties are VAT un-registered VAT becomes a cost to all but at the reduced 8%. When all parties are VAT registered then there will not be a complication. Refer **Table 01** below for some combinations of VAT registrations and impacts on currently performing contracts or on the contracts with Base Date on or before 31st December 2019.

VAT Registration Status after 1st January but had registration before that, in Contracts Base Date is on or before 31st December 2019.				Key Has – Still registered in VAT even after 1 st January 2020 No - VAT registration revoked after 1 st January 2020 due to increased VAT threshold (from 1 million per month to 25 million per month for registration)
Employer	Contractor	Subcontractor	Supplier	Impact on Contracts on Increase of VAT Registration Threshold
Has	No	No	No	All parties input VAT will be an additional cost to the Employer
Has	Has	No	No	Input VAT of un-registered parties will be an additional cost to the Employer
Has	Has	Has	No	Do
No	Has	No	No	Input VAT component of un-registered parties and of VAT registered Contractor will be an additional cost to the Employer.
No	No	Has	Has	Input VAT component of subcontractors and of Contractor will be an additional cost to the Employer.
No	Has	Has	Has	Input VAT component of Contractor will be an additional cost to the Employer.
No	Has	Has	No	Input VAT component of un-registered parties and of registered Contractor will be an additional cost to the Employer.
Has	No	Has	Has	Input VAT component of Contractor will be an additional cost to Employer. Direct contracts with subcontractors would be a possibility.
Has	Has	Has	Has	No impacts
No	No	No	No	VAT becomes a cost, of such inputs but at the reduced 8%

Table 01

Now the calculation with regard to additional costs of relevant contracts will be a tedious task depending on which situation it would be. Firstly, to find whose VAT registration has been revoked in the supply chain and checking such records. Then, if the records are not for the particular project but general purchases for many projects then the calculations will become further complicated.

In any case, purchased quantity will have to be analyzed to pay the additional costs. The consultants will have to spend lot of time analyzing these records and additional fees may have to be charged. The time to be spent by the contractors, subcontractors, consultants and employers to calculate these will be substantial and cost of which would be more than the adjustment in some projects.

Therefore, VAT percentage reduction with increased threshold in certain cases will increase the cost of construction and reduction in cost may be accrued depending on having VAT registration. *(Refer example calculations given at the end of this article as **Appendix A** and readers are advised to consult a qualified accountant without depending on the given examples)*

Corporate clients contracting with SME sector will depend on prices of SME in future where their prices “with VAT” to be less than major contractors “without VAT” prices to be competitive. VAT registered contractors may also tend to do business with VAT registered subcontractors and suppliers to be competitive but not with VAT un-registered SME. If SME’s lesser overheads could compensate the added VAT input cost such SME’s could offer competitive prices and the Bid invitations should include both types of firms (VAT registered and un-registered) to ascertain the situation. Bid evaluation will have to be done carefully in such cases.

In joint ventures, if one partner, more partners or all of them cannot get registered in VAT after 1st January 2020 it will have impacts, as the case may be.

In price fluctuation payable contracts, this matter will be impacted differently. Initially NBT abolition will decrease certain material prices reducing the respective indices, whereas cost of material will be higher when bought with VAT in actual situation for VAT un-registered entities. Hence, it has be dealt with an additional cost claim. As the indices deal with net increase of inputs it will not be an issue.

3. NBT

1st November 2019 to 30th November 2019

The NBT applied to Contractor (main contractor) has been removed in the above period. Hence, the 2% NBT included or considered in the performing contracts and contracts with Base Date on or before 31st October 2019 should be deducted from the amount due.

From 1st December 2019

The NBT is abolished from 1st of December hence the NBT related costs in construction inputs will not be there. Further, NBT for contractors also will not be there anymore. Consequently, both NBT components shall be deducted in adjusting the Contract Price of performing contracts and of contracts with Base Date falling on or before 30th November 2019 for the effect.

The adjustment will not be that simple to reduce the above NBT components from the amount due to the Contractor.

The reasons are;

1. Base Dates of the contracts should be checked carefully. Base Date prior to 1st August 2017, after that till 31st October 2019, then from 1st November to 30th November 2019, thereafter from 1st December 2019 should be administered separately. **(Refer Table 02 below)**,
2. NBT is not there in all construction inputs but in some of them. Therefore, such items should be evaluated of the Contractor and Subcontractors,
3. Some NBT applicable items as per previous tax regime would have already been procured or paid for,
4. The NBT component in construction inputs is 2.04% whereas the other NBT applicable now for contractors is 2% when calculated it from the amount due for payment as the base,
5. The retention held from the amounts with NBT before and now what should be done,
6. Variations in future should not include NBT but previously including NBT and monitoring them separately,
7. Materials on Site would include with NBT items and without NBT items depending on when they were bought,
8. Daywork rates in the performing contracts includes NBT,
9. In price fluctuation payable contracts, the NBT reduction of such inputs will be realized with reduction in indices but not the other NBT on contractor as per the NBT applicability since 1st August 2017,
10. In design and build contracts consultancy services NBT also now abolished,
11. Prime Costs defined will now be changed, and
12. If the base value to apply taxes and duties in the imports are changed with this NBT abolition there would be a change in Cost in which as well.

There could be other situations as well. Hence, a proper understanding and agreements, how these should be adjusted is a need to finalize same in avoiding and minimizing disputes.

NBT Application Changes

Period	Main Contractor	Sub-Contractor
Prior to January 2011	Exempt form NBT	Liabe for NBT
1st January 2011 till 31st July 2017	Exempt form NBT	Exempt form NBT
On or After 1st August 2017 (Please refer Note 1)	Liabe for NBT	Exempt form NBT
1st November 2019 till 30th Nov. 2019	Exempt form NBT	Exempt form NBT
After 1st December 2019 – Abolished	NA	NA

Table 2

Notes:

1. Services by a construction contractor if such service is provided under a contract agreement executed prior to August, 1st 2017; - Exempted.
2. The gazette notification on above should be checked.

4. Income Tax on Construction Industry

This has been reduced from 28% to 14% and administration of same under the contracts may not be necessary if this change is done to enhance the performance of contracting sector but not expecting reduction in construction cost. **A clarification from the authorities are necessary in order to administer the change.**

5. Economic Service Charge

The above has been abolished and in administering the contracts the mentioned details (in Item 4) may be considered.

6. Reduction in Telecommunication Levy

This may result in reduction in such costs but administrating will be costlier than paying it.

7. Cancellation of Sand Transport Permits

This will result in reduction in sand prices. In price fluctuation payable contracts, it will be reflected in such payments. In fixed rate and lump sum payment methods this has to be a detailed calculation if it is to be administered.

If contractors intend to claim any additional cost due to the changes in tax laws as mentioned above they shall send notice of claim in due time as per the Conditions of Contract. (Directory notice under CIDA / SBD / 02 Sub Clause 19.1 and mandatory notice under FIDIC Sub Clause 20.1). Employers may also give notice of Contract Price adjustments on account of relevant tax reductions under Employer's Claims.

The best practice would be to administer these changes in a fair and reasonable method for government and private sector construction contracts. Rather than waiting to raise audit queries later, in government contracts a directive may be issued describing how these changes should be administered in a simplified method.

If further changes to come in these taxes in near future, the contract administration will render rather difficult in terms of payment management.

By

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Scenario 01 - All Parties VAT Registered							Appendix	A
		At Import	Supplier	Subcontractor	Contractor	Employer		
1	Basic Cost	50.00	50.00	120.00	222.00	416.40		
2	Value Additions (VA)							
2.1	Processing / finishing with VAT applicable input cost		20.00	35.00	50.00	10.00		
	VAT @ 8% of total input cost	9.20						
2.2	Do without VAT applicable or disallowed inputs		30.00	30.00	75.00	5.00		
	Net Price		100.00	185.00	347.00	431.40		
2.3	OH & Profit (20%)		20.00	37.00	69.40	86.28		
	Selling Price		120.00	222.00	416.40	517.68		
	VAT @ 8%	4.00	9.60	17.76	33.31	41.41		
	Price with VAT	63.20	129.60	239.76	449.71	559.09		
	VAT Output		9.60	17.76	33.31	41.41		
	VAT Input		4.00	9.60	17.76	33.31		
	VAT inputs in 2.1		1.60	2.80	4.00	0.80		
	VAT Remittance to IRD	13.20	4.00	5.36	11.55	7.30		
IRD - Inland Revenue Department								
Assumed; Imports only for item 2.1 and no input VAT in OH & Profit in all examples								

Scenario 02 - All Parties VAT Un-registered							Appendix	A
		At Import	Supplier	Subcontractor	Contractor	Employer		
1	Basic Cost	50.00	63.20	137.76	246.67	450.81		
2	Value Additions (VA)							
2.1	Processing / finishing with VAT applicable inputs		21.60	37.80	54.00	10.80		
	VAT @ 8% of total input cost	9.20						
2.2	Do without VAT applicable or disallowed inputs		30.00	30.00	75.00	5.00		
	Net Price		114.80	205.56	375.67	466.61		
2.3	OH & Profit (20%)		22.96	41.11	75.13	93.32		
			137.76	246.67	450.81	559.93		
	VAT @ 8%	4.00	-	-	-	-		
	Price with VAT	63.20	137.76	246.67	450.81	559.93		
	VAT Remittance to IRD	13.20						

Scenario 03 - Some Parties VAT Registered and Some are Not							Appendix	A
		At Import	Supplier VAT Rgd.	Subcontractor Not Rgd.	Contractor Not Rgd.	Employer VAT Rgd.		
1	Basic Cost	50.00	50.00	129.60	236.88	439.06		
2	Value Additions (VA)							
2.1	Processing / finishing with VAT applicable inputs		20.00	37.80	54.00	10.00		
	VAT @ 8% of total input cost	9.20						
2.2	Do without VAT applicable or disallowed inputs		30.00	30.00	75.00	5.00		
	Net Price		100.00	197.40	365.88	454.06		
2.3	OH & Profit (20%)		20.00	39.48	73.18	90.81		
	Selling Price		120.00	236.88	439.06	544.87		
	VAT @ 8%	4.00	9.60	-	-	43.59		
	Price with VAT	63.20	129.60	236.88	439.06	588.46		
	VAT Output		9.60	-	-	43.59		
	VAT Input		4.00	-	-	-		
	VAT in 2.1		1.60	-	-	0.80		
	VAT Remittance to IRD	13.20	4.00	-	-	42.79		