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CLIENT PRACTICE NOTE

GST RATE CHANGE – SOME PRACTICE ISSUES REVISITED

A Client Practice Note by Eugenie Lip, Head of KPK Contracts Support Group

INTRODUCTION

With effect from 1 July 2007, as announced by the Government, the Goods and Services Tax (GST) rate will be increased to 7% from the current 5%. The increase as when the rate was changed from 3% to 4% on 1 January 2003 and to 5% on 1 January 2004 will once again affect all GST-registered businesses and more importantly, where transactions span the rate change.

Construction contracts typically have their distinctive features and attract a unique set of transitional rules especially when applied to activity transactions that straddle the rate change.

With the upcoming rate change, this practice note revisits the transitional issues affecting some of the transactions which are characteristic of construction contracts.

‘TIME OF SUPPLY’ RULE

The rule sets down the time when GST is chargeable which is the earliest of the following events: receipt of payment for supplies or performance of services; issue of the tax invoice; or delivery of goods or performance of services.

In respect of construction services which include works done and professional services rendered, the time of supply for accounting of GST is whichever occurs first – receipt of payment for the supplies or services performed or the issue of the tax invoice.

TRANSITIONAL ISSUES

Projects fully Completed before 1 July 2007

For projects which are fully completed before 1 July 2007, the transitional rules allow GST to be charged at 5% on any balance payments (including retention monies) made on or after the changeover date as such payments relate to works done or construction services already performed before 1 July 2007.

Construction contracts typically provide for minor outstanding works to be completed during the maintenance period or defects liability period. If such works are carried out after 1 July 2007 even though the main contract works have been certified as completed before 1 July 2007, GST is chargeable at 7%.

Projects straddling 1 July 2007

Where the construction of the project straddles 1 July 2007, payments made for the portion of the works done, unfixed goods and materials supplied or any other construction services performed before 1 July 2007 are charged at 5% GST even though payment may have been made after 1 July 2007. For the remaining portion of the works done or any construction services performed after 1 July 2007, GST is charged at 7% on any payments made (Figure 1).

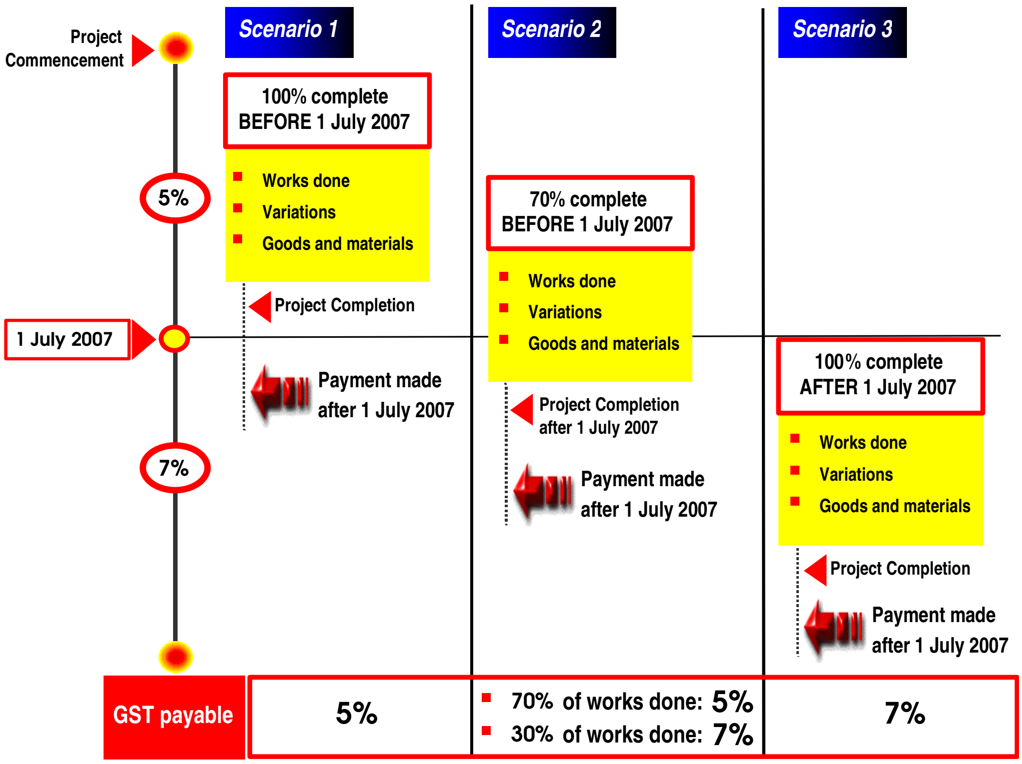

Figure 1:

Impact of Rate Change on Projects

Variation works carried out are also treated transitionally in a similar manner regardless of whether the variation is pending approval through Requests for Variation Order (RVO), issuance of instructions (or directions) by the Architect or Superintending Officer as the case may be, or pending agreement on the variation cost.

Pivotal to the transitional treatment is a valuation to be carried out by the Consultant Quantity Surveyor as at 30 June 2007 on the works done (including variations) and unfixed goods and materials. This task is essential for the ascertainment of the total amount of retention held before 1 July 2007 and when the project is completed, the apportionment of the retention amount attributable to 5% and 7% GST at the time of its release in accordance with the terms of the contract.

Retention

The retention scheme encourages Contractors and Sub-Contractors to fulfil their defects liability obligations and safeguards the Employer against defects which subsequently develop. The fund is accumulated by deducting the appropriate percentage from the value of works done, variations and unfixed goods and materials at each monthly payment certificate until the stipulated maximum amount is reached.

Where the retention amount is drawn from payments made for works done, variations and unfixed goods and materials before 1 July 2007, the transitional rules allow for the GST payable for that portion of the retention that relates to such works, variations and goods and materials to be charged at 5%.

It is of paramount importance for the purposes of apportionment of the retention amounts to be released upon certified completion of the works and when all defects notified have been made good that the total amount of retention held as of 30 June 2007 be recorded. This is necessary to establish the retention amounts which are subject to 5% and 7% GST.

Illustrated examples on the apportionment for GST accounting when releasing retention monies are set out below.

CONTRACT PARTICULARS

- **Contract Sum:** $10,000,000
- **Maximum Retention:** $500,000
- **Commencement Date:** Before 1 July 2007
- **Completion Date:** After 1 July 2007

Max Retention reached BEFORE 1 July 2007

- **1st Release:** $250,000 at 5% GST
- **2nd Release:** $250,000 at 5% GST

Max Retention reached AFTER 1 July 2007

- **Retention Amount as at 30 June 2007:** $400,000
- **Retention Amount after 1 July 2007:** $100,000
- **1st Release:** $250,000 at 5% GST
- **2nd Release:** $150,000 at 5% GST
$100,000 at 7% GST

Sub-Contract Works

The transitional rules governing valuation of works done, unfixed goods and materials, variations and retention payments similarly apply to nominated (and in the case of the SIA Form, and designated) sub-contract works. As more often than not each sub-contract has different commencement dates, the value of the works done before and after 1 July 2007 and the apportionment percentages will differ between sub-contract packages and also from the main contract works.

Tender Deposits

Tender deposits have their primary purpose of providing a form of security to the Employer to ensure that the tenderer abides by the conditions of tendering. The amount submitted is also used to defray the copying and binding costs of documents and drawings for tendering and contract execution.

Depending on the tender operating procedures of the procuring organisation, tender deposits required may be submitted as a non-refundable documentation fee (to cover the copying costs) as well as a tender security (to ensure compliance with the tendering conditions). The documentation fee is treated as a transaction for purchase of the tender documents and drawings and is subject to GST. In the case where only a tender deposit is required, it is usual practice that the amount submitted by the successful tenderer will be retained to cover the copying and binding costs.

When calculating the amount of tender deposit to be stipulated for projects where the tendering stage straddles over 1 July 2007, provisions must be made for GST at 5% where the tender documents are expected to be issued before 1 July 2007. Contract documents supplied after 1 July 2007 will be charged GST at 7%.

Professional Fees

Consultants' services straddling the changeover date must be similarly apportioned with regard to the time that the services are performed.

It must be borne in mind that the duration of professional services may not correspond with the project construction period. By way of an example, for a project certified as complete before 1 July 2007, the value of construction work done is charged GST at 5%. However, professional services rendered to bring about financial settlement of the final accounts may continue after 1 July 2007. GST on such services is charged at 7%.

Construction Insurance

As sales of residential properties are classified as exempt supplies or supplies where any input tax cannot be claimed, developers of such type of properties should consider in view of their own GST status whether or not GST should be included in the calculation of the Total Sum Insured under the Contractors' All Risks Policy and when computing the total reinstatement cost of their buildings for property insurance.

Authorised Deductions under the Contract

Damages payable by the contract-breaker for breach of warranty and delays in completion (which include liquidated damages) are not subject to GST.

However, where deductions are made for defects in lieu of requiring it to be made good, adjustments for the GST previously charged have to be made as it is considered a reduction in the value of the works done. When making such deductions, the corresponding GST should be based on the percentage originally charged which was applied to the works in which the defects have appeared.

Advance Payments

Advance payments are made by the Employer to the Contractor usually for start-up or mobilisation or as a down-payment for purchase of equipment with long lead delivery times such as lifts and escalators. Terms of agreement for such payments include the requirement for an advance payment bond and the repayment amounts and times (typically by way of deductions in the payment certificates) at which the advance payment will be reimbursed by the Contractor to the Employer.

Any advance payments made before 1 July 2007 are charged GST at 5%. Whilst making advance payments may *prima facie* appear to be an option to reduce GST expenditure, the associated risks must be appreciated and the Employer needs to be aware of this. As construction firms braze themselves (and most already are) for a rebound amidst improving business optimism and expectations, full order books, surging number of tender invitations and strong employment increases, opting for significant advance payments to save GST must be approached with caution and carefully weighed against the potential risk of mismanagement of the advance funds and the premium payable for providing an advance payment bond.

CONCLUSION

Having managed and administered the previous rate changes, it is expected that the impact of the forthcoming new rate and the attendant transitional rules will be less complicated as the industry especially the parties affected by GST are more familiarised with the mechanics of GST computations and apportionments.

Above all, there can of course be no substitute for professional advice in respect of proper accounting and invoicing of the input tax paid for the making of taxable supplies and the output tax charged on the supply of goods and provision of construction services.