VAT and RCT Interaction in Construction Operations

Ted Holohan *Director Indirect Tax, Deloitte*
Alan Kilmartin *Senior Manager, Indirect Tax, Deloitte*

Introduction

Relevant Contracts Tax (RCT) occupies a minute part of TCA 1997, but mistakes in its operation can prove very costly. The VAT reverse-charge rules under s16(3) VATCA 2010 will generally follow the RCT rules, so it is important to consider the two pieces of legislation together.

In this article we wish to draw your attention to certain risks and pitfalls in the interaction between VAT and RCT in relation to construction contracts only. Not least among the risks is the new "computer-generated penalty" regime for RCT. As the scope of RCT and the cost of non-compliance were discussed by Emer O'Sullivan in the previous issue of *Irish Tax Review,*[1] we deal with those aspects only briefly in this article.

1 Emer O'Sullivan, "Scope of Relevant Contracts Tax and Cost of Non-Compliance", Irish Tax Review 28/2 (2015).

Principal Contractor

Those required to operate RCT and associated reverse-charge VAT are termed "principal contractors" and are defined in s530A(1) TCA 1997 as:

> *(a) in respect of the whole or any part of the relevant contract, the contractor under another relevant contract,*
>
> *(b) a person –*
>
> *(i) carrying on a business that includes the erection of buildings or the development of land (within the meaning of section 639(1)) or the manufacture or extraction of materials for use, whether used or not, in construction operations* [references to forestry and meat processing are excluded from this extract],
>
> *(c) a person connected with a company carrying on a business mentioned in paragraph (b),*
>
> *(d) a local authority, a public utility society (within the meaning of section 2 of the Housing Act 1966) or a body referred to in subparagraph (i) or (ii) of section 12(2)(a) of that Act or section 19 or 45 of that Act,*
>
> *(e) a Minister of the Government,*
>
> *(f) any board or body established by or under statute or any board or body established by or under royal charter and funded wholly or mainly out of moneys provided by the Oireachtas,*
>
> *(g) a person who carries on any gas, water, electricity, hydraulic power, dock, canal or railway undertaking, or*
>
> *(h) a person who carries out the installation, alteration or repair in or on any building or structure of systems of telecommunications."*

Please refer to Emer O'Sullivan's article for a detailed discussion of the above.

Own-Use Exclusion

Although persons connected with property developers or builders may be liable to RCT and associated reverse-charge VAT, there is an exclusion for "own use" under s530A(2) TCA 1997, i.e. where a person "erects buildings or develops land for the use or occupation of such person or employees of such person". Note that the exclusion applies provided that the person is not liable to RCT for other reasons.

For example, a garage constructing new premises for itself would not be obliged to operate RCT or associated reverse-charge VAT on such construction. Revenue accepts that landlords come within this exclusion provided that they grant leases of 35 years or less and are not subject to RCT for other reasons (*Tax Briefing*, Issue 66, July 2007).

Relevant Contract

In order for RCT and associated reverse-charge VAT to apply, a principal contractor must engage a sub-contractor to carry out "relevant operations" under a "relevant contract".

Under s530 a "relevant contract" means:

> *"a contract (not being a contract of employment) [reference to NAMA is excluded from this extract] whereby a person (in this Chapter referred to as 'the contractor') is liable to another person (in this Chapter referred to as 'the principal') –*
>
> *(a) to carry out relevant operations,*
>
> *(b) to be answerable for the carrying out of such operations by others, whether under a contract with the contractor or under other arrangements made or to be made by the contractor, or*
>
> *(c) to furnish the contractor's own labour or the labour of others in the carrying out of relevant operations or to arrange for the labour of others to be furnished for the carrying out of such operations…".*

The critical point is that RCT may arise if a person "is liable to" another person to carry out the operations, even if such a person is not itself a builder but engages the services of others to fulfil that obligation.

It also applies to labour-only contracts; therefore, where a development company organises its employees within a separate subsidiary, care needs to be exercised to verify RCT compliance for "inter-company" charges.

Combined supplies

A major risk with the definition of relevant contract arises for contracts that cover both RCT-type and non-RCT-type supplies. Even where the construction element might be incidental or minimal, this provision could be read to mean that the entire contract would be subject to RCT.

Revenue has acknowledged the complex nature of such cases, where there can be a fine line between what can be regarded as falling within or outside the scope of RCT. In this regard, Revenue has stated that these situations should be considered case by case to ascertain the correct RCT and VAT treatment. For example, a design, build and operate contract might theoretically come entirely within scope of RCT, but reverse-charge VAT will apply only to the build services.

Construction Operations

"Construction operations" are defined in s530 TCA 1997 (cross-referenced in VATCA 2010) as:

(a) *the construction, alteration, repair, extension, demolition or dismantling of buildings or structures,*

(b) *the construction, alteration, repair, extension or demolition of any works forming, or to form, part of the land, including walls, roadworks, power lines, telecommunications apparatus, aircraft runways, docks and harbours, railways, inland waterways, pipelines, reservoirs, water mains, wells, sewers, industrial plant and installations for purposes of land drainage,*

(c) *the installation, alteration or repair in any building or structure of systems of heating, lighting, air-conditioning, soundproofing, ventilation, power supply, drainage, sanitation, water supply, burglar or fire protection,*

A major risk with the definition of relevant contract arises for contracts that cover both RCT-type and non-RCT-type supplies.

(ca) *the installation, alteration or repair in or on any building or structure of systems of telecommunications,*

(d) *the external cleaning of buildings (other than cleaning of any part of a building in the course of normal maintenance) or the internal cleaning of buildings and structures, in so far as carried out in the course of their construction, alteration, extension, repair or restoration,*

(e) *operations which form an integral part of, or are preparatory to, or are for rendering complete such operations as are described in paragraphs (a) to (d), including site clearance, earth-moving, excavation, tunnelling and boring, laying of foundations, erection of scaffolding, site restoration, landscaping and the provision of roadways and other access works,*

(f) *operations which form an integral part of, or are preparatory to, or are for rendering complete, the drilling for or extraction of minerals, oil, natural gas or the exploration for, or exploitation of, natural resources,*

(g) *the haulage for hire of materials, machinery or plant for use, whether used or not, in any of the construction operations referred to in paragraphs (a) to (f).*"

Difficulties of interpretation

Considerable uncertainty exists around the above definition of construction operations, which presents practical difficulties and risks in the administration of RCT and VAT:

- No clear definition is available of "alteration", used in paragraphs (a) and (b). Is painting a building a different colour to be regarded as an alteration? This word is also an issue in the VAT definition of "development".
- Can we, in reality, distinguish between "repair" and "maintenance", as most maintenance would include an element of repair?
- Can "rendering complete" a building include, say, the fit-out of movable furniture, curtains or appliances in an apartment or movable equipment in an industrial unit?

- What level of "installation" is required to bring a contract within the scope of RCT? For example, can RCT apply to the supply of free-standing refrigeration in a shop/equipment in a gym by simply placing the equipment in the building and plugging it in?
- Do "works forming…part of land" include fitted furniture, seating etc. designed to be fixed in a permanent manner to a building? We believe so, but Revenue has issued contrary opinions on such supplies.
- What is meant by "systems of telecommunications"? Could these include computers and servers, which now carry voice data?

Accounting for Reverse-Charge VAT as Principal

Where a principal to whom s530A TCA 1997 applies "receives services consisting of construction operations", VAT on those services should be accounted for by the principal on a reverse-charge basis under s16(3) VATCA 2010. This means that the sub-contractor should not charge VAT to the principal contractor, and instead the principal is obliged to self-account for the relevant VAT.

The principal may also claim a simultaneous input deduction for the VAT that it has self-assessed, subject to the normal deduction rules. Therefore, if the principal has 100% VAT recovery, the net effect of this transaction will be VAT neutral, as the principal has, in effect, included the VAT amount as both a "sale" and a "purchase" on the VAT return.

Where a principal to whom s530A TCA 1997 applies "receives services consisting of construction operations", VAT on those services should be accounted for by the principal on a reverse-charge basis under s16(3) VATCA 2010.

It should be noted that the reverse-charge VAT rules do not apply to operations in the forestry or meat-processing industries or to "haulage for hire", i.e. transport services, in the construction industry.

Note also that the VAT deduction could be lost if VAT is charged on invoices that should properly have been issued under the reverse-charge procedure.

Connected parties

Section 16(5) of VATCA 2010 also provides for the reverse-charge procedure where construction work is supplied in the State to a connected party. In this context, VAT should again be accounted for on a reverse-charge basis by the recipient, and the supplier is required simply to issue a document to the recipient stating that VAT should be accounted for on the supply under the reverse-charge procedure. The definition of a "connected person" is set out in s97(3)(b) VATCA 2010.

Non-application of the "two-thirds rule"

Note that the "two-thirds rule" is not applicable to such reverse charge supplies; therefore, even if the value of materials in such construction contracts exceeds two-thirds of the contract price, the low rate of VAT and the reverse charge will apply.

Contradictory Position on Certain Supplies of Goods

In general, the bare supply of goods would not fall within the scope of RCT, and consequently their supply should be accounted for not under the reverse-charge procedure but under the "normal" VAT rules. They would generally be liable to the standard rate of VAT (but note that blocks and wet cement are liable to the low rate of VAT).

If, however, we are to regard the fit-out of buildings as coming within the scope of RCT – as it can be regarded as "rendering complete" a construction operation – one would expect the low rate of VAT and the reverse-charge to apply. To use the examples given above, if the supply of movable furniture or curtains in an apartment or equipment in an industrial unit are considered a "construction operation" for RCT purposes, it seems that the low rate of VAT should apply.

Revenue, however, continues to hold to the apparent contradiction that certain fit-out is subject to RCT but is, nevertheless, not liable to the low rate of VAT under the reverse charge.

Offshore Operations

Section 530 TCA 1997 states that "this Chapter applies in relation to relevant operations which are carried out in the State…". In the past, Revenue took the view that operations conducted on the Continental Shelf were subject to RCT. However, in eBrief No. 54/2015, issued in May 2015, Revenue confirmed that RCT is not applicable to works conducted outside the State's 12-mile territorial waters. The new guidance now brings RCT into line with VAT guidance.

Requirement for Non-Resident Sub-Contractors to Register for VAT

As it is the principal's responsibility to account for the VAT on the provision of "construction operations", non-resident sub-contractors are not regarded as accountable persons in respect of those services. Consequently, the non-resident sub-contractor is not required to register or to account for VAT on the provision of same. Such contractors, however, may decide to register for VAT in Ireland in order to claim a VAT input deduction for VAT incurred while carrying out works in the State.

As we understand matters, a policy decision has been taken by Revenue on VAT claims by non-established sub-contractors conducting construction operations in the State. It appears that Revenue will not accept an application for a refund of VAT through the electronic VAT refund system (Eighth Directive reclaim process) but will require the non-resident sub-contractor to register for VAT and to reclaim it in a standard VAT return.

Rates of RCT

There are three rates of RCT withholding tax that may apply:

- a 35% rate applies where sub-contractors are not registered with Revenue or have serious compliance issues;
- a 20% rate applies where sub-contractors are registered with Revenue and have satisfactory compliance records; and
- a zero rate applies where sub-contractors have applied for and received zero-rate authorisation from Revenue to allow them to receive payments gross, without deduction of RCT.

New Penalty Regime for RCT

Further to the enactment of Finance Act 2014, a new computer-generated penalty regime was introduced with effect from 1 January 2015, which applies to principals who fail to operate RCT correctly on relevant payments to sub-contractors. The penalties are determined by the RCT status of the sub-contractor:

- a 3% penalty where the sub-contractor is on the zero rate of RCT,
- a 10% penalty where the sub-contractor is on the 20% rate of RCT and
- a 20% penalty where the sub-contractor is unknown to Revenue or is on the 35% rate of RCT.

These penalties are discussed in detail in an article by Emer O'Sullivan in *Irish Tax Review,* Issue 2, 2015.

"No Loss of Revenue"

The strict application of these penalties could, without exaggeration, be catastrophic for a business. We do not know at this stage whether the new regime will allow for "no loss of revenue" situations. The Code of Practice for Revenue Audit seems to permit some latitude, which we believe is essential.

With the best will in the world, human errors will arise, and it would be most unfair to penalise taxpayers for inadvertent lapses in operating RCT. Our hope is that common sense will prevail and that a practical approach will be adopted by Revenue in the implementation of these penalties.

Conclusion

The area of RCT and reverse-charge VAT presents many difficulties of interpretation. The Institute is in discussion with Revenue at present to clarify as far as is practical the areas of doubt. Moreover, failure to operate RCT and to apply reverse-charge VAT correctly can lead to considerable tax exposures. Where a business is involved in construction operations, great caution should be exercised in considering whether an RCT or reverse-charge VAT issue arises.

Read more on taxfind *Law of Value-Added Tax, Finance Act 2014,* Volume 1