

VAT treatment of construction services 2/14/23

The VAT Act has imposed reverse-charge VAT on construction services since 2018. But is it clear in what cases a service, especially one that doesn't involve technical construction works, is governed by the VAT rules on construction services? Practice shows it's not clear.

The legal framework

Contrary to the general procedure, VAT on a domestic supply of construction services is paid by the customer if both the supplier and the customer are registered for VAT. Construction services mean any construction works and all types of design work included in an agreement for construction services.

The guidance published by the State Revenue Service (SRS) on its website links the VAT Act's provisions for reverse-charge VAT with the Construction Act's definition of construction works: these are part of the construction process and are carried out on a construction site or in a building to create a building, to place a prefabricated building or its part, to rebuild, renew, restore, conserve or demolish a building, or to install an engineering network. The SRS goes on to explain that reverse-charge VAT applies also on construction services that are supplied as separate construction services (e.g. repair works supplied separately), without linking those exclusively to the process of renewing or rebuilding a property. Reverse-charge VAT doesn't apply on works carried out to maintain or clean a building or to change equipment, without affecting the internal or external walls of the building. Such works don't qualify as construction services for VAT purposes.

The SRS guidance singles out the VAT treatment of design services because the VAT Act mentions design as a construction service on condition that it is prescribed by the agreement for construction services.

The guidance includes a number of examples that assess whether reverse-charge VAT applies on particular services. The essential criteria for treating a service as a construction service for VAT purposes are as follows:

- The works are construction works with the meaning of the law governing the construction sector.
- The works affect the internal and external walls of the building.
- The works are specified in the construction agreement and its appendices (estimates for construction works).

The SRS explains that the VAT treatment of site clean-up and landscaping works, for example, depends on whether these services were included in the overall construction agreement. If such services are supplied separately, they should be subject to the general procedure.

This seems to mean that various services of an administrative nature, such as legal, project management or financial accounting services, are not construction services for VAT purposes, especially if such services are not part of the overall contract for construction works.

However, recent practice shows that the SRS tends to broaden the scope of services that are subject to reverse-charge VAT. Where a Latvian company acting as general contractor for construction works acquired various services from another Latvian company, including a lease of personnel to manage the construction project and perform support functions (taking out permits and performing financial accounting and other functions), the SRS stated that such services should have been subject to reverse-

charge VAT, not the general procedure.

Although the company explained that construction works on the construction site are acquired from other suppliers engaged in separate construction agreements, and the services are subject to reverse-charge VAT, the SRS dismissed these arguments and stuck to its original view.

The SRS's opinion

In reply to the company's arguments for separating administrative services from construction works, the SRS stated that if the company has acquired personnel services to secure the management, supervision and administrative functions for the construction project and those services are included in the contract for construction works signed by the company as general contractor and in its appendices (estimates for construction works), i.e. the costs of those services form part of the value of construction services, the transaction is subject to reverse-charge VAT under section 142 of the VAT Act.

Basically, all the services acquired by the general contractor represent costs that are included in the costs of construction services, which might also be specified in the estimates, so there is the risk of the SRS finding that most of the services are subject to reverse-charge VAT.

An incorrect VAT treatment appearing on an invoice (i.e. VAT charged under the general procedure instead of the reverse charge) may serve as a basis for the SRS to deny the right to recover input tax. Construction projects involve high costs, so VAT amounts are substantial. Applying VAT incorrectly may create both the risk of a late fee and the risk of a penalty resulting from a tax audit.

We believe that each situation should be assessed on its merits, and if there are any questions, a letter confirming the VAT treatment should be sought from the SRS.