

Can VAT be levied on penalties in a construction contract?

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When projects in the construction run over their deadline, penalties are imposed at an agreed rate from the contractual stipulated date to the actual date of completion. The agreed rate is meant to represent a genuine pre-estimate of damage that may be suffered as a result of the failure of one of the parties to fulfill its obligations timeously, or at all, and if it is excessive or out of proportion to the prejudice suffered it may be susceptible to relief provided for under the provisions of the Conventional Penalties Act, Act 15 of 1962.



Source: Supplied

A survey performed in 2020 reported that more than 70% of government construction projects were delivered late for various reasons where the contractors would have been held liable for penalties.

Payment in construction contracts is generally made through a certification process where an amount is stated in a payment certificate as due and payable within a period of time after an invoice has been issued for that amount. Penalties are generally also regulated by the same process and are included as a deduction in the payment certificate. This can result in a negative payment certificate where the amount due to the employer is invoiced to the contractor for payment.

Can value-added tax (VAT) can be certified and invoiced for the penalty levied?

The requirement to pay VAT is regulated by statute, in this case section 7(1)(a) of the VAT Act that says “[s]ubject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value added tax on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him”.

However, penalties may result in a deduction to the contract price and accordingly reduce it, which then in effect results in the opposite of the “supply of goods or services in the course or furtherance of a vendor’s enterprise”.

In addition, penalties are a substitute for general damages claims, so a penalties payment is for damages suffered and not for any services rendered.

The South African Revenue Service (Sars) *VAT 409 – Guide for Fixed Property and Construction for Vendors* sheds some light on the issue, stating that a “penalty could represent a reduction of the agreed contract fee, in which case the value of the supply is reduced and VAT must be accounted for **on the reduced amount**”. Furthermore, “the penalty could be a payment which is not in relation to a taxable supply of goods or services and as such not subject to VAT”, which indicates that penalties are therefore not subject to VAT.

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