Complex transactions typically require well drafted contracts. But how close do you look at the tax clauses of your contracts or written agreements? A poorly drafted contract can often result in unintended consequences when it comes to Value Added Tax (VAT) and the parties’ responsibilities.

VAT has four fundamental areas that impact contract terms:

- Nature of supply (e.g., goods, services, tangible property, real property, intellectual property)
- Consideration paid (e.g., cash or in kind payments)
- Place of supply (e.g., domestic or foreign transaction)
- Time of supply (i.e., when the VAT is payable)

A contract should address each of these fundamental areas to avoid ambiguity and limit risk of VAT liability. No business person wants to face the costly mistake of being unable to collect the VAT from their customer or having to absorb unexpected VAT costs in their bottom line. Below are some common areas where tax ambiguity often exists.

**Tax inclusive pricing**

The Value Added Tax Act, 2014 ("the VAT Act") states that the price charged by a person registered for VAT is deemed to include the tax whether or not the vendor has included the tax in their price. Thus where formal agreements are silent on whether VAT will be added to a contract price, the law provides that it is inclusive. Only where the vendor carries on a marketing campaign can they state a VAT-exclusive price provided they also include a statement that VAT will be added to the price.

One area where problems most often arise is where a vendor assumes a particular transaction is VAT exempt or zero-rated. The vendor may enter an agreement that states that the price is inclusive of VAT “if applicable.”

Down the road, an amendment to the VAT Act may occur which then causes the transaction to be subject to the standard rate of tax. Normally, the vendor would simply start adding VAT to their invoices in this case. However, because the vendor has already stated in their agreement that the pricing includes VAT, the customer has actually received a tax windfall since they become entitled to recover the VAT inclusive in their price.

**Real property**

VAT applies to most real property transactions with limited exceptions. Uncertainty can exist where the vendor is a VAT registrant and enters into an agreement of purchase and sale for the transfer of real property with a stated price. As noted above, the VAT Act states that the price paid for a taxable supply is deemed to be inclusive of VAT. In the case of a real property transaction, because VAT is not paid to the vendor but to the VAT Comptroller directly by the purchaser’s agent (typically their lawyer), the opportunity exists for disagreement over the actual proceeds the purchaser expects to pay since the law presumes the price to be VAT inclusive.

However, where real property is sold by a non-registrant, the vendor has no obligation to collect or state that the price is VAT-inclusive. The obligation to collect the tax in this case simply falls upon the Comptroller and is paid by the purchaser’s agent at the time of registration. In this case, VAT becomes a “tax extra” disbursement upon closing.

Therefore, when dealing with real property transactions, it is important that the Agreement of Purchase and Sale and closing documents clearly address the agreed upon price and the assumptions concerning the amount and payment of VAT. Caution should be taken to avoid using terms that may contradict the VAT definitions or statutory requirements. When ambiguity exists and the Courts
cannot discern whether the purchase price was intended to be VAT inclusive or VAT exclusive, they must turn to the VAT Act itself to draw conclusions.

**Sale of a business**

The disposition of a taxable activity as a going concern (including such part of the activity capable of separate operation) is treated as a taxable supply of goods. Where a taxable activity is supplied by one registrant to another registrant, the VAT Act provides that the supply will be zero-rated. In other words, the sale of the business is taxable but the rate of tax is zero percent (0%).

To qualify for this zero-rating treatment there are very specific criteria that must be met including:

- The business cannot be dormant and must be operational prior to the sale
- The transfer of assets must constitute its entire taxable activity

When the agreements are drafted for these business sales, the purchaser may decide to split some of the assets between two separate entities for estate planning or creditor protection reasons. For example, a holding company will own the building and an operating company own the equipment. These types of changes prior to closing can impact whether the sale continues to qualify for the zero-rated treatment. However, both parties have entered the agreement believing that the sale will be zero-rated and the vendor does not collect the VAT.

Two issues emerge in this case. One, the current practice is that VAT will be collected by the Comptroller on the real property when it is registered despite the zero-rating provisions. Second, the agreement assumes the purchaser has no obligation to pay VAT either on the real property or on the remaining assets. The purchaser’s actions however, would negate their entitlement to the zero-rating since they’ve split the asset sale into smaller bundles. The sale is no longer a sale of a business as a going concern. The vendor in this case needs to ensure their agreements protect them from any tax liability from unintended results of changes to the planned business sale.

**Construction contracts**

A construction contract by its nature is a supply of services which include the underlying materials used in the project. These contracts normally provide for a series of progress billings and are subject to specific holdback provisions. The VAT Act provides that the VAT applies to each payment that is due under the agreement. Furthermore, the timing of the tax liability is based on the earlier of the due date or the date of invoice. Holdbacks are treated in a similar manner.

Generally as scheduled work is completed the contractor issues an “application for payment” which requires an engineer or architect to certify the value of the work completed and the value of the materials delivered to the site. The developer is then obliged by the contract to pay the certified amount within a certain period of time after the certificate has been issued. Under the circumstances the application for payment itself is not an invoice for VAT purposes since it is only a request for the payment certificate. Accordingly, the VAT liability occurs on the date determined under the contract terms for payment or when the contractor issues their invoice – whichever is earlier.

On cost-plus contracts, the overall contract price is based on the underlying net costs plus a builder’s fee or margin. It is important in these arrangements that both the contractor and purchaser clearly address VAT on the costs included in the contract. For example, if the materials are being brought in under a VAT deferral arrangement (such as under the Industries Encouragement Act), the contract price in total will still be subject to VAT unless the contractor is importing the materials as agent of the developer. When the contractor issues their invoice, they need to be clear that the costs are exclusive of VAT so that when VAT is applied to the invoice no “double taxation” occurs.

Construction contracts by their nature are complex. Because VAT can create significant cash flow issues and reflects 75% of the contract price, it is important that all terms and conditions anticipate possible VAT obligations for both parties.

**Barter**

Not every contract involves money. Sometimes two parties want to exchange goods or services with another party in trade. Trading one good or service (supply) for another is referred to as a barter transaction. When any two parties agree to a reciprocal exchange of goods or services and carry out that exchange usually without using money, they’ve entered into a barter agreement. When the two parties are dealing at arm’s length it is a fundamental principle that each person considers that the value they receive is equal to the value of the good or service they have given up in exchange.

When entering into contracts where all or part of the consideration is an offset of goods or services, it is important that VAT is addressed as part of the agreement. Even though you may have no cash involved or only a partial cash payment, you are still agreeing to provide a good or service in exchange for consideration. Consideration by law is the inducement to a contract and can be anything of value whether cash, goods or services. The VAT liability on a supply of taxable goods or services is determined by calculating the total consideration for the taxable supply. The VAT Act states that consideration is defined to be money or “money’s worth” paid or payable for the supply.
Therefore, it is important that any VAT clauses in your contracts that include a barter element appropriately addresses the agreed upon value of the offset for proper reporting of VAT by both parties.

**Changes to tax rate**

Contracts typically include clauses that address the issue of changes that can be agreed to by each party. In the case of fixed price contracts, a vendor could be at a loss if the VAT rate increases but the contract does not allow for any pricing changes that result from any change to the VAT rate. To avoid this, it is important your legal counsel includes language that entitles you to an increase in payment for a change in the contract price attributable to an increase in any VAT or other taxes that form part of the price of the contract.

**Place of supply**

For VAT purposes, the place of supply is the location where the transaction is deemed to take place for determining the jurisdiction and whether or how much tax will apply. The basic principle in a VAT regime is that the tax should only apply to the supply of goods or services within the domestic jurisdiction. Therefore, in the case of cross-border transactions, the place of supply is especially important as services provided to non-residents are typically zero-rated (i.e. no VAT collected) and goods that are delivered outside the country are also similarly zero-rated. If a Bahamian vendor relies on the transaction taking place outside The Bahamas and thus does not collect or remit VAT on their related sales, they are at risk of liability if the place of supply is later determined to be within The Bahamas and taxable at the standard rate. Alternatively, a Bahamian purchaser may acquire goods from a non-resident, non-resident that are delivered in The Bahamas but have no means to recover VAT that would be included in the purchase price.

Say for example a Bahamian retailer purchases inventory from a distributor in the US. The terms state that the transfer of risk and possession occurs when they leave the port of Miami. This means that the place of supply is outside The Bahamas and the Bahamian importer will be liable for VAT at the time the goods clear Customs and accordingly recover the VAT through their input credit. However, if the vendor has agreed to clear the goods and deliver them to the purchaser’s warehouse in The Bahamas, the VAT obligation rests with the vendor since they are the importer. If the vendor is not registered for VAT, the prices would likely be inflated to cover the vendor’s cost. The purchaser would not be able to claim input VAT since the Customs documents would be in the name of the vendor.

Clear contract language supported by proper documents supporting the place of supply and related VAT obligations is key to ensuring that both parties do not encounter any unintended VAT costs relating to their transactions.

**Summary**

Contracts by their nature protect the rights and interests of both parties. The purchaser knows what they expect to receive and how it will be delivered. Similarly, the vendor needs to clearly understand what goods or services they must supply, where it will be supplied and the price they will be paid. Ambiguity or absence of details can sometimes lead to adverse VAT consequences for either party.

This article illustrates some of the areas where businesses can examine their contracts to ensure that their VAT liabilities have been appropriately accounted for with the underlying transactions. Would your contracts and agreements allow you to properly address a VAT obligation or refund?

A contract review helps you to identify possible VAT liabilities and exposure. KPMG can assist with these reviews by reviewing the nature of the transactions detailed in your agreement(s) and whether VAT would be payable and on what value. We can also help identify pricing matters that may provide opportunity to renegotiate to manage your profitability under the contract.