

ETRS/SRTL Public Ruling 2001/6

Public Ruling: Construction income and subcontractors

Relying on this Ruling

This is a public ruling within the meaning of Section 66 of Regulation 2000/18. Information in this ruling may be relied upon by taxpayers as the basis for determining their tax liability.

Introduction

1. As a result of Regulation 1999/1, the *Law on Income Tax* applies to business income in East Timor, subject to some modifications in Regulation 2000/18 (as amended). Many types of business income will be subject to withholding tax under the *Law on Income Tax*.
2. Both final and non-final withholding taxes may be imposed on business income derived by persons who are residents of East Timor or who are non-residents but who derive the income through a permanent establishment in East Timor.
3. Business income (including income from construction activities) derived by a non-resident of East Timor who does not derive the income through a permanent establishment in East Timor is subject to a final withholding tax.
4. Where a non-final withholding tax is imposed on business income, the taxpayer deriving the income must deliver an income tax return at the end of the tax year. If the taxpayer's tax liability for the year on business income exceeds the tax withheld on business income paid to the taxpayer, the additional tax is a debt owed to the East Timor Transitional Administration. If the taxpayer's tax liability for the year on business income is less than the tax withheld on business income paid to the taxpayer, the excess tax paid will be refunded to the taxpayer.
5. By way of contrast, where a final withholding tax applies to income, no further tax liability is imposed on the income and no adjustments to the tax will be made.
6. The following types of income related to the construction industry are subject to a *final* withholding tax when paid to persons who are residents of East Timor or who are non-residents but who derive the income through a permanent establishment in East Timor:

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income from construction and building activities	2 %
income from construction consulting services including project management, engineering design and site supervision services	4 %

7. The following types of income related to the construction industry are subject to a *non-final* withholding tax when paid to persons who are residents of East Timor or who are non-residents but who derive the income through a permanent establishment in East Timor:

income from the provision of the following services: interior and landscape design architectural surveying	5 %
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8. A 20 % final withholding tax is imposed on income of non-resident contractors with no permanent establishment in East Timor. However, since a construction site will normally give rise to a permanent establishment under the *Law of Income Tax*, it can be assumed that in most cases the relevant withholding tax rate is 2 %.

9. The responsibility for withholding tax will usually rest with the payer and this ruling deals with withholding tax obligations in these circumstances. In certain situations, the responsibility of withholding the tax rests with the recipient. These “self withholding” arrangements will be the subject of a separate public ruling.

10. A variety of contractual arrangements exist in the construction industry. Most arrangements fall into one of four categories:

- A builder may build a project on his own account and then sell the completed building to a new owner.
- In some cases, a contractor contracts with a customer to provide construction of a building or infrastructure and that contractor carries out the work directly, employing its own specialists with the various skills required.
- Sometimes, a contractor contracts to provide construction supervision and project management services for a construction project but the individual specialist contractors that carry out different types of construction tasks (e.g., tilers, plumbers, electricians, bricklayers, roofers, and so forth) contract directly with the person for whom the building or infrastructure is built.
- Finally, contractors often contract to provide construction services and then subcontract various parts of the construction work to specialist sub-contractors.

11. The second (next) part of this ruling explains the difference between income from construction and building activities (which is subject to 2 % final withholding tax) and income from construction consulting services (which is subject to 4 % final withholding tax). The third part of the ruling explains how the withholding tax works in the case of contractors and subcontractors. The fourth part of the ruling explains what happens if a person paying income that should be subject to final withholding tax fails to withhold the tax as required.

Which rate of withholding tax applies?

12. Income from construction and building activities is subject to 2 % final withholding tax while income from construction consulting services is subject to 4 % final withholding tax. The two different rates reflect the fact that taxpayers providing the first type of activity will usually incur higher costs as a percentage of their total income than taxpayers providing the second type of service.

13. The distinction between construction and building activities and construction consulting services is a distinction between on the one hand the actual activities that are directly part of the physical labour of construction or building and on the other hand the one-step removed process of supervising or managing a project in which other persons carry out the physical labour. A person who undertakes direct construction or building work will incur costs of tools, other equipment and supplies that are likely to be much greater than the costs incurred by a person who provides supervisory or management services.

14. In most cases, there will be little difficulty in ascertaining whether a person is carrying out construction and building activities or construction consulting services. Where a person is carrying out only construction consulting services, the persons providing the construction and building activities will be doing so under contracts with the customer to provide a building or construction item or under contracts with a head contractor who is responsible for the actual building or construction.

15. In some cases, the same person may be responsible for actual building or construction and supervision of a building or construction project. In this case, the person will be a head contractor who has contracted with the customer to provide a building or construction item and then contracted with subcontractors to carry out various parts of the construction and building work. The supervisory and management services performed by the head contractor are merely ancillary to the construction and building activities which that person provides. His contract with the customer is for the product of construction and building activities, not supervisory or management services. These are only incidental to the taxpayer's work and arise

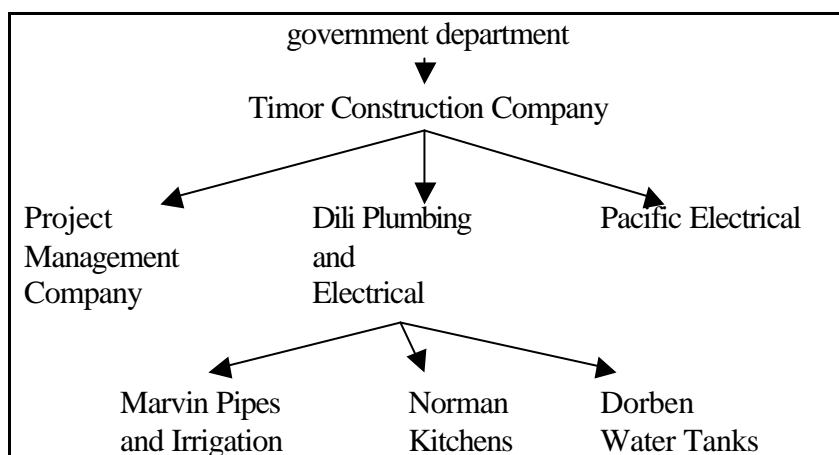
only because the taxpayer in this situation relies on subcontractors to carry out some or all of the tasks involved in the construction and building activities.

How does the withholding tax apply to head contractors and subcontractors?

16. Where a contractor contracts to provide the product of building and construction activities and undertakes all the work required itself, the only payment subject to final withholding tax will be the payment from the customer to the contractor. If the contractor acts as a head contractor and subcontracts various building and construction activities to subcontractors, the payments to those persons, who are also being paid in respect of building and construction activities will also be subject to the final 2 % withholding tax. Even if the head contractor does none of the actual work itself, it is providing building and construction activities as this is what it had contracted to do. The choice to use subcontractors instead of doing the work itself will not change the nature of the services it has contracted to provide. The customer's recourse if there is a problem with the work is with the head contractor, not any subcontractors that the head contractor may have used to carry out particular tasks.

Example:

Timor Construction Company has contracted with a government department to reconstruct a damaged school building. Timor Construction Company in turn subcontracts parts of the project to three businesses, Project Management Company, Dili Plumbing and Electrical, and Pacific Electrical. Project Management Company is responsible for supervising the activities of the other subcontractors for the project. Dili Plumbing and Electrical in turn contracts with three businesses: Marvin Pipes and Irrigation to install water and sewerage pipes required for the project, Norman Kitchens to finish the canteen area of the school and the toilet facilities, and Dorben Water Tanks to produce and install water storage facilities on the roof of the building.



The government department has contracted with Timor Construction Company to rebuild the school. This contract is a primary "construction and building activity" contract. Timor Construction Company can do the actual work required as part of the construction and building activity itself or it can subcontract the work, as it has done. The payment to Timor Construction Company is income from construction and building activities and will be subject to a 2 % final withholding tax.

The payments by Timor Construction Company to Dili Plumbing and Electrical and Pacific Electrical are also payments for building and construction activities and accordingly will be subject to a 2 % final withholding tax. The payments by Timor Construction Company to Project Management Company are for supervisory and management services and will be subject to a 4 % final withholding tax.

The payments by Dili Plumbing and Electrical to Marvin Pipes and Irrigation, Norman Kitchens and Dorben Water Tanks are all in respect of building and construction activities and each of these will be subject to a 2% final withholding tax.

What happens if a person paying income subject to withholding tax fails to withhold tax?

17. Regulation 2000/18 and, by reason of Regulation 1999/1, the *Law on Income Tax* impose a liability to withhold tax on persons paying the types of income subject to withholding tax. The failure of a person required to withhold tax to do so will not relieve the recipient of income of liability to pay the tax that should have been withheld. If a person required to withhold tax fails to do so, pursuant to section

38.5 of Regulation 2000/18, the Commissioner will assess the recipient of the income for the tax that should have been withheld.

18. Conversely, if a person who is responsible for withholding tax under Regulation 2000/18 and the *Law on Income Tax* fails to do so and as a consequence the Commissioner assesses the recipient of the income for the tax, the fact that the tax has eventually been paid will not affect the liability of the person paying income to withhold and deliver the tax. In other words, a person who pays income that should be subject to withholding tax has no option to “elect” not to pay the tax so that the recipient of the income will pay the tax.

19. If the Commissioner is required to assess the recipient of the income because of the failure of the person paying the income to withhold tax, the Commissioner may separately impose additional tax on the person who failed to withhold tax as required under the law for failure to deliver a tax return and failure to deliver the tax that should have been withheld. In addition, the Commissioner may charge the person who should have withheld tax with the offences of failure to provide information or a tax return and failure to pay tax as required. Financial penalties or imprisonment may be imposed on a person convicted of these offences. The Commissioner may also deny the person who should have withheld tax from claiming a tax deduction in respect of amounts that have not been correctly subject to withholding tax.

Date of effect

20. This Public Ruling has effect from 14 March 2001.

Thomas Story
Commissioner of East Timor Revenue Service
14 March 2001

Legislative references:

final withholding tax	Reg 2000/18 s 38.3
withholding tax rate on construction and building activity	Reg 2000/18 Sch 1, s 6, Pt A, (a)(i)