

## **Service Tax on Construction Contracts: Separate Tax Treatment for Material/Services, Retention Sums and the January 2026 Update for Non-Reviewable Contract Exception**

*From 1 July 2025, construction work services were subjected to 6% service tax under the amended Service Tax Regulations 2018 which has come into force. This article discusses the latest 2026 updates on the construction work services SST and specifically, separate tax treatment to the supply of construction materials/goods and construction work services, treatment of retention sums, and the application of the exemption for non-reviewable contracts.*

Since 1 July 2025, construction work services were subjected to 6% service tax under Group L, First Schedule of the Service Tax Regulations 2018 which has come into force.

After 1 July 2025, all construction work services became subject to service tax, except where payment for the construction services has been made in full prior to the implementation of service tax on construction work services.

For construction work services that commenced before 1 July 2025 and continue after that date, service tax is chargeable only on the portion of services performed on or after 1 July 2025.

While the position on the application of service tax on construction contract is now generally understood, several points of confusion still persist in the construction industry. These include the separate tax treatment to the supply of construction materials/goods and construction work services, treatment of retention sums, and the application of the exemption for non-reviewable contracts.

### **Separate Tax Treatment to the Supply of Construction Materials/Goods and Construction Work Services**

Royal Malaysian Customs Department has issued Service Tax Policy No. 7/2025, to clarify its position on the Tax Treatment on Invoices Related to the Supply of Construction Materials/ Goods and Construction Work Services.

The Service Policy has specified that service tax is imposed on only the value of the construction work services, and not on the value of supply of construction materials/goods, provided the construction service provider issues separate invoices or itemised billing for the value of construction materials/goods supplied and construction work services.

### **Retention Sum**

In construction contracts, the retention sum is typically released only after the project is completed and upon the expiry of the defect liability period.

For service tax purposes, where the construction contract was executed and fully completed before 1 July 2025, but the defects liability period extends beyond that date, then the retention sum is not subject to service tax.

Where the construction contract was entered into before 1 July 2025, but the construction services continue on or after 1 July 2025, service tax is chargeable on retention sums that relate to construction services performed after the effective date.

According to Royal Malaysian Customs Department's Guide on Construction Work Services, for construction projects executed after the effective date, service tax shall be imposed on retention sum payments once the retention liability period has expired or the retention sum is received by the contractor, whichever is earlier.

Even if the retention sum is not paid out to the contractor within 12 months from the expiry of the retention liability period, the service tax will still be deemed due and payable by the contractor, on the day immediately following the end of that 12-month period.

Finally, service tax should only be imposed on the final retention sum, after taking into consideration any deductions, e.g. deductions imposed for defects.

### **Two-Year Exemption for Non-Reviewable Contracts**

Under the Service Tax Regulations, construction work carried out pursuant to a *non-reviewable contract* is granted a two-year exemption from service tax, by the Minister of Finance under the provision of **section 34(3)(a) of the Service Tax Act 2018**, from 1 July 2025 to 30 June 2027.

The concept of "non-reviewable contract" has previously been utilised in the now-repealed Goods and Services Tax Act 2014.

Under **section 187 (3) (a) of the GST Act**, a "*contract with no opportunity to review*" *"means any written contract or agreement which has no provision for a general review of the consideration for the supply for such a period until a review opportunity arises."*

Against this background, **Appendix A of the SST Policy No. 3/2025 (Amendment No. 3)** which was amended on 30 January 2026, sets out specific conditions that must be satisfied before a construction contract can be treated as non-reviewable.

To qualify for this exemption, the contract must, among others:

- a. be a fixed lump sum contract with no price revision or value adjustment mechanism;
- b. be in writing, signed, and stamped by LHDN on or before 31 December 2025;
- c. specify a fixed contract value, the type of service, and the contract duration;
- d. remain in force after 1 July 2025; and
- e. ensure that any Variation Orders or Extensions of Time do not alter the overall contract value, and are properly documented, signed before 1 July 2025 and duly stamped with stamp duty by LHDN before 31 December 2025.

Where a construction contract qualifies as non-reviewable, service tax does not need to be charged during this exemption period. Service tax will only become chargeable for construction work performed from 1 July 2027.

### **Does a Variation Order Clause Make a Contract "Reviewable"?**

Construction contracts commonly include Variation Order (“VO”) clauses, which allow changes to the scope of work, such as additional or omitted works.

It has been argued by the Royal Malaysian Customs Department that the existence of a VO clause renders a contract *reviewable*, on the basis that parties are able to revise the contract price. This argument was decisively rejected in the High Court case of ***Konsortium CMC Engineering Sdn Bhd — Colas Rail SA — Uni-Way Sdn Bhd v Ketua Pengarah Kastam, Jabatan Kastam Diraja Malaysia [2023] 12 MLJ 393***, and the decision was subsequently affirmed by the Court of Appeal.

The High court held that a variation to design and supplementary work cannot be deemed to be a ‘general review of the consideration’. A mere VO does not mean that there is an opportunity for general review of the contract, and the consideration of the contract (i.e. contract price) is a fixed lump sum that shall not be subject to adjustment or recalculation.

Although this case was decided in the context of the now-repealed Goods and Services Tax Act 2014, the concept of a non-reviewable contract is arguably identical, and the reasoning remains relevant as a reference point.

## **Conclusion**

The service tax guide and newly updated policy provide some further clarity on implementation of service tax for the construction industry, however if you require any clarification on the effect of the new service tax on your business, please contact the author at [brandon.shen@azmandavidson.com.my](mailto:brandon.shen@azmandavidson.com.my) or 03-2164 0200.

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