How will you be affected by the new UAE VAT regime? Failing to Prepare is Preparing to Fail

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This article provides an update on the status of the VAT implementation across the GCC, the future legal framework of VAT in the UAE and the expected features of the UAE VAT system based on the first workshop recently held by the UAE Ministry of Finance.

GCC VAT Framework Agreement

The GCC VAT Framework Agreement, which is yet to be published, has now been signed by all six countries in the GCC. It is understood that it will be made public after it has been ratified by all the GCC countries, which is expected to happen shortly.

The GCC VAT Framework Agreement sets out broad principles to be followed by all the GCC countries whilst giving individual member states some freedom to adopt a different VAT treatment in respect of certain matters. Each GCC country will issue its own domestic legislation to implement VAT based on the underlying principles in this common framework.

Implementation date

All GCC countries have agreed to implement VAT from 1 January 2018 and by 1 January 2019 at the latest. Currently only the UAE, which has been at the forefront of the GCC VAT drive and appears to be at the most advanced stage in terms of implementation, has formally announced that it will introduce VAT on 1 January 2018.

The other GCC countries are likely to face many challenges and obstacles in finalising the domestic legislation and pushing it through by 1 January 2018 and so it is anticipated that not all the GCC countries will achieve implementation simultaneously as has been reported. VAT is expected to be effective in the Kingdom of Saudi Arabia in the first quarter of 2018 and in Bahrain by the middle of 2018. Qatar, Oman and Kuwait have not yet made any official announcements on the specific timing.

The UAE VAT Administration and Legislative Framework

A federal tax authority (“FTA”), which is currently in the process of recruiting staff, was established last year and is entrusted with the management, collection and enforcement of VAT.

The Federal National Council recently approved the tax procedure law and this is expected to be issued before Ramadan (June 2017). The tax procedure law will be relevant for all current and future taxes, including VAT, and will set out the procedures for tax registration, collection, audits, penalties, appeals etc.

The VAT rules and obligations will be governed by a separate Federal VAT law. This will be supported by executive regulations which will provide guidance on the detailed application of the VAT law. As there are still a number of key policy decisions to be taken, it is likely that the VAT law will be issued around mid-2017 with the executive regulations to follow later in the year.

VAT Basics

VAT is a consumption tax that is levied on the value added at each stage in the supply chain. VAT registered businesses will charge VAT on the goods and services supplied to customers and pay VAT on goods and services received from suppliers. The difference will be accounted for by the business and paid to, or reclaimed from, the government as appropriate.

Although VAT is collected by businesses on behalf of the government, it is generally ultimately borne by the final consumer. Unless the goods or services are exempt or zero rated, the supply of the goods or services will be subject to VAT at the standard rate.

The distinction between zero rated and exempt supplies is important. Businesses that make zero rated supplies may be entitled to register for VAT and recover VAT on their purchases but exempt businesses will not.

What do we know about VAT in the UAE?

Under the GCC VAT Framework Agreement, VAT will apply at the standard rate of 5% across the GCC. Additional details have emerged from the first Ministry of Finance VAT awareness session on the specific features of the future VAT regime in the UAE. However, the VAT treatment described below may be subject to change and can only be confirmed once the VAT law is approved.

VAT will be charged based on the destination principle on the local supply and importation of goods and services (i.e. VAT applies where the goods and services are consumed in the UAE), with exports subject to VAT at zero rate.

Businesses must register for VAT if they have annual turnover that exceeds the mandatory registration threshold of AED 375,000 – reduced from AED 3.75 million, which was proposed last year. An option to register for VAT will be available if the taxable supply and imports are below the mandatory registration threshold but exceed the voluntary registration threshold of AED 187,500 – reduced from AED 1.875 million. The previous limits were set high to alleviate the compliance burden on businesses; however, in a shift to the strategy designed to enable businesses to recover VAT, these limits have been significantly lowered.

For businesses with no turnover, it will be possible to register voluntarily if the expenses exceed the voluntary registration threshold, which gives start-up businesses the ability to recover input VAT. The Ministry of Finance has indicated that it will be possible to register for VAT on a voluntary basis from the third quarter of 2017, before VAT registration becomes compulsory from the final quarter of 2017.

Group registrations will also be available for companies that meet the criteria of a “VAT Group”. A VAT group will be treated as a single person for VAT purposes with the consequence that only one VAT return will be required to be submitted for the group.

Although VAT will be levied at the federal level, businesses will be required to report revenue for each Emirate in the Federal VAT return. This will result in an additional compliance burden for businesses that will need to ensure that their systems record sales in this manner.

Healthcare and education services will be zero rated rather than exempt, which was widely expected to be the case. Zero rate will also be applicable to medicine and medical equipment.

It is expected that margin-based financial services will be exempt due to quantification issues while fee-based products will be subject to the standard rate of VAT. The VAT treatment of Islamic finance will be aligned with the conventional equivalent. General insurance services will be subject to the standard rate of VAT except life insurance, which will be exempt.

In terms of real estate, sale and lease of commercial property will be subject to VAT at the standard rate whereas the sale and lease of residential property will be exempt. However, the first sale of new residential property will be zero rated, which is good news for property developers who will be able to recover VAT on costs (including construction costs). Supplies of bare land will be exempt.

Local passenger transport, such as taxis, buses and trains, will be exempt from VAT. Jewellery will be standard rated whereas investment grade gold, silver and platinum will be zero rated.

The import of goods into the UAE will be subject to the reverse charge mechanism, which means that there will be no cash impact for most businesses because though VAT will be charged by the recipient there will be a corresponding deduction for the input tax. On the other hand, import VAT will apply on import of goods into other GCC member states transhipped through the UAE with no right to recover the VAT in the UAE.

Exports of goods and services outside the GCC and international transportation are expected to be zero rated. Given the low rate of VAT, it is currently anticipated that initially there will no VAT refunds for tourists, but this is subject to further deliberation.

The VAT treatment of supplies within free zones is still under consideration, including whether there should be a different VAT treatment adopted for businesses operating in “fenced” free zones and “unfenced” free trade zones as well as the treatment of supplies to, within, from and between free zones. The Ministry of Finance will issue further guidance on this area in due course.

There will be no special “body” level exemption for the government and, accordingly, supplies to government bodies will be subject to VAT at the standard rate and a VAT refund claim would need to be made by the relevant government authority.

VAT returns will be due on a quarterly basis for most businesses with returns and payments required to be submitted within a month after the quarter end. There is a possibility that larger businesses may be permitted to file on a monthly basis. The UAE will introduce an electronic registration, filing, payment and refund system. There is a requirement to keep records, including invoices, for five years.

There will be strict penalties for non-compliance – including business closure for three days and penalties up to 500% of the VAT owed in cases of fraud. The FTA will also have the power to conduct VAT audits with five days notice, unless fraud is suspected.

Final thoughts

The introduction of VAT will help the UAE generate additional revenue to fund public expenditure and to reduce its dependence on hydrocarbons, in line with the national diversification strategy. VAT is a popular tax for governments because it is easy for them to administer and enforce, as the compliance burden is transferred to businesses and it is cheaper for them to operate than direct taxes. It also allows governments to generate sustainable tax revenue which is collected on a regular basis at each stage of the production and distribution chain. The fact that it will be levied on transactions at the low rate of 5%, compared to the global average rate of about 15% for VAT and similar taxes, combined with the VAT recovery mechanism for businesses and exceptions for some sectors means that it should not have an adverse impact on foreign investment and the economy in general.

The UAE Ministry of Finance delivered on its promise to be transparent about this tax and to educate businesses. Its clarification on how the VAT regime is expected to operate in the UAE and how some of the key sectors will be affected is a welcome development. There are many positives which indicate that the UAE government have taken into account socio-economic policy considerations and carefully assessed the potential effect of VAT on certain types of businesses and industry sectors.

The zero rated treatment for healthcare, education and property development is unlikely to affect prices for these services and, therefore, businesses and customers in these sectors should not be impacted. The reduced mandatory VAT registration threshold and a low voluntary VAT registration threshold will enable many small and medium enterprises and start-up businesses to register and recover VAT.

While VAT is not imposed on and should not be a cost to businesses, ultimately the responsibility of accounting for VAT resides with them. There will be significant compliance costs for companies in ensuring that they collect and remit the tax to the UAE Ministry of Finance and otherwise comply with the reporting requirements Given that VAT will be introduced from 1 January 2018 in the UAE, businesses will be under pressure to get ready within a limited time. The challenges are compounded when you take into account that the VAT legislation will not be finalised and issued until later this year. However, the clarity provided by the UAE Ministry of Finance in the interim will help UAE businesses to prepare their people, vendors, customers and systems even before the VAT law is issued.

It is important for businesses to start preparing now by proactively assessing the impact of VAT on their operations across all functions including finance, legal, procurement, sales, marketing, IT and human resources. Existing functions, processes, invoicing, operating models, enterprise resource planning systems and commercial contracts should be reviewed and any changes implemented as soon as possible in order to be compliant with requirements in the VAT legislation.

Companies should not only consider including clauses in new contracts to address any VAT risks which were previously not relevant, but existing long term contracts, such as construction contracts, that straddle VAT implementation and agreements with automatically renewable terms should also be examined and potentially renegotiated. The lack of adequate protection in the agreements may have the unintended consequence of the suppliers bearing the VAT cost rather than the customers. Contracts with long payment terms should also be renegotiated to manage cash flow otherwise businesses will end up funding the VAT cost. Putting appropriate systems and measures in place is the key and will help to reduce compliance costs, maintain margins and minimise cash-flow issues.

As the VAT should ultimately be borne by the final consumer, it should have a neutral impact on most UAE businesses if the risk is properly managed. In practise, however, the ability of suppliers to shift the VAT burden to customers will be a matter of commercial negotiation. Companies will have to decide whether to bear the burden of the VAT cost or pass on the cost to customers. It will be a difficult balancing act between maintaining margins and risk low revenue due to reduced customer demand and so some businesses are likely to or will be forced to absorb a share of the VAT cost to remain competitive. Companies that make exempt supplies, such as financial institutions, will suffer an absolute cost unless the VAT cost is passed on to customers because they will not be able to recover the VAT on their purchases.

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