

How will the Introduction of Value Added Tax (VAT) in the UAE impact your existing Construction Contracts?

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Many contracts for the supply of goods and services, especially those relating to construction contracts, are intended to remain in place for a fairly significant period of time. Herein, we answer the question: How will VAT be applied where your existing contract extends beyond 1 January 2018?

The VAT law contains transitional rules that accommodate this type of scenario, but not all scenarios are addressed by these rules. The executive regulations, which will provide further details on the transitional rules, are expected to be issued during the fourth quarter of this year.

In general, the Law provides that if the supplier receives a payment or issues an invoice for goods or services prior to the Effective Date, but the goods or services are supplied after the Effective Date, the date of the supply shall be deemed to be 1 January 2018, in certain circumstances, thus, the goods and services would attract VAT. The Law further provides that if the contract has been concluded prior to the Effective Date, and does not contain 'clauses related to tax', and the supply occurs on or after the Effective Date, the contract price shall be treated as being inclusive of VAT.

We expect that the executive regulations, forthcoming, will provide an exception in circumstances where the recipient is also VAT registered and can recover the VAT, in which case the supplier would be entitled to add VAT to the contract price and shift the VAT burden to the recipient, who in turn would be entitled to deduct the input VAT in their VAT return.

The general rule appears to be, however, that the supplier will bear the burden of VAT, unless the contract states otherwise, or the executive regulations provide exceptions allowing a supplier to charge VAT where the supply is made to a VAT registered recipient.

On what price is the VAT calculated?

Once the contract price is deemed to be VAT inclusive and the supplier has, in effect, been burdened with the VAT obligation, the further disadvantage is that the VAT payable is calculated on the original contract price, regardless of whether it has made a provision for VAT. In other words, the VAT payable to government is calculated on the original contract price even though the contract price never included VAT.

What does it mean to have 'clauses related to tax' in your contract?

It is still to be determined if a typical price escalation clause in the case of a 'change in laws', such as Sub-Clause 13.7 of the FIDIC Red Book, would be broad enough to constitute a 'clause related to tax' or would otherwise independently allow suppliers to increase the contract price on account of VAT.

This sub-clause of the FIDIC Red Book makes provision for an adjustment of the contract price to take into account any increase or decrease in cost 'resulting from a change in the laws of the country (including the introduction of new laws and the repeal or modification of existing laws) made after the base date, which affect the contractor in the performance of obligations under the contract'.

The potential challenge lies in the activation of that sub-clause since it is arguable that the change in law by the introduction of VAT will not 'affect the contractor in the performance of obligations', since the obligations (to provide the goods or service) will not be affected by the increased price. This means that such a sub-clause may not be sufficient in itself to protect a supplier who will be seeking to pass on the VAT cost to the recipient.

What will the executive regulations say?

The VAT law also provides that the executive regulations of the Law will set out special provisions relating to the implementation of the law where a contract has been concluded before the Effective Date but the supply under the contract is wholly or partly made after the Effective Date.

The executive regulations are expected to be published in the latter part of this year, and it is anticipated that they may flesh out, in more detail, how the transitional rules will be implemented in practice. It is important to note that these executive regulations may have a significant impact on how the VAT obligation is intended to be applied to a host of construction specific issues, such as variations, delays in the supply caused by the employer or any receiver, or long lead items, such as elevators or control systems.

If businesses are entering into new contracts or renewing existing contracts before 1 January 2018, it is advisable to ensure that adequate provision is made for the application of VAT in respect of the supply of goods and services.