

# VAT Considerations for Commercial Contracts in the UAE

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## Introduction

The tax-free status of the countries within the Gulf Cooperation Council (GCC) is world renowned and a major draw for international corporations and foreign individuals alike, both of which are of great importance for the economy of the region. Personal income is mostly tax-free and corporation tax is generally non-existent with a few exceptions, for instance corporate taxation on revenues generated from the oil industry and in respect of branches of foreign banks (in the UAE).

It is understandable how such a low level of taxation has been feasible bearing in mind the region's proven oil reserves are some of the largest in the world. However the market price, and demand, of this finite resource is intrinsically linked to global economic growth. The rapid fall in the price of oil in 2009 was a result of the global recession at that time and, although OPEC may be able to control price to an extent, in practice it is difficult and prices have dropped by more than 60% since the middle of 2014. To counter this volatility, economic diversification is paramount and the UAE leads the way with its tourism, financial services and manufacturing industry sectors.

However the changing landscape has meant that the practice of GCC governments' funding budget deficits from (oil) cash reserves is no longer viable in the long term and valuable government services and infrastructure projects must be paid for. Whilst forms of indirect taxation exist, for example municipality housing charges, tourist and motoring fees, direct taxation is being considered and the GCC Supreme Council has resolved that all GCC countries will implement a VAT on or between 1 January 2018 and 1 January 2019.

## VAT

The legal framework is expected to be in circulation in June 2016 but it has already been announced by the Minister of State for Financial Affairs that the UAE shall implement a consumption tax (VAT) as from 1 January 2018. Other GCC Countries are expected to implement the following year.

Worldwide VAT levels range from 0% to around 25% and the UAE has confirmed that it shall impose a moderate 5%, on goods and services at point of sale, which is expected to generate around AED 12 billion in the first year.

A low consumption tax would appear to do little to deter from the "tax free" environment and is less of a disincentive to investment in the region than imposing direct corporation or income tax. However VAT is generally considered as a regressive tax, impacting those on lower salaries in relative terms, albeit those on higher salaries are impacted on absolute terms. This can be addressed by Government targeted welfare spending and exempting certain goods from VAT, which appears to be the approach in UAE, since it is expected that certain food items, healthcare and education will be declared as exempted goods for VAT purposes. In a positive light, a consumption tax may in fact reduce consumption and therefore our carbon footprint in support of sustainable development.

## **How it works**

Quite simply, VAT is charged by adding the VAT rate to the charges for the supply of goods and services. For example, if Company A sold its product or service to Company B, Company B would pay the cost of the product or service plus 5% (in the UAE). Of course, there will be a whole raft of other matters for a trading company to consider including registration with the competent tax authorities, administration of payments, eligibility for input / output tax recovery and exempt supplies. Moreover, actual location of the delivery of the services and/or products will have an impact on which jurisdiction the charges are imposed in and suppliers must consider cross border implications. As expected, tax evasion or avoidance will result in series sanctions, both criminal and civil.

## **Basic considerations for commercial contracts**

VAT will be generally chargeable on goods and/or services at the point of sale and, in most cases, the responsibility to account to the relevant authority for the VAT element will be on the supplier.

As a supplier of goods and/or services in the UAE, whether pursuant to a services agreement, distribution agreement or otherwise, generally at present the contractual terms in relation to payment will not provide for the consequences of taxation on the supply since this has not been an issue needing to be addressed. Therefore this means that standard form agreements are being issued regularly without any contractual VAT protections for the supplier and although, at present, no VAT is payable, many contracts will run across the implementation dates.

Contracts should clearly state whether the price is “inclusive” or “exclusive” of any applicable sales or value added tax and, in addition, a provision should allow for a valid tax invoice to be issued against payments if required by applicable law, as well as indemnification against loss or penalties. Given that a supplier is generally responsible for the VAT, if the contract is silent on these aspects then the supplier may find that it is required to account to the relevant authority and it may be unable to recover the VAT from its customer, leaving the supplier short changed.

## **Conclusion**

The introduction of a sales tax means that companies are advised to undertake a review of their current commercial arrangements and general terms and conditions of sale to ensure that their contractual position is suitably protected. In addition, internal procedures should be put in place to deal with collection and payment of the VAT.

An interesting point to note is in relation to the thousands of Free Zone consultancy businesses which are registered in the UAE and which, from time to time, in certain grey-areas of business may be deemed to have traded on-shore in the UAE and, therefore, to have undertaken activities that are not permitted by their license. With the introduced of VAT, these business owners will need to be conscious of the additional sanctions which may be imposed against them for non-payment of VAT in relation to any services which may be deemed to have been delivered on-shore, although of course this is assuming that the legislation does not impose a VAT on Free Zone services. Once the legal framework has been implemented, a deeper analysis of the law and regulation will be required to understand the reach of the taxation.

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