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Six months in: the impact of VAT on the GCC construction sector

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Executive Summary

In June 2018, six months after the UAE and Saudi Arabia introduced value-added tax (VAT) in accordance with the Gulf Cooperation Council Unified VAT Agreement, Thomson Reuters Projects in conjunction with Deloitte Middle East hosted a roundtable in Dubai to discuss the impact of the tax on the construction industry.

The roundtable brought together local and regional construction firms, offering a platform for them to share their experiences of operating within the new tax regime, while VAT experts from Deloitte Middle East and Thomson Reuters also offered their perspective.

Guest speaker Nurena Tarafder, Director, Indirect Tax at Deloitte Middle East, provided insights on the roll-out of VAT across the Gulf and updated attendees on the clarifications and guidance issued by the various tax authorities.

Attendees discussed the impact of VAT on the construction industry's complex supply chains, uncertainties over the application and recovery of VAT, emerging industry best practices, and the impact of filing periods on cash flow.

Participants shared the practical knowledge they've gained through collecting and recovering VAT. By comparing experiences, they were able to discern where correct practice is clearest as well as the areas where the tax authorities might need to provide further clarification.

This detailed outline of the discussion takes in what the audience considered to be the most important updates and the main areas of contention.

Introduction

In 2016 all six members of the GCC (Saudi Arabia, United Arab Emirates, Kuwait, Bahrain, Oman and Qatar) agreed to implement a unified tax system. By early 2017 all had signed up to the common GCC Unified VAT Agreement, which detailed the principles of how VAT should operate across the bloc, setting the framework to which signatories must abide.

More than a year later and only the UAE and Saudi Arabia have introduced VAT, with both countries levying the 5 percent tax from January 1, 2018. The remaining member states continue to work on their implementation planning. Such a complex undertaking makes it unlikely any of the remaining four countries will introduce VAT in 2018.

All GCC countries, however, have committed to following the framework agreement, which has the advantage of making VAT laws fairly uniform. This can already be seen in the similarities in the laws implemented in the UAE and Saudi Arabia.

Yet the GCC treaty does provide some flexibility to each member state to determine the VAT treatment of goods and services in specific sectors. This is evident in real estate, which includes construction services, with GCC member states able to choose whether to individually exempt or zero-rate the sector for tax. The UAE and Saudi have adopted somewhat different approaches.

As yet there is no indication whether the remaining four states will apply different VAT rates for the construction sector, so the industry must await further guidance while preparing for potentially different tax scenarios.



Saudi Arabia: six-month update

Saudi Arabia had previously established a tax authority to administer corporate tax and this has helped the country get off to a strong start regarding VAT implementation and enforcement.

Guidance

The General Authority of Zakat and Tax (GAZT) issued numerous guides covering the application of VAT for various industries, in both Arabic and English. GAZT also launched an app that has reportedly achieved more than 1.4 million downloads.

Although not legally binding, these guides have been useful in providing direction for businesses and an indication as to the thinking behind GAZT's decisions.

Compliance inspections

Deloitte reported that the Saudi tax authority appears to be conducting field inspections, a fact confirmed by a roundtable attendee whose firm received a visit within two weeks of its first return. GAZT has also issued violation notices, with more than 5,000 sent to non-compliant businesses across multiple sectors. These notices were for issues such as late registration, not displaying the VAT registration certificate, issuing incorrect invoices and late filing of returns.

Arabic invoices

One of the early issues that arose with VAT in Saudi Arabia was the need for invoices to be in Arabic. Given the difficulty that some businesses had in generating Arabic as well as English language invoices, businesses have questioned whether they can recover VAT if an invoice received from a supplier is not in Arabic. Initially, it was thought not, but subsequent GAZT guidance has suggested that the businesses would be able to recover VAT as normal providing there is adequate supporting documentation. This does not, however, absolve the issuing entity of its obligations to issue Arabic language invoices.

UAE: six-month update

The UAE implemented VAT on schedule and has steadily issued further guidance to flesh out the law and regulations. Pending such clarification, or guidance, the roundtable attendees said they have felt the need to err on the side of caution for instances that the current guidance does not cover.

Guidance and clarification

The UAE's Federal Tax Authority (FTA) released its guide for the country's real estate sector in March 2018, the only industry-specific guide published so far. It is also the guide most relevant to the construction sector – there are other guides, but these mainly relate to administrative aspects of VAT. The clarifications guide is the most important of these. Subject to certain requirements, this enables businesses to ask the tax authority directly for clarification in respect to uncertain or ambiguous aspects of the legislation and outlines the formal process to do so.

It should be noted that these guides are not considered legally binding.

Voluntary disclosure

The UAE now also has a voluntary disclosure function available on its e-services portal, and a guide has recently been released on how and when to use it. Such voluntary disclosures must be submitted within 20 business days of discovering an error.

Foreign exchange rates

For businesses issuing invoices in currencies other than dirhams, the UAE Central Bank now publishes a daily exchange rate, which should be used in VAT calculations. Businesses are advised to use the exchange rate published at 18:00 the day before the invoice is created. The FTA has issued a public clarification that explains the rates that must be used for invoices relating to the period prior to the central bank issuing its first exchange rates.

Transitional contracts

The tax authority has also issued a clarification on the treatment of transitional contracts in line with the stated laws. This states that if a contract is explicit about a payment being inclusive or exclusive of VAT, then businesses should follow what is in the contract.

If the contract is silent on VAT, then it is up to the supplier to communicate with its customer to ascertain whether or not the customer is VAT registered and if it is in a position to recover VAT. If the customer is able to recover VAT, then the supplier has the right to charge the tax in addition to the contractual price. That communication should have been sent to customers prior to January 1, 2018.

Enforcement

Earlier this year the FTA introduced an amnesty for businesses that hadn't registered for VAT within the required timeframe. This meant the tax authority would not apply any late registration penalties if a business registered before April 30. The authority also realigned the first tax period for a lot of businesses, giving them additional time to file their first VAT return.

Mutual non-recognition

The UAE and Saudi Arabia currently do not recognise each other as 'implementing states' for the purposes of the VAT law. This means any transactions that a business in the UAE has with Saudi Arabia, or vice-versa, must be treated the same as transactions with any other country.

A unified electronic system to exchange information on intra-GCC transactions is apparently on the drawing board for the Gulf. Until that is established, Saudi Arabia will not recognise the UAE as an implementing state. The UAE's regulations indicate that until the country is recognised as an implementing state, it won't in turn recognise Saudi Arabia.

It may be some time before this issue is resolved, but all firms must be alert to it because VAT systems will require updating once mutual recognition occurs.

Industry issues

Although guidance for the real estate sector, which includes the construction industry, has been released, the emerging VAT regulatory environment is revealing some unanticipated areas of ambiguity.

These possibly grey areas - where the law and regulations surrounding VAT are open to interpretation and the treatment the authorities will adopt is unclear - quickly emerged as the main concerns for roundtable attendees. While some of these issues are not unique to the construction industry, they are acute pressure points for businesses in the sector.

Attendees debated the different approaches being taken to each one. The differing views that were discussed showed the difficulty in arriving at a consensus approach, as well as the level of detail tax authorities will eventually have to cover to deliver a comprehensive VAT process.

All agreed a single source of absolute truth would be welcome in order to remove ambiguities. Unfortunately, there are so many factors to be considered in many of the affected transactions that such a source is unlikely to become a reality for some time.

Labour accommodation

In the UAE and Saudi Arabia, the supply or letting of residential accommodation, is exempt from VAT.

There are specific definitions in both countries as to what constitutes residential accommodation, but the question for the construction sector is whether labour camps fit within those definitions. In both jurisdictions, to be VAT-exempt, accommodation should simply be a place of residence, with no additional services available as would be common at a hotel, motel, or serviced apartment.

Deloitte reported that the question of whether labour camp accommodation is exempt from VAT has been asked frequently. A consensus is emerging among businesses that where additional services are being offered, such as laundry, cleaning or catering, then the accommodation should be standard rated for VAT.

One attendee noted that while they had initially thought accommodation would not be subject to VAT, in the end management elected to treat it as standard rated. They felt this avoided any complexity and uncertainty and was the most risk-averse solution.

Another attendee explained that their company had a multiple entity structure, where a separate property company owns all the labour camp accommodation. This rents the accommodation to an operating company, so its supply of solely the building is clear and exact. The operating company then provides additional services, following the standard rated model suggested by Deloitte.

Subsequent to the roundtable, the tax authority issued a Public Clarification on the VAT treatment of labour accommodation. According to this, the supply of labour accommodation is broadly exempt from VAT unless additional services provided with the accommodation are not “incidental” in nature. The clarification also states that where charges are split – one invoice for accommodation and another for all the additional services – each element has to be considered independently.

Medical insurance

While VAT is recoverable on medical insurance supplied to employees as per the law, there is a question mark over VAT on medical insurance provisions that are more comprehensive than the required minimum.

This issue could affect instances where family members of an employee are being covered by a company’s medical insurance. Whether or not the VAT is recoverable in such an instance remains uncertain. Deloitte warned there may be a risk for businesses recovering VAT on any insurance that goes beyond what is legally required.

One attendee noted that their business is recovering the VAT in such instances on the basis that it is normal business practice for their company to supply insurance for an employee’s family.

Motor vehicles

A similar issue arose around company vehicles and whether or not they are subject to any personal use. Deloitte felt that if an employee is using a car to drive to and from work then there is an element of personal use, which would affect a business’s ability to recover VAT.

One attendee stated that motor vehicles represent their company’s biggest blocked VAT (where they could not recover the tax). They described exploring various ways to avoid the VAT blockage, but they were unable to find a robust workable solution for distinguishing between work and personal use. As any solution would recover a relatively small amount of tax they opted to avoid the risk and just block all VAT on motor vehicles.

One solution offered may be to request the FTA accept a fixed recovery percentage, but Deloitte stressed that this should be agreed in advance of any recovery claim.

Advances and retention

Advances and retention payments were the most contentious issues discussed at the roundtable. It was evident that exactly when to levy and recover VAT on these payments, in an industry where late payment is rife, was extremely problematic for all involved. The phased nature of construction contract payments adds another layer of complexity to an already difficult issue.

Deloitte explained that advances received after January 1, 2018 are subject to VAT in full, based on whichever is earliest: when they were received, or when the VAT invoice for that advance was issued.

What remains less clear is how to proceed when advances are categorised in different ways within contracts. Deloitte said it had seen instances of advances being described as loans. It is important for any business describing an advance as something else to determine whether VAT must be accounted for, because loans forwarded to a business are not supposed to be considered. In such instances, it is crucial that the manner in which the transaction is accounted for in the accounting system is consistent with the documentation, and that the VAT treatment is consistent with both.

More problematic were advances received before January 1, 2018. Technically, advances received before this date, but which relate to work that will take place after, are subject to VAT. But there is uncertainty about when to account for the VAT.

Deloitte noted that no consensus approach has emerged, with some businesses accounting for VAT in their first return, others accounting for the VAT on the unrecovered advance as and when it's recognised in the staged billing. Neither the legislation nor the real estate guide offer sufficient clarity, possibly because it will depend to an extent on the terms of each contract. In lieu of clear guidance, Deloitte pointed out that contractors could be punished if they delay accounting for VAT on advances, even though the law remains unclear.

On the issue of retention, VAT becomes significantly opaquer. No single approach is being taken and attendees all reported a variety of processes, including different processes within the same organisation. Some of these differences come down to client demands, with contractors feeling forced to acquiesce simply to secure some portion of payment. Attendees acknowledged this was far from ideal, but also noted that the lack of regulatory clarity was pressuring them to act as their clients wished.

Deloitte noted the danger of applying a tax treatment based on what customers believe their submission to be. This could leave a business exposed to risk if a tax authority conducts an audit without an unambiguous position on these issues being agreed.

Cash flow

The impact of VAT has been felt most directly on cash flow.

Attendees were resigned to the fact their businesses were paying VAT before they had received payment for the work to which the VAT applied; construction is an industry notorious for payment delays to contractors and sub-contractors across the entire supply chain.

The problem is particularly acute for businesses filing monthly VAT returns. These find themselves paying VAT in a two-month window, but routinely wait six months to get paid by clients. Quarterly filers avoid this problem somewhat, gaining a longer period in which to recover VAT.

One suggestion from Deloitte that may alleviate some pressure is issuing a demand for payment, rather than an invoice. This may avoid creating a tax point long before any payment is likely to be made. This tactic means the tax invoice would be raised once payment was received, or once the due date of the payment was made clear, bringing the tax date much closer to the payment date. However, attendees felt they may struggle with this tactic because customers are acutely aware of the benefits of early VAT recovery.

Conclusion

If there is one message for businesses to take from the roundtable it is that a conservative approach to VAT collection and recovery is advisable .

In the absence of complete and legally-binding guidance, a conservative and risk-averse approach to filing VAT returns seems likely to be the most cost-effective in the long run. For areas of ambiguity it is vital that businesses have a clear paper trail to support any decisions which may be examined during any audit.

Attendees agreed that there are plenty of operational collection and recovery issues to iron out. While they acknowledge this will be a gradual process, there was a feeling that more effort is needed to speed it up.

For the construction industry the long project timelines, complex supply chains and phased payment programmes are all compounding the challenges of adjusting to the new tax regime. The most crucial issues for the businesses represented revolved around getting clarity on exactly when they should be collecting and reclaiming VAT. Processes to narrow the gap between raising invoices and actual payment are much needed in order to prevent businesses having to carry the VAT burden for an unreasonable period.

As the four remaining GCC states go live with their VAT systems in the coming years, demand for clear and consistent processes across the region will grow. Tax authorities will remain under pressure to deliver.

Author's details

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