THE VAT AND FREE ZONES CONUNDRUM

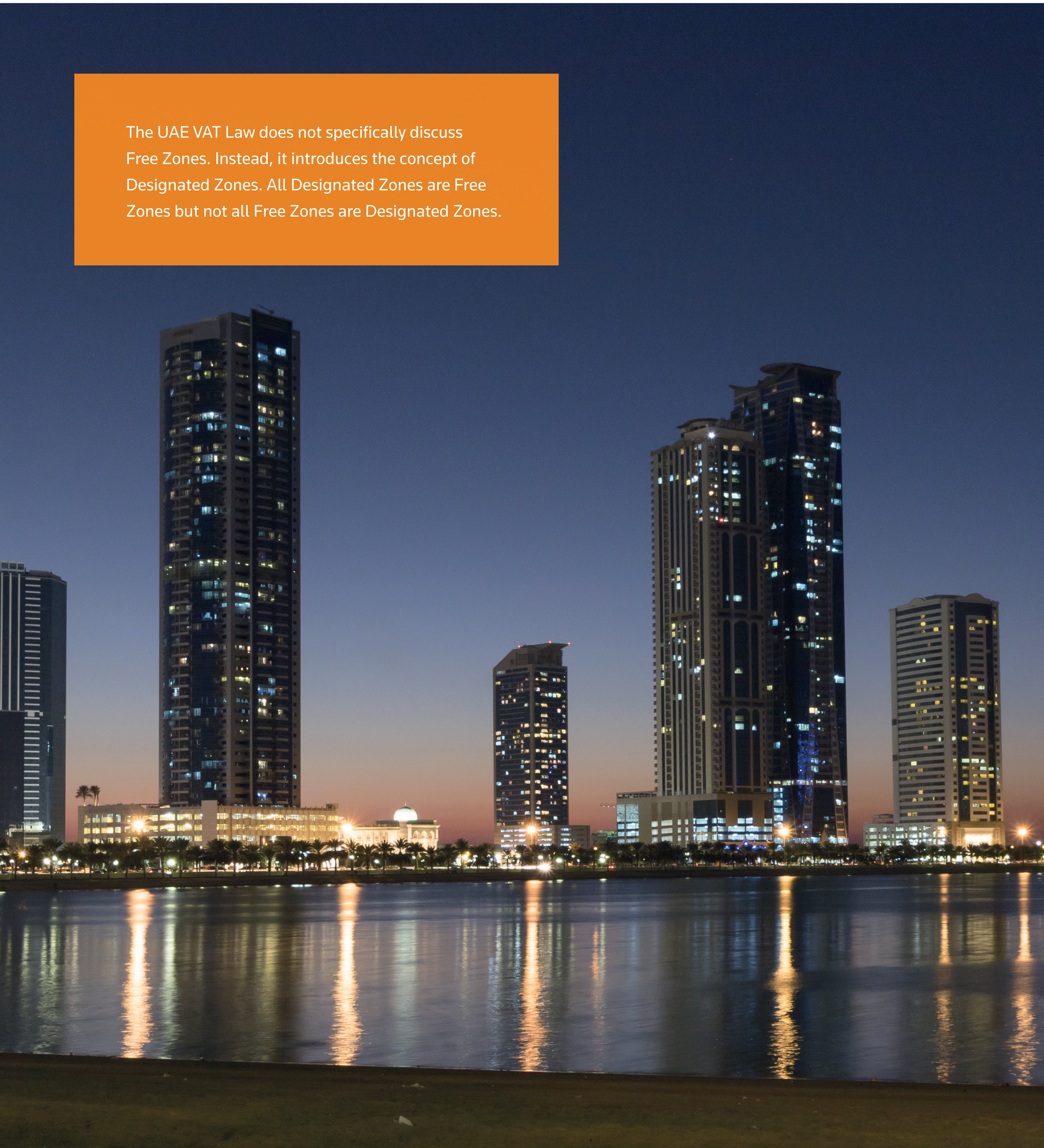
How does VAT work in Free Zones in the UAE?

AURIFER

the answer company™
THOMSON REUTERS®

The United Arab Emirates (UAE) is a business friendly place in the Middle East because of its infrastructure development, its access to high potential growth markets in Africa and Asia, competitive labor costs, few trade barriers and economic and political stability. Another key factor in this success is the availability of Free Zones in the UAE. Although the Free Zones are intended to simplify business in the UAE, the introduction of Value Added Tax (VAT) has seen an increased complexity in commercial transactions with these Free Zones.

The UAE VAT Law does not specifically discuss Free Zones. Instead, it introduces the concept of Designated Zones. All Designated Zones are Free Zones but not all Free Zones are Designated Zones.



What are Free Zones

The UAE allows foreign businesses to operate within Free Zones, where usually amongst others they benefit from 100% foreign ownership. In addition, Free Zones usually offer the guarantee of a tax holiday during a number of years. Each Free Zone has its own rules and regulations, but they commonly share the same basic incentives.

Free Zones in the UAE, and around the world, can be fenced or unfenced areas. Free zones have a special customs and imports regime and are governed by the framework of regulations set by the relevant Free Zone authority to control goods and persons coming in and out.

Despite the benefits, businesses in the Free Zones do not have the same rights as the businesses located on the mainland. They cannot freely trade in the UAE for instance.

When these Free Zones were established, there was no mention yet of the idea of the introduction of VAT. Therefore, a central question arose whether the commitment of Free Zones was also to grant investors a tax holiday with respect to VAT and what would be the consequences on transactions with Free Zones.

Granting Free Zones the benefit of remaining outside of the scope of VAT in the UAE, had the potential to distort the balance of the UAE economy and the fragile regulatory difference made between Free Zone companies and Non-Free Zone companies.

The implementation of VAT in the UAE

The UAE is part of the Gulf Cooperation Council (GCC). The Member States of the GCC have decided to implement VAT at the latest by the 1st of January 2019. The UAE has implemented VAT on the 1st of January 2018, simultaneously with the Kingdom of Saudi Arabia (KSA). The VAT introduction is a paradigm shift in the economy and business landscape for both countries.

VAT is an indirect tax applied on the sale of goods and services. It is levied at each stage in the supply chain and is collected by businesses on behalf of the Government.

The burden of VAT is ultimately born by the end consumers of the supply chain. Although it applies to most goods and services at a standard rate of 5%, some zero rated and exempted items have been identified by the legislation.

VAT and Free Zones

The UAE VAT Law does not specifically discuss Free Zones. It, however, covers Designated Zones, a specific type of Free Zones.

The legislation determines that VAT is not due on the transfer of goods from one Designated Zone to another, or when importing goods into Designated Zones from outside the UAE.

Such Designated Zones are specific fenced geographic areas which comply with procedures set by their respective Authorities. They have security measures and customs controls in place to monitor movements of individuals and goods to and from the areas. Additionally, they have internal procedures regarding the method of keeping, storing and processing of goods therein.

Only Free Zones specifically mentioned in the UAE Cabinet Decision as Designated zones can be considered as such.

There are over 45 Free Zones in the UAE, however only 20 were named as Designated Zones. Therefore, for VAT purposes, the rest of the free zones are simply considered in the UAE mainland.

Below is the list published in January 2018:

Designated Zones (Abu Dhabi)
Free Trade Zone of Khalifa Port
Abu Dhabi Airport Free Zone
Khalifa Industrial Zone
Designated Zones (Dubai)
Jebel Ali Free Zone (North - South)
Dubai Cars and Automotive Zone (DUCAMZ)
Dubai Textile City
Free Zone Area in Al Quoz
Free Zone Area in Al Qusais
Dubai Aviation City
Dubai Airport Free Zone
Designated Zones (Sharjah)
Hamriyah Free Zone
Sharjah Airport International Free Zone
Designated Zones (Ajman)
Ajman Free Zone
Designated Zones (Um m Al Quwain)
Umm Al Quwain Free Trade Zone in Ahmed Bin Rashid Port
Umm Al Quwain Free Trade Zone on Sheikh Monhammed Bin Zayed Road
Designated Zones (Ras Al Khaimah)
RAK Free Trade Zone
RAK Maritime City Free Zone
RAK Airport Free Zone
Designated Zones (Fujairah)
Fujairah Free Zone
FOIZ (Fujairah Oil Industry Zone)

For VAT purposes, all of the supplies of goods to the mainland from a Designated Zone will be taxable as an import in the hands of the importer of record. The VAT on this import can be reverse charged. Supplies from the mainland to a Designated Zone are simply taxed as a local supply.

When it comes to services, for VAT purposes, their treatment does not change between UAE mainland and Designated Zones.

Therefore for the services sector, Designated Zones have no impact in terms of the VAT treatment.

That being said, granting a special status for goods in certain situations for Designated Zones means the complexity of the UAE VAT regime has increased significantly.

VAT impact for companies located in Free Zones

There is a need for businesses to understand the implications of the introduction of VAT to their organization.

Due to its regulatory and federal structure, the implementation of VAT poses additional challenges in the UAE in comparison with other GCC Member States which are introducing VAT around the same period.

Everything discussed above means companies have to carefully map and understand each of their transactions as depending on the origin and destination of the goods combined with the location of buyer and seller, the VAT treatments can be completely different.

As a quick exercise, if we compare a simple Business to Business (B2B) transaction: a sale of goods in Saudi Arabia (KSA) and the UAE:

There are no Free Zones in KSA. Therefore only two scenario are possible (we are intentionally over simplifying here):

- Domestic sales at 5% from KSA to KSA
- Export at 0% whether it is to another GCC states or a country outside the region.

In the UAE, in addition to the aforementioned scenarios, companies have to consider the VAT treatment of transactions with Designated Zones:

- Domestic sale from UAE to a Designated Zone – 5% because as a domestic sale
- Domestic sale from Designated Zones to UAE mainland – Import taxable at 5%
- Domestic sales from Designated Zones to Designated Zones – VAT is not applicable
- Domestic sales within Designated zones – No VAT applicable (except for retail sales)
- Export from Designated Zones to GCC countries/Outside GCC country – 0% VAT as treated as an export

Below is a summary table for ease of comparison –
Please note we also disregard the impact of customs on these transactions.

KSA	VAT Treatment	UAE	VAT Treatment
Domestic sales	5%	Domestic sales (with turnover in each Emirate to be reported separately)	5%
Sales to GCC countries & Non-GCC Countries	0%	Sales to GCC countries & Non-GCC Countries	0%
		Sales from the UAE mainland to Designated Zones	5%
		Sales from Designated Zones to the UAE	5%
		Sales from Designated Zones to the GCC countries & Non-GCC Countries	0%
		Sales between the Designated Zones	N/A
		Sales within a Designated Zone	N/A (exceptions apply)

It's easy to see how a simple regulation can increase the complexity of a tax regime by several folds.

All companies had to prepare for the VAT introduction on the 1st of January 2018 to ensure their compliance to the new tax regime.

Filing their first VAT return on the 28th of February 2018 or 28th of April 2018 is a real-life test to see how well prepared these companies are. More specifically, the amount of details available in their VAT compliance data to produce that first return. If the transaction mapping was overlooked, it is obvious how quick one could make mistakes in their tax treatment of certain transactions.

Applying the wrong treatments lead to either overstate VAT liability (which in turn leads to cashflow and margin issues) or to understate VAT liability (which leads to compliance issues and fines).

If we add to the mix the emirate by emirate reporting requirement (for sales only) by the Federal Tax Authority (FTA) of the UAE, one can easily see how a simple concept can easily turn into a more challenging day to day compliance management.

In conclusion, the UAE brings an additional set of challenges when it comes to VAT compliance compared to the other countries in the GCC region so far.

Bearing in mind, tax regimes usually tend to become more complex overtime, companies must ensure their internal VAT compliance framework and their IT system are setup in a future proof and scalable way to cope with any future change in legislation but also identify the right tax treatment to apply to all the different type of transactions possible with Designated Zones.

Contact us

Pierre Arman, Market Development Lead for Tax and Accounting, MENA

Pierre Arman is the Market Development lead for Tax & Accounting at Thomson Reuters based in Dubai, and is responsible for the strategy and product management of all Tax & Accounting and Global Trade Management solutions in the MENA region.

pierre.arman@thomsonreuters.com

Thomas Vanhee, Founding Partner

Thomas is a founding partner at Aurifer Middle East Tax Consulting. He moved to the Gulf in the beginning of 2017 and has since advised different GCC governments on the pending introduction of VAT. He is currently assisting GCC businesses with getting ready for the implementation of VAT.

thomas@aurifer.tax

About Thomson Reuters

Thomson Reuters provides trusted answers as a dedicated partner serving consultancy and accounting firms, corporations and governments. Blending intelligence, technology and human expertise, we provide leading tax and accounting solutions for a fast-paced and evolving world.

We work with your organization to introduce ONESOURCE® VAT-approved trusted advisors and systems integrators to help make the VAT implementation process as seamless as possible.

https://mena.thomsonreuters.com/en/corporate-solutions-mena/tax-solutions-corporate.html

About Aurifer

Aurifer is a leading GCC boutique tax firm based in Dubai which provides strategic tax advice to governments and global top-tier businesses in the health care, real estate, finance and FMCG sector.

AURIFER

the answer company™
THOMSON REUTERS®