VAT focus

VAT in the Gulf

Speed read

A broad-based VAT system is being implemented across all six Gulf Cooperation Council states, with a common standard rate of 5%. The United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA) will introduce VAT on 1 January 2018, with the rest of the GCC countries to follow thereafter. The introduction of VAT is a significant development in the region, and many businesses are still putting in place the mechanisms required to be 'VAT-ready'. The legislative framework is designed to be simple and is based on a GCC Treaty agreeing common principles between all states, but allowing for domestic legislation to introduce rules specific to each member state in certain areas.

Eleanor Thompson
Deloitte
Eleanor Thompson is a senior manager at Deloitte LLP in the UAE. She is a real estate specialist and is currently advising Middle Eastern businesses of the impact that VAT will have on their financial reporting, systems and cash flow. Email: eleathompson@deloitte.com; tel: +971 (0)4377 8929.

Matt Parkes
Deloitte
Matt Parkes is a VAT policy expert working with Deloitte Middle East, with 15 years' experience working in the UK and Australasia advising on VAT and GST systems globally. He has recent experience working on VAT policy development projects in the region. Email: matparkes@deloitte.com; tel: +971 (0)4376 8888.

On 30 January 2017, the Unified VAT agreement for the Cooperation Council for the Arab States of the Gulf ('The VAT Treaty') was signed by all the Gulf Cooperation Council (GCC) states (Bahrain, Kuwait, Oman, Qatar, the Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE)). This 'treaty' sets out the common principles of the VAT system which are to apply in each GCC state, including a basic 5% rate, and it provides a structure on which domestic VAT legislation will be developed. The treaty has similarities to the EU VAT Directive: it sets out broad rules of operation for VAT, whilst allowing individual countries to make choices of VAT policy (such as exemptions and zero rates) in some areas.

The introduction of VAT in the Gulf has been described as crucial from a fiscal perspective, as member state governments attempt to bolster economies affected by highly variable oil prices. However, indications are that VAT will not be a universal panacea which in itself addresses all fiscal issues: it will be an aid to government revenues but in many countries it will not be enough to bridge the gap between income and expenditure on a national scale. Given the low incidence of taxes across the region, the effects of introducing a broad-based VAT will be a significant move towards more formal financial reporting practices in the region, and may set the tone for further tax reform in future.

Current state of play

KSA is the largest economy in the region and was the first of the GCC states to publish a domestic VAT law. In August, it also released implementing regulations, providing the full details of the legal framework for taxpayers to understand the domestic VAT system. At the time of writing, the UAE has only published the VAT law – with executive regulations expected during October. In the meantime, the authorities in the UAE have made additional details available on their website, but the release of regulations will clarify a number of specific VAT rules for businesses in certain sectors. Both KSA and UAE have confirmed that VAT will be introduced on 1 January 2018.

Whilst all countries had initially aimed for this date, the remaining countries now seem unlikely to introduce VAT from January. Oman, an early front runner, has now announced that it will be delaying the implementation until later in 2018. Qatar and Bahrain are also planning to go ahead with the introduction later in 2018. Kuwait has been less open about its plans, but a January introduction is not expected.

> The introduction of VAT in the Gulf has been described as crucial … as governments attempt to bolster economies affected by highly variable oil prices

There is much for GCC businesses to do over the next few months in order to get systems and processes ready, VAT registrations submitted and initial VAT returns calculated and submitted to the tax authorities. Following the implementation of VAT in Malaysia in 2015, businesses were asked with hindsight how much preparation time they considered necessary in order to be 'VAT ready': the average answer was nine to 12 months. Preparation is the key.

GCC VAT is a revolution in terms of being a completely new tax (i.e. it does not replace an existing sales tax or transactional tax in the local states). Businesses in the region have simply not been required to have transactional systems and processes to qualify their sales and purchases in detail before; and the practice of companies manually raising invoices in a word processing system is surprisingly common. The introduction of VAT therefore introduces a whole new set of processes and controls for businesses which have yet to operate in such an environment.

Given the relatively few tax systems already in place across the GCC, tax authorities are also going through a fundamental change process to get ready for the sheer number of taxpayers, filings and processes resulting from a broad-based VAT system. Indeed, the UAE has created a Federal Tax Authority from scratch, as it did not have a national body of this nature previously.

Legislative framework

The legislative framework is based on the GCC Treaty, which sets out the main VAT principles to be adopted in the GCC. It is important to note that this is only a framework agreement, and does not have direct effect – albeit that some of the principles within it are considered fundamental principles which all member states will doubtless adopt (the 5% rate and the turnover threshold for mandatory registration of $100,000 are good examples). The treaty allows for interpretation and differing VAT treatment in places. Thus, member states must formulate their own domestic legislation in order to implement the framework agreement. Unlike the European Union – where the Treaty of the Functioning of the European Union (the EC Treaty) provides authority to the Council and Commission to make regulations (which are instantly binding) and directives (which require the passing of domestic law to come into force) – recommendations and opinions of the GCC's Finance and Economic Cooperation Committee have no legally binding effect.

Practically, we see it as unlikely that significant amendments will be made to the GCC Treaty resulting in further guidelines being prescribed, given the process and timeframes for formal agreement at this level. This results in greater ability for interpretation at a domestic level. Any issues or problems arising in the GCC system will, without such intervention, fall to each member state to remedy through further legislation.

Comparisons between the GCC and EU system

On the whole, the GCC VAT system bears a strong resemblance to many of the EU rules. The main taxing principle on supplies made for consideration – as well as rules to establish place of supply, time of supply and value of supply – are grounded on general OECD principles. The ability to relieve VAT for social reasons on education, health, real estate and local transport strikes a familiar chord. Many of the administrative rules (such as length of tax periods, submission of returns and payment of tax) have been left for individual member state interpretation, but early signs are that these will be similar to the EU rules.

We examine below some of the more significant design and practical differences between the VAT systems in the GCC and the EU.

Complexity of law

The context for interpretation of the GCC Treaty, discussed above, leads us to the first main difference between the GCC and the EU VAT systems – the level of complexity. The GCC system has been deliberately designed in order to be as simple as possible. Christine Lagarde, managing director of the International Monetary Fund, declared on a visit to the UAE in February 2017 that there was a need for the GCC VAT system to be 'simple enough and digital enough' to be a success.

The published version of the GCC Treaty runs to only 37 pages, despite including both Arabic and English language clauses side by side. Whilst a framework agreement is not expected to include detail, this is notably shorter than the EC Directive. This results in individual countries having broad descriptions to work within. By way of example, the term 'financial services' is not defined. Further, member states are enabled by the treaty to apply exemption or zero rating to the 'education, health, real estate and local transport' sectors – but must individually define what these sectors include. Whilst this reduces complexity in the system and the drafting of the treaty itself, it does provide a broad scope for countries to take different interpretations in these areas, which may in future result in unintended tax arbitrage between the states.

A broad base with a low rate

Only one standard rate applies to all Gulf countries: 5%. This applies across all countries; and there are no lower rates (other than zero rating, where the treaty permits). The single rate gives a consistent approach to applying tax across the GCC, and reduces the scope for businesses to set up in particular countries to take advantage of a lower tax rate. Whilst the rate is low compared with most global VAT systems, the tax take is expected to be relatively high due to the broad base of tax. Countries are only permitted to give exemptions or zero rates in a small number of specified areas (much less than the scope allowed by the EC for reduced rates), and the indications from the KSA and UAE law is that the standard rate will be applied in most cases. Some examples are explored below.

Zero rating

The GCC Treaty gives the option to zero rate a list of around 100 basic food items. Though food is a common area for VAT relief globally, both the UAE and KSA are applying the 5% rate to all food items. This approach does keep the domestic VAT system for retailers (and the tax authority) much simpler; and removes potential uncertainty (and the option for legal challenge) over distinctions between cakes and biscuits, or other lines in the sand in food classification.

Investment gold, silver and platinum are all zero rated (whereas in the EU only investment gold is zero rated). In part, this reflects the fact that these other metals are often used in Sharia compliant financing products. Zero rating is available for the oil and gas sector, reflecting the importance of that sector to all GCC economies. Interestingly, whilst member states are able to determine whether tax applies to health services, they are required by the treaty to zero rate medicines and medical equipment.

The GCC Treaty includes zero rates for exports and international transport, in line with most international practice. An export of services outside the GCC will, however, be zero rated, following the approach in most non-EC countries – rather than attributing a global 'place of supply' test as is done in the EU (which results in exported services generally being 'outside the scope' of VAT).

Exemptions

As noted above, member states are able to exempt the education, health, real estate and local transport sectors. From the law released to date, only residential rental is being exempted in domestic practice in the KSA, whilst the UAE is implementing more reliefs across these sectors (summarised in the diagram below).

The GCC Treaty suggests that financial services will be exempt, but only when provided by licensed banks and financial institutions. It also sets out that prescribed recovery rates can be set for these financial institutions. Despite this, the KSA and UAE have both indicated a different approach, with explicit fees for financial services being taxable (unlike in the EU but following the approach in newer VAT systems, such as Singapore), for exemption to apply to any institution, and for recovery to be based on a pro rata method (the latter points aligning to practice in the EU).

Goods in transit

The GCC is a customs union, so the introduction of a unified VAT across this area makes it similar to the EU system. However, there are differing rules in some cases where goods which are imported and transited through another country (a common phenomenon in the GCC): import VAT is theoretically payable in the first port of import, and revenues then transferred between countries through a refund mechanism. A similar transfer system applies to individuals travelling between GCC states with expensive goods. These mechanisms appear difficult for tax authorities to apply in practice, and it is likely that application will differ between countries.

Voluntary registration threshold

The presence of a voluntary registration threshold – to register a business must have an annual turnover of at least $50,000 (50% of the mandatory threshold) – differentiates the GCC system from the EU, where there is generally no lower limit for those trading under the threshold but wishing to register for VAT recovery purposes. This reduces the administrative burden that the tax authorities already face with registering those new taxpayers that must be compulsorily registered. However, it can be perceived as unfair, especially for businesses in a start-up phase, and the UAE and KSA have both addressed this by allowing the threshold to apply to expenses, as well as annual turnover.

New administrative requirements of VAT

Businesses operating in the GCC should be aware of the following VAT administrative requirements:

Retention of records

In the GCC, records must be kept for at least five years (records relating to real estate must be kept for 15 years). This will lead to enhanced document storage requirements for all businesses, most of which haven't needed to retain records for tax or other control purposes.

Domestic reporting requirements

The introduction of a VAT system is a good opportunity for countries to introduce domestic requirements not required by the GCC Treaty. For example, UAE is expected to introduce an Emirates reporting requirement, under which it will be necessary to declare in which of the seven Emirates of the UAE (Abu Dhabi, Ajman, Dubai, Fujairah, Ras al-Khaimah, Sharjah and Umm al-Quwain) a supply has taken place. This is expected to be used to allocate the VAT to the public purse for that particular Emirate. Whilst the EU has additional reporting requirements (such as the EC Sales Lists (ESL) and Intrastat), this domestic requirement may potentially require additional reporting functionality. Businesses should be aware of this and other new domestic requirements.

VAT refunds

It is possible that for some GCC states, where a taxpayer is in a repayment position (i.e. due a refund of VAT as declared inputs have exceeded declared outputs), then the tax authorities will hold onto that credit and offset it against future payments due once the business is making taxable supplies. This will have serious cash flow implications for businesses and also gives rise to the question of how to manage projects with a long development phase. It remains to be seen how easily businesses in these positions will obtain refunds of VAT in practice.

GCC reporting and refunds

The long term plan is for the GCC countries to operate a real-time electronic reporting and exchange system for any cross-border GCC trade. As with the Intrastat and ESL requirements in Europe, this is intended to allow member states to track sales from and purchases into their countries, and ensure that VAT is being correctly accounted for. A system is not in place yet, and it seems unlikely that a fully operational system will be agreed between the countries and ready for 'go live' on 1 January. In the meantime, it is possible that member states may have transitional reporting requirements – or transitional arrangements for VAT to be collected as a fallback on some intra-GCC trade.

The GCC treaty allows states to give VAT refunds to non-resident entities, including businesses in other GCC states, non-GCC businesses and foreign tourists. In theory, refunding VAT to GCC businesses is required by the treaty, but the practical application of this is not yet determined, and it may take some time for this to be implemented and agreed between all GCC countries. This will be of particular interest to many local businesses with staff that travel frequently on business to other member states and incur expenses on subsistence and accommodation. Unless businesses have a VAT registration in the member state that the charges have been incurred in, it is possible this VAT will present an additional sticking cost to the business.

Summary of domestic VAT treatment: KSA and UAE

Sector	KSA	UAE
International transport of passengers and goods, and related goods, including intra-GCC transport	Zero rated	Zero rated
Local transport	Standard rated	Exempt
Food items	All standard rated	All standard rated
Real estate	Residential rental: exempt All other real estate: standard rated	Residential rental: exempt Bare land: exempt New housing: zero rated All other real estate: standard rated
Education	Standard rated	Specified services: zero rated
Health	Qualifying medicines and medical goods: zero rated	Specified services: zero rated
Oil and gas	Standard rated	Specific goods: zero rated
Means of transport (e.g. airplanes for passengers)	Zero rated	Zero rated
Export of goods and services	Zero rated	Zero rated
Financial services	Fee based services: standard rated Margin based services: exempt	Fee based services: standard rated Margin based services: exempt
Investment metals	Gold, silver and platinum at purity level no less than 99%: zero rated	Gold, silver and platinum at purity level no less than 99%: zero rated

Action points

All parties across the GCC countries, both businesses and the tax authorities themselves, need to be 'ready' for VAT. It will be interesting to see how things develop in the coming months. For many, this process will doubtless be challenging at the outset, but the simplicity of the system may help businesses to cross the line.

In the meantime, businesses must get prepared, and in doing so they should take at least the following actions:

- carry out an impact assessment of how VAT is going to affect their business streams;
- determine the VAT treatment of all their supplies;
- identify how their systems and processes need to change in order to cope and begin IT reconfiguration; and
- train staff to ensure compliance with the new VAT regime. ■

For the English version of the Unified VAT agreement for the Cooperation Council for the Arab States of the Gulf, see bit.ly/2phbx3u.