VALUE ADDED TAX IN THE UNITED ARAB EMIRATES

A PRE-LEGISLATIVE GUIDE

Sunstream
Research & Consulting

July 2017

Contents

Introduction

Sunday, 9 July 2017

With value added tax (VAT) legislation in the United Arab Emirates, expected over the course of the coming weeks and with only six months left for nationwide implementation; there is limited time for organisations to become compliant.

The introduction of VAT is likely to have implications across business functions, especially, but not limited to finance, IT and legal. Companies need to prepare by reviewing existing systems and building a plan for applying changes needed, to conform to upcoming regulation.

This report aims to guide readers on the fundamental concepts of VAT and the basic mechanisms by which it is generated. It should be of particular interest to business managers in the Emirates. For those who possess limited exposure to value added tax, we illustrate how this works using simplified scenarios.

It also represents the first in a series of VAT reports. Subsequent publications will cover aspects of the new legislation once released, and look at more complex VAT situations pertinent to the UAE and GCC.

We hope that you find this report beneficial. Equally, we are open to providing further information. As such please feel welcome to contact me.

Danyal Tirmazi
Engagement manager
danyal.tirmazi@sunstream.ae

Value added tax in the United Arab Emirates

Background

The six member states for the Gulf Cooperation Council; the United Arab Emirates, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait are together working to introduce a formal VAT system.

The common framework, known as the Unified Agreement for Value Added Tax, has already been signed off and released. It sets out key principles and allows each member state to develop its own national VAT laws based on those principles.

VAT is applicable in the GCC from 1 January 2018. In the Emirates, the new tax will start on this date, however it is expected that not all countries will begin at the same time.

The standard rate of value added tax in the United Arab Emirates, is 5% on the consumption of goods and services.

Why VAT is coming in

Falling oil prices in recent years, from a high of $113 per barrel in June 2014 to less than $50 today, have affected the economies of the GCC.

The Emirates has the most diversified economy amongst the six states. However, being a major oil producer, revenues from this resource remain highly significant constituting 25% of the country's total GDP, according to the Ministry of Economy. In comparison, the average contribution of oil sales to GCC revenues is 46%.

The result of a fall in prices, bears negatively on government balance sheets and public spending. It affects liquidity and growth. Equally there is a knock-on effect on non-oil related industries largely from the perspective of close associations between government and the private sector.

In addition to government in the UAE taking supportive action elsewhere, by encouraging economic diversification, with austerity in public spending and through reducing subsidies in electricity and water tariffs for example; the new VAT is expected to provide an extra Dh 12 billion in its first year and Dh 20 billion in the second. These policies, it is believed, will help deliver on economic and social programmes as a result of long term, sustainable revenues.

What exactly is value added tax?

VAT is a general consumption tax that is added onto the sale price of goods and services. It is charged at each stage in the supply chain.

The tax is not a levy on business and is ultimately borne by the final consumer. However, companies are responsible and accountable for the collection and recording of VAT and its payment to the government.

VAT is calculated as a percentage of the sale price. As stated, for the Emirates this will be 5%. In many cases, a business can net the tax that it has paid to its suppliers. Companies that charge more VAT to their customers than they have paid to their suppliers, must remit the difference to the government. Where a firm has paid more VAT than it has charged, it can claim the difference from the government.

The newly formed UAE Federal Tax Authority, an arm of the Ministry of Finance, is responsible for administering the new tax.

Origins of VAT and rates around the world

The concept of VAT is attributed to German industrialist Wilhelm von Siemens early in the twentieth century, following World War 1, however it was first introduced in France in 1954. It gained momentum in parts of the world, including Europe in the 1960's where it eventually became requisite for European Union membership. VAT was viewed as being an effective system to help regulate trade within Europe, making redundant the need for the import or export of tax transfers. As such parallels can be drawn with VAT implementation in the GCC.

More than 167 countries employ VAT. Across the world, the levy varies significantly. For example, the standard rate is 14% in Egypt, 27% in Hungary, 14% in South Africa, 18% in Turkey and 20% in the United Kingdom.

VAT terminology

In order to further understand the new tax; in this section, we explain VAT terms.

Input tax

Input tax is the tax paid as a result of a purchase from a supplier.

The amount is calculated based on the invoiced value for goods or services, and the prevailing rate, 5%, in the case of the Emirates.

Output tax

Output tax is the tax charged, as the result of a sale to a customer.

The amount is calculated based on the invoiced value for goods or services, and the prevailing rate, 5%, in the case of the Emirates.

VAT payable

VAT payable is the difference between output tax and input tax. It is the amount due to the tax authority.

VAT payable = output tax - input tax.

If output tax is higher than input tax

When output tax is higher than input tax, VAT payable is what a business is liable for. This amount it must pay the Federal Tax Authority.

If input tax is higher than output tax

Where a firm has paid more on tax for its purchases, than it has charged for its sales, then it should submit a request for reimbursement from the Federal Tax Authority, giving rise to a tax credit.

Standard rate

This is the standard prevailing VAT rate for all taxable goods and services. In the United Arab Emirates, it is 5%.

Zero rate

A zero rate good or service is a taxable supply charged to the customer at a rate of 0%. When supplies are zero rated, it implies that input VAT for the business can be reclaimed.

Reduced rate

Selected goods and services are taxable at a reduced rate, lower than the prevailing standard VAT rate.

We are not aware of a reduced rate in the Emirates.

Exempt supplies

These are goods and services that are exempt from a VAT charge. Input VAT for a business that offers exempt supplies cannot be reclaimed.

Who does VAT apply to in the United Arab Emirates?

VAT registration is based upon two criteria; annual turnover and whether the goods or services provided are tax exempt or not.

Businesses that offer exempt goods or services or that do not meet the threshold levels are not required to register for VAT.

As for firms that that provide goods or services subject to VAT, these are categorised as follows.

Companies with an annual turnover above Dh 375,000

It is mandatory for firms with annual revenue greater than Dh 375,000, to register for value added tax. This should be done three months before nationwide implementation, meaning Sunday 1 October 2017.

Companies with an annual turnover between Dh 187,500 and Dh 375,000

For businesses that generate yearly sales between Dh 187,500 to Dh 375,000, registration with the government is voluntary. There is an advantage, in that this allows companies to recover input tax while also making them VAT ready prior to a forthcoming phase of implementation.

Companies with an annual turnover below the Dh 187,500 threshold

Firms with turnover below Dh 187,500 cannot register with the tax authority. It provides a safeguard from the expense associated with tax documentation and reporting, however companies will also not be able to recover or reclaim input tax, increasing costs. It is however expected that all businesses will eventually be required to register for VAT.

What else do we know so far?

Basic food items

In the common framework agreed by GCC members, there are around 100 exempt basic food items. However, the Emirates has disclosed that it intends to subject these to the standard rate.

Healthcare services, medicines and medical equipment

Healthcare services and a list of medicines and medical equipment will be zero rated. This list is yet to be disclosed. Hence while it will not increase the cost to consumers, these businesses will be able to recover their input tax as long as they fall into the threshold levels.

Land and property

Bare land will be exempt from VAT. The sale and lease of commercial properties will be subject to the standard rate. The first sale of a new residential property will be subject to a zero rate. The sale and lease of residential properties on the secondary market will however be exempt from VAT.

Insurance

Life insurance is exempt from VAT, however all other non-life insurance, such as marine and general insurance, will be subject to the standard rate of VAT. It is unclear at this point whether medical and health insurance are exempt, zero rated or standard rated.

Financial services

Fee-based financial services will be subject to the standard 5% rate, where some others may be exempted. These have not yet been categorised.

Free zone companies

VAT on supplies made by free zone entities into the mainland and within free zones, is still under consideration and any directive on this is yet to be announced by the Ministry of Finance.

Education and public transport

Education and public transport services are also expected to be zero rated. Hence while it will not increase the cost to consumers, these businesses will be able to recover their input tax as long as they fall into the threshold levels.

Precious metals

Investment in gold, silver and platinum will be zero rated.

How VAT works

Registered businesses add VAT to the goods or services they supply. This comes as part of the sale price. They then pay, the tax collected from their customers, to the government.

Firms can also reclaim VAT they have been charged. The result being, that they pay a 'net-off' amount. This is the difference between output tax charged and input tax paid.

The four simplified illustrations on the following pages, depict differing VAT scenarios. Firstly, how VAT is added at each stage of supply, and how it progresses to the consumer. Next, we have a situation that tells us how VAT at the standard rate affects a retail store. Thirdly we have an example depicting a pharmacy and its consideration of zero rated tax. Finally, we have a tax-exempt setting for a small business turning over less than AED 187,500 annually.

Input and output VAT along the supply chain

SELLER	NET SALE PRICE IN DIRHAMS	5% OUTPUT TAX IN DIRHAMS	5% INPUT TAX IN DIRHAMS	NET VAT PAYABLE IN DIRHAMS
Chocolate factory	10	0.5	0 *	0.5
Distributor	15	0.75	0.5	0.25
Retail store	20	1	0.75	0.25
Total VAT paid by the customer over and above the retailer's price				1

* For illustrative purposes we assume no input VAT for the chocolate factory.

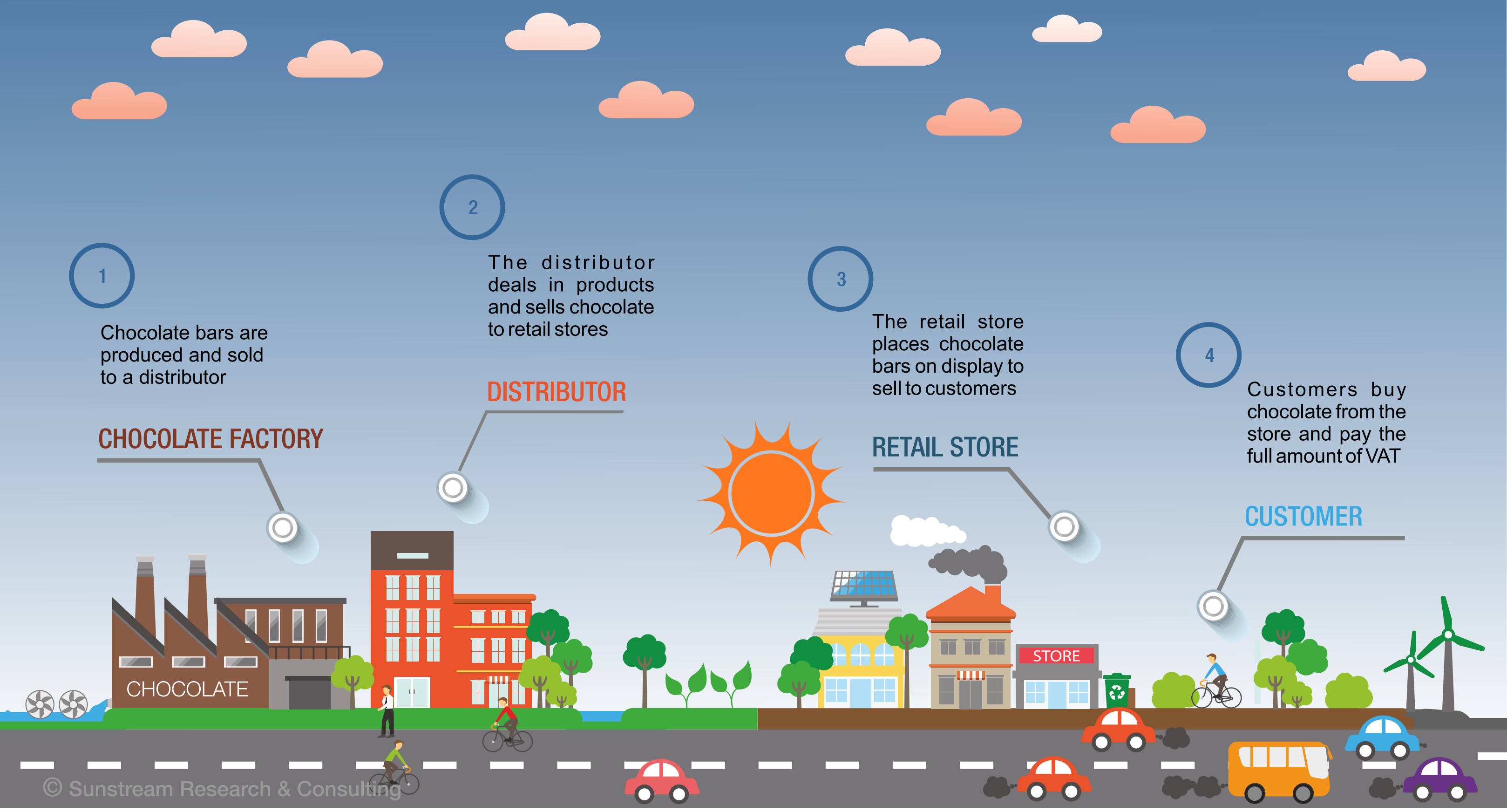
The factory sells chocolate bars for the net price of Dh 10, but must also include a 5% VAT on its sale price. Therefore, the total cost to the distributor is Dh 10 + Dh 0.5 = Dh 10.5. Assuming there is no input VAT for the chocolate factory, the output VAT of Dh 0.5 from the distributor is paid to the tax authority.

The distributor in turn sells chocolate bars to retail stores for Dh 15, and must charge 5% VAT on its sale price. Therefore, the total cost to retail stores is Dh 15 + Dh 0.75 = Dh 15.75.

The distributor pays a net-off amount of its output and input VAT Dh 0.75 – Dh 0.5 = Dh 0.25 to the tax authority.

Similarly, customers at the store pay the retail price + VAT Dh 20 + Dh 1 = Dh 21. The store pays a net-off amount of its output and input VAT Dh 1 – Dh 0.75 = Dh 0.25 to tax authorities.

VAT along the supply chain



Dh 10.5 = Dh 10 + Dh 0.5

Dh 15.75 = Dh 15 + Dh 0.75

Dh 21 = Dh 20 + Dh 1

CHOCOLATE FACTORY ← DISTRIBUTOR ← RETAIL STORE ← CUSTOMER

CHOCOLATE FACTORY

The chocolate factory collects VAT from the distributor as part of its sale price.

This represents its tax liability to government.

DISTRIBUTOR

The distributor collects VAT from the store.

It subtracts the amount of tax paid to the factory, to calculate its net tax liability.

RETAIL STORE

The store collects VAT from the customer.

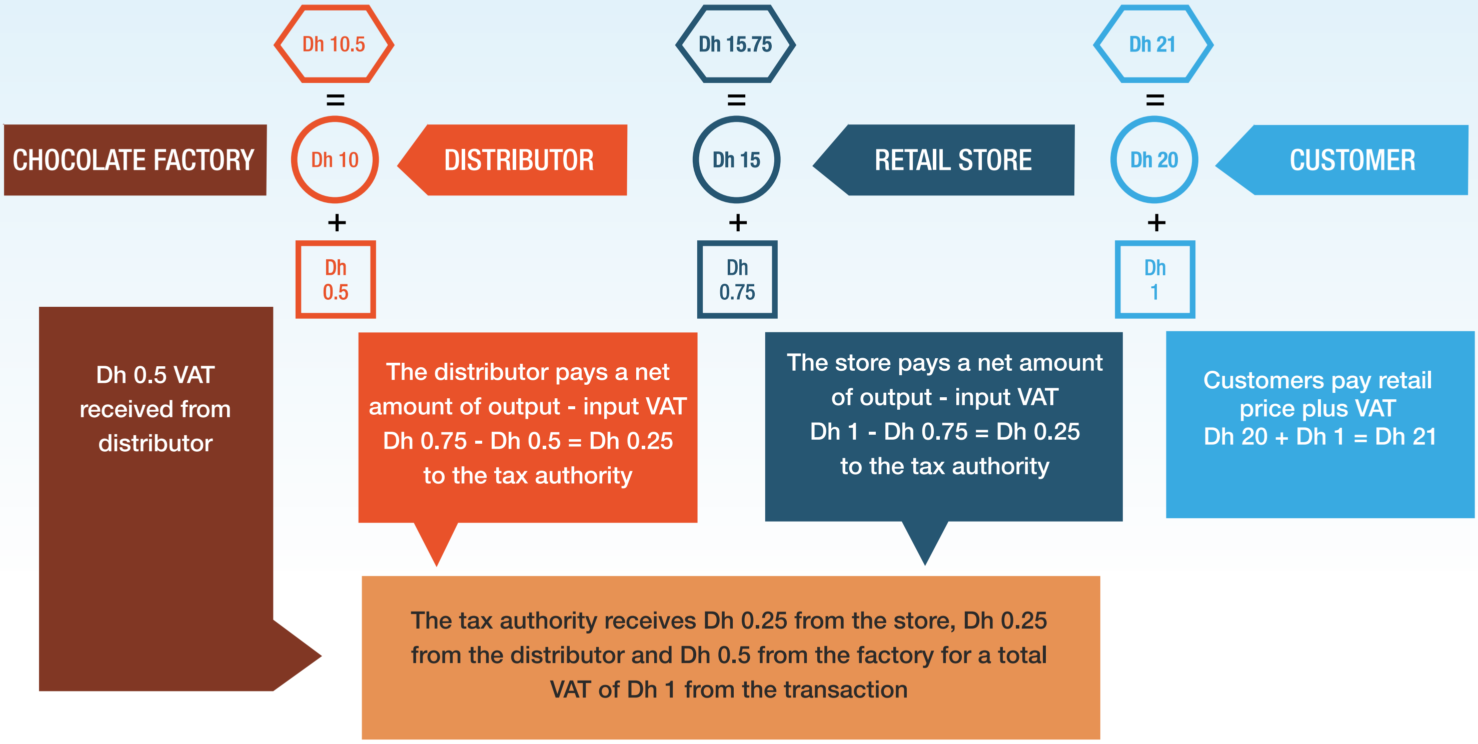
It subtracts the amount of tax paid to the distributor, to calculate its net tax liability.

CUSTOMER

The consumer bears the full burden of tax, equal to all the VAT collected in the supply chain.

Net price + VAT = Sale price

The retail store and VAT at the standard rate of 5%



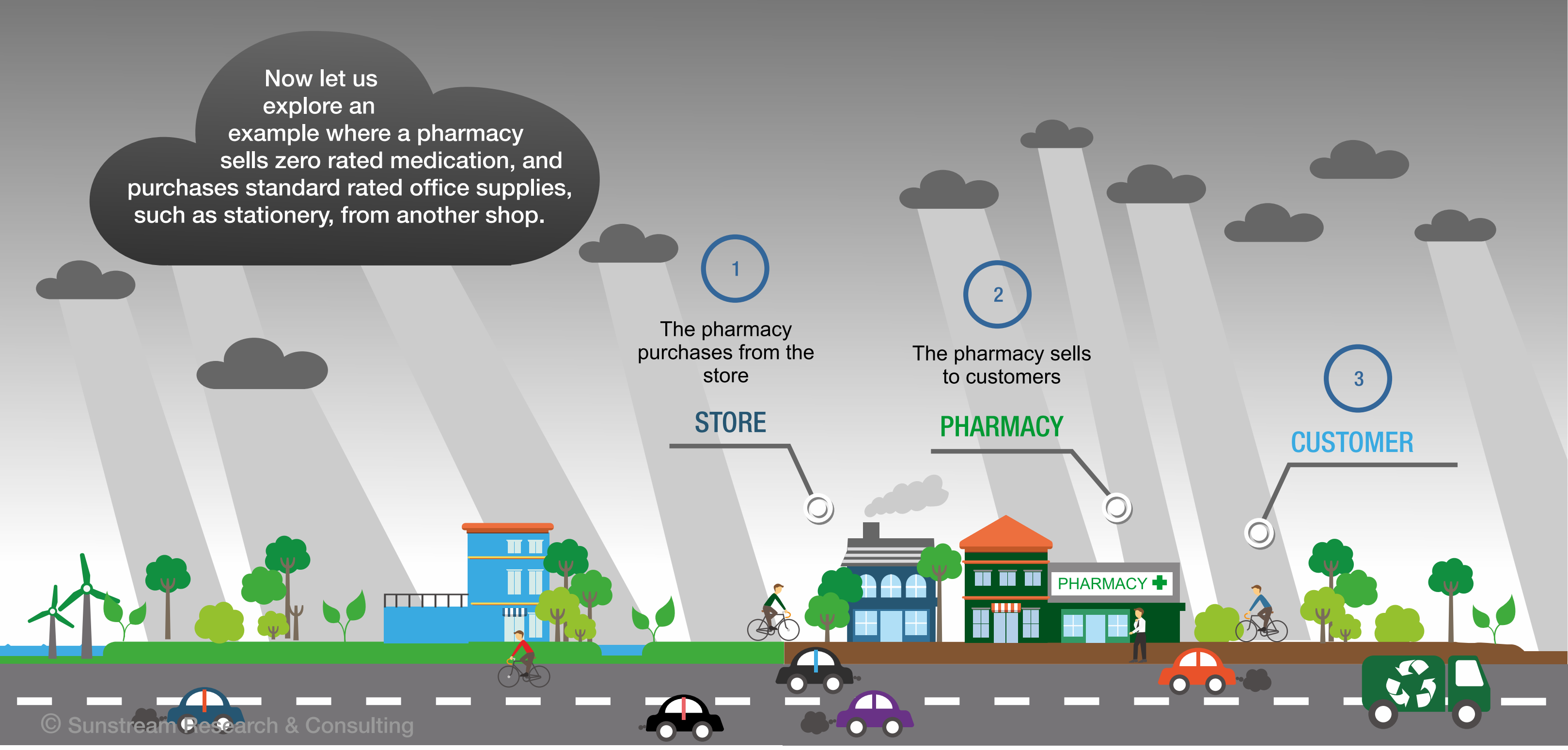
The store has collected VAT of Dh 1, from the customer. It has also paid Dh 0.75 to the distributor. The net amount payable is the difference between what it has collected; the output VAT, and paid, the input VAT. In this case it comes to Dh 0.25.

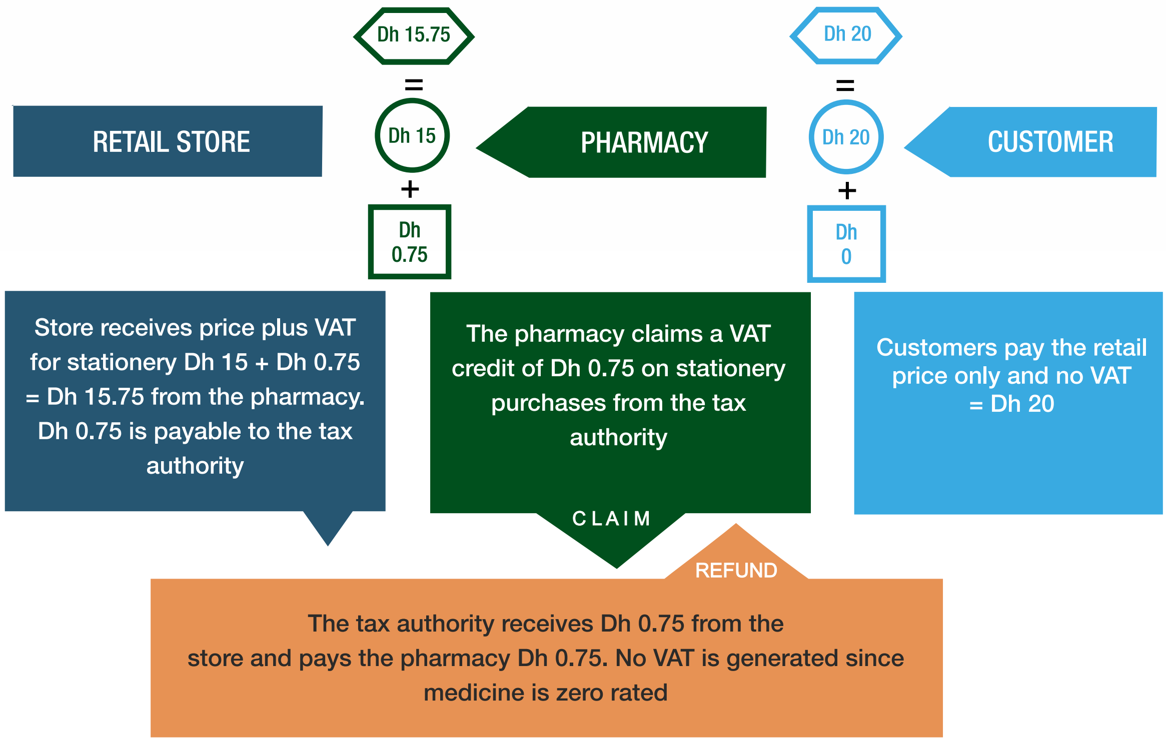
The margin will be sale price – purchase price – net VAT payable
Dh 21 – Dh 15.75 – Dh 0.25 = Dh 5.

As demonstrated, **it is the customer, not the business who bears the full brunt of the 1 Dirham tax.**

If VAT paid on purchases is higher than VAT collected, then a business can claim this from the government. This will most likely only arise in the case where the retail store has made more purchases than it has generated sales.

The pharmacy and VAT at zero rate, 0%





The pharmacy supplies medicine that is zero rated and therefore there is no collection of VAT from the customer. However, a tax credit is available. The pharmacy can claim VAT it has paid to the stationery supplier. In this case the pharmacy files a claim of Dh 0.75 to the government on its tax return. The margin on the sale will therefore be sale – purchase + VAT reclaimed Dh 20 – Dh 15.75 + Dh 0.75 = Dh 5.

Remember, VAT is not a tax on business revenue, it is a consumption tax aimed at consumers. **Where companies supply goods and services that bear a zero-rate tax, they are also able to claim any VAT they have paid on their own supplies.**

In both cases, where the store sells standard rated chocolate, and the pharmacy zero rated medicine, purchasing at 15 Dirhams and selling at 20 Dirhams, the profit margin will not change. However, the case for exempt supplies is different as shown next.

VAT exemption for a small business generating less than AED 187,500 per annum

Dh 15.75 = Dh 15 + Dh 0.75

Dh 20 = Dh 20 + Dh 0

DISTRIBUTOR ← **RETAIL STORE** ← **CUSTOMER**

Distributor receives price plus VAT Dh 15 + Dh 0.75 = Dh 15.75 from the store. Dh 0.75 is payable to the tax authority

The store cannot make an input VAT claim to the tax authority. Dh 0.75 is an added business cost

Customers pay the retail price only for exempt supplies = Dh 20

Tax authority receives Dh 0.75 from distributor

Businesses that supply goods and services that are exempt will not collect any VAT from their customers. However, to these businesses there will also be no tax credit available. In the case illustrated here, the net margin is calculated as...

...the sale – purchase, Dh 20 – Dh 15.75 will therefore result in a Dh 4.25 margin.

The store will have to decide whether to absorb these costs and thus lower margins, or alternatively, pass these costs onto their customers, but then possibly risk losing market share.

How VAT could affect businesses

The introduction of VAT will bring up some corporate challenges in the GCC, especially since many firms have not been previously exposed to tax regulations and some have thrived on the tax haven status the Emirates has traditionally offered.

Even though VAT does not set out to target companies, and firms that meet the registration criteria simply collect and remit tax from customers, there will be significant costs for compliance and readying systems to correctly capture all input and output VAT.

Implementation of robust documentation, processes and internal controls needs to be established, to capture relevant information. In some situations, this could mean a complete overhaul of financial systems, while in others, might only[1] require recalibration within existing ERP and IT software. In either case, resources will need to be trained on the new systems and monitored till full adoption.

To ensure thorough compliance with regulations, the tax authority may conduct tax audits by selecting businesses at its discretion.

In addition to increased administrative costs, such as recording transactions and maintaining records for tax audits, companies will also need to consider how VAT will affect their pricing strategies.

VAT implementation may, potentially, affect consumer behaviour and businesses need to assess what this could mean on sales and profitability. For example, firms will have to consider whether they need to absorb the tax into their costs or pass on the burden to their customers. This is especially relevant for the ones that cannot recover input VAT. Similarly, consumers may reconsider spending due to price increases.

The effect of VAT will vary based on organisational structures. Multinational companies for example will need to establish processes to capture relevant taxes paid and received. For businesses that have multiple units across the GCC, the impact of VAT not being introduced simultaneously amongst member states needs to be considered and factored.

The introduction of VAT also affects cashflows, especially in the case where claims are filed with the tax authority. Until these are refunded, capital will be tied up and this could strain liquidity.

Businesses should also review existing contracts for goods and services to consider if these are still financially viable after 1 January 2018. Managers may need to renegotiate contracts with VAT being an explicit part.

[1] Enterprise resource planning

What are business owners and managers saying?

We discussed the new tax with eight individuals, business owners, sales and finance managers. The following questions were asked.

1. How concerned are you about VAT and the impact it has on your business?
2. What information have you acquired about VAT?
3. What steps have you or your organisation taken to be VAT ready?

Business owner of a newly established free zone manufacturing firm

1. Not very concerned. Priorities lie in growing the business and acquiring new customers. VAT is a secondary concern for me.

2. Attended the briefing session by the Ministry of Finance, which was helpful. It was an initial exploration and gave me a broad understanding, however more needs to be understood with relevance to my own business that we will consider once the UAE VAT law is out.

3. We are considering completely outsourcing the accounting function to a professional third party who can manage all the accounting and compliance responsibilities.

Finance manager in a construction company

1. We are not panicking, but are certainly concerned about the implementation of VAT and the challenges it poses. VAT is new to the region and while there are a few in-house resources and external consultants that understand VAT, their knowledge is based on implementation in other countries. This could prove to be different from here. We are concerned about the impact it will have on our revenues, relationships with our customers and the business as a whole.

2. No steps have been taken yet due a lack of clarity on the UAE VAT law.

3. Encouraging employees in the company to learn more about VAT informally as we already have resources with experience in other countries. We have also recently reinstalled a completely new ERP system. We made sure that it had the capacity to account for VAT when we procured it.

Finance manager in a local conglomerate

1. We are very concerned about the impact VAT will have on our business, particularly due to the industries that we are in. We source raw materials both locally and from other parts of the world and there is no clear directive on how to account for VAT so far.

2. No steps have been taken yet, but we will drill down the details once the law is out.

3. Procurement strategies are under consideration, contracts are being reviewed and negotiations are taking place with suppliers.

Owner of an electronics installations business

1. Not concerned since we offer only services and not sure whether VAT applies to us. We do not think VAT applies to us since we deal with the government on our contracts.

2. No steps have been taken yet to learn about VAT.

3. We have checked our ERP systems to ensure that they do have the capacity to account for VAT.

Sales manager at a print supplies firm

1. I am concerned because we are uncertain how this is going to affect us. We purchase materials locally and are not sure how this is going to change buying and selling rates. There are some customers whom we have been dealing with for years and we may risk losing or frustrating them if pricing changes too much.

2. We are speaking with our auditors to learn more and understand the VAT rate and what is applicable.

3. As of now no steps have been taken, we are mostly relying on the auditors and advisors to manage this for us.

Finance manager in a hospital

1. Quite concerned as we do not know the implications of VAT on our business. There is ambiguity on how much our purchases are going to go up by. There is no clarification yet on a list of zero-rated or exempt goods that we are waiting for.

2. We have received presentations from our auditors that explain a little on how the tax works and how we can be compliant. We also receive significant material from a number of other consultancies on VAT engagements.

3. Not yet, we are undergoing a systems revamp and are focused on this at the moment. However, we have been given clear directives from senior management through memos, that once the systems integration is complete, we will pay close attention to the VAT.

Finance manager for a machinery retail company (outside the Emirates but in the GCC)

1. Extremely concerned because there is a big gap in understanding what the VAT law is. Things are slow and not clear to us.

2. No steps can be taken as the government here has not taken measures such as awareness sessions.

3. We have already recruited resources with VAT experience in other markets and have also implemented a new ERP system that has the capacity to account for VAT.

Owner of a medical facility

1. I am moderately concerned, I do not understand the mechanism and am not sure about how it will affect my business cost. I am aware that the cost of doing business will go up, but it is unclear by how much and by what method.

2. We have received nothing official. The only information that I have learnt about VAT is in the main, just hearsay.

3. We do not need to do anything to be VAT ready as we are in healthcare and this sector is exempt from VAT.

Survey summary

From the eight businesses with whom we have spoken on VAT, representing different industries and sizes, there seem to be some conclusions we can draw.

It appears that most business managers and owners have reasonable concerns on the introduction of the new tax, but there is no sense of alarm.

A general understanding exists that there will be implications, with financial managers expressing more emphasis and concern on accounting, costs and profitability.

In almost all cases, there is a sense of ambiguity and a lack of clarity; which is expected since local VAT legislation is still to be released. Only one respondent attended a Ministry of Finance awareness session, however this person did not seem to possess much more information than the others interviewed. Everybody had ideas of expected rates, implementation timelines, what may be included and what could be exempt. However not all were right with the information they had.

The majority of people asked are preparing for tax implementation in one way or another. They have taken steps to deploy ERP systems with the capacity to account for input and output VAT. Larger firms have begun hiring resources with relevant experience. Smaller operations were unsure on how to asses existing infrastructure, and two respondents stated that they would potentially outsource the accounting function and VAT compliance. Overall, it is evident that companies, in anticipation of the change, are gearing themselves to be VAT ready. However significant distance is yet to be crossed before this is achieved.

A path to VAT compliance

A roadmap is essential for a planned, thorough approach to dealing with potential issues and becoming a VAT compliant business.

01 Step One
Planning and preparation

- Read and understand VAT requirements and applicable regulations
- Identify key stakeholders
- Select a project team to manage the implementation
- Develop a roles and responsibilities matrix
- Create a project plan with budgets and timelines
- Establish clear line of communication with all concerned

02 Step Two
Impact assessment

- Review existing business functions
- Review current business contracts and transactions
- Identify high and low-level impact areas
- Understand and forecast the effect of VAT on cashflows and the overall business
- Assess existing systems capacity to accomodate VAT
- Measure gaps between requirements and existing processes

03 Step Three
Design and implement change

- Map existing transaction flows
- Develop VAT training manuals
- Set staff training calendar and material
- Schedule changes to systems
- Manage change across levels
- Understand and report on user acceptance

04 Step Four
Testing and operating

- Test new systems
- Ensure troubleshooting management
- Resolve teething issues
- Maintain log and prioritise key concerns
- Remedy high priority matters
- Fine tune new processes
- Supervise and oversee corrections in accordance to new practices

THIS FOUR-STAGE APPROACH CAN OFFER SOME GUIDANCE

Sunstream Research & Consulting

117, The Offices 1, One Central,
World Trade Centre District – Dubai

contact@sunstream.ae
+971 4 523 2535