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THE CHALLENGE OF VAT IMPLEMENTATION IN THE UNITED ARAB EMIRATES

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Abstract

To raise additional tax revenue and to boost economic growth, the United Arab Emirates enforced Value Added Tax law, effective from 1 January 2018, for taxation of goods and services in UAE. In this article, the author discusses background for introduction of VAT by the UAE government. After presenting regulatory framework of the UAE VAT law, major challenges likely to be faced by the UAE tax authorities in implementation of VAT are being discussed. At the end, way forward for successful and effective implementation of VAT in the UAE is suggested.

Keywords: Value Added Tax, United Arab Emirates, Fake and Flying Invoices, VAT Frauds, VAT gap

INTRODUCTION

Value Added Tax (VAT), the most influential form of indirect taxation in the latest century, taxes supply of goods and services based on the destination principle (D'Ascenzo, 2019). Some 166 countries operated VAT/ GST in 2016 (Chanel, 2019). With implementation of VAT in the three countries of the Gulf Cooperation Council (GCC), including the UAE, the Kingdom of Saudi Arabia and Bahrain, during 2018/2019, currently the VAT/GST system is being operative in 169 countries around the world.

There are strong economic reasons behind quick and rapid spread of VAT across the globe since its gradual adoption in France during the period from 1948 to 1968 (Brederode & Susilo, 2017) VAT is considered a stable source of revenue as it ensures taxation of significant proportion of economic activity throughout production chain and raises large amounts of revenue. On average, countries with VAT experience 40% to 50% less tax revenue instability than countries which do not have a VAT system (Ebrill et al., 2002). Well-structured VAT maintains neutrality (Tait, 1991) because it has relatively little influence on the decisions of businesses and individuals (Dubay, 2010). VAT ensures that all goods face the same level of tax regardless of where they are manufactured subject to the condition that uniform VAT rate applies to all goods and services. By taxing imports at standard rate and zero rating exports, VAT achieves neutrality in the treatment of goods and services entering international trade (Amirthalingam, 2010).

It is empirically established that a VAT with a constant tax rate over time would not distort household saving choices, nor would it distort business's choices regarding new investments, financing instruments, or organizational form (Brown & Gale, 2012). VAT is also an efficient tax because cost incurred on its enforcement is less as compared to cost associated with enforcement of other taxes (Dubay, 2010). So VAT produces more revenue with relatively less collection cost. VAT accelerates economic growth (Acosta-Ormaechea & Yoo, 2012) by excluding saving and investment from the tax base (Dubay, 2010) and by allowing exporters of goods and services to better compete in the international markets (Hassan, 2019). It is empirically found that the presence of VAT increases levels of investment and rate of economic growth (Ufier, 2014).

In the remainder of the article, the author discusses introduction of VAT in the UAE in section 2 and VAT regulatory framework in section 3. Section 4 gives account of major challenges likely to be faced by the tax authorities of the UAE in implementation of VAT. Finally, section 5 presents way forward for successful and effective implementation of VAT.

VAT IN THE UNITED ARAB EMIRATES

The UAE with a population of more than 10 million and per capita GDP of USD 67,741 is almost a tax free economy without income tax and federal corporate tax. There are only local and tourism taxes as well as toll taxes and service fees for the provision of government services. Overall tax burden equals 8.9% of total income. The UAE has been amongst the world's most favourable tax-free regime deemed attractive for foreign direct investment (Stanley-Smith, 2015). The government's budgets in the UAE have largely been balanced through revenue generated from petroleum production. Nonetheless, declining prices of petroleum products in the world market has significant reducing impact on the UAE revenue in the recent past (Zafarullah, 2018) forcing the government to bring change in the taxation system for compensating declining revenue. As a result, the government introduced VAT effective from 1

January 2018 to generate additional tax revenue for balancing the budgets and for boosting economic growth following the Unified GCC VAT Framework Agreement that sets the basis for its members to implement VAT in their respective jurisdictions.

The UAE VAT system is designed in line with the EU VAT systems with minimum exemptions and without special schemes or reduced rates to uphold the principle of neutrality. Right to deduction, which is a key element in the operation of VAT, is provided in the VAT law so that input tax excess of output tax could be refunded to taxable persons. To ensure VAT compliance, administrative penalties are provided in the VAT law for failure by a taxable person:

- to display prices inclusive of tax;
- to notify the authority regarding charge of tax based on the margin;
- to comply with the conditions and procedures related to keeping goods in a designated zone or moving them to another designated zone;
- to issue a tax invoice or an alternative document when making a supply; for failure person to issue a tax credit note or an alternative document; and
- to comply with the conditions and procedures regarding issue of electronic tax invoices and electronic tax credit notes

VAT in the UAE is levied on the basis of consideration agreed between the supplier and the buyer, which represents the value of supply. If the entire consideration is measured in monetary terms, then the value of supply will be consideration less tax and if all or part of consideration is not measured in monetary terms, then value of supply will be monetary part plus market value of the non-monetary part. The value of supply of services will be equal to market value of the consideration without addition of tax on that supply. The import value of goods consists of customs value determined in accordance with Customs Legislation, including the value of insurance, freight and any customs fees and excise tax paid on the import of such goods. To determined value of supply, the rate of VAT is applied to compute the VAT liability. Based on the assumption that transactions between related parties may not reflect a fair market price, transfer pricing rules have been incorporated into the UAE's VAT legislation. Tax authorities are not obliged to accept this value of supply:

- if the supplier and the buyer are related parties;
- if the value of supply is less than the market value; and
- if the supply is taxable and the buyer is not entitled to recover the full tax that will have to be charged to such supply as input tax.

Under such circumstances, the value of supply or import of goods or services will be the market value. It is believed that introduction of VAT in the EU will have accelerating impact on the businesses and hence, economy in the long run. Furthermore, introduction of VAT will stabilize revenue (PWC, 2019). VAT being easily understandable will likely to attract foreign investors in different sectors in the UAE. It is also anticipated that introduction of VAT is likely to enhance inflation rate that will push upward the cost of living in the UAE (Domat, 2018). However, any impact based on inflation on specific household purchasing power will be neutralized by the zero-rating and exemption from tax of certain items and services.

REGULATORY FRAMEWORK OF VAT IN THE UNITED ARAB EMIRATES

Among the member countries of the Gulf Cooperation Council (GCC), the UAE along with Saudi Arabia were the first those implemented VAT. This section discuses regulatory framework of the UAE VAT system.

Scope

In the UAE, VAT will apply at the standard rate of 5% on every taxable supply i.e. supply of goods or services for a consideration by a person conducting business in the UAE but does not include exempt supply and deemed supply (anything considered as a supply and treated as a taxable supply) of goods and services made by a taxable person and also on importation of taxable goods. A supply of goods is deemed to be carried out in the UAE in the following cases:

- where ownership of the goods or the right to use the goods is transferred from one person to another person;
- where title of goods transferred under a contract between two parties, which stipulates that the ownership of goods will be transferred in future or the contract mentions the intention to transfer the possession of goods; and
- the supplies of water, real estate and all forms of energy will be considered as supply of goods.

In relation to supplies of services, the UAE VAT law provides that any supply that does not constitute a supply of goods will be considered a supply of services, including the provision of services. However, the UAE Executive Regulations of the Federal Decree-Law No (8) of 2017 provides that the following should be treated as a supply of services:

- the granting, assignment, cessation, or surrender of a right;
- making available a facility or advantage;
- not to participate in any activity, or not to allow its occurrence, or agree to perform any activity;
- the transfer of an indivisible share in a good; and

— the transfer or licensing of intangible rights.

However, under Article (7) of the UAE VAT law, the following does not constitute supply:

— sale or issuance of any voucher unless the received consideration exceeds its advertised monetary value; and
— the transfer of whole or an independent part of a business from a person to a taxable person for the purposes of continuing the business that was transferred.

Specific provisions governing composite supply, supply by an agent, supply by government entities and deemed supply are provided in the UAE VAT law.

Registration for VAT

The UAE VAT law provides that all businesses who have a place of residence in the UAE and whose value of supplies in the GCC member states in previous 12 months has exceeded AED 375,000 should mandatorily register for VAT. Also, if the businesses anticipate that the total value of supplies will exceed the mandatory registration threshold of AED 375,000 in the next 30 days, then such businesses must be registered under the UAE VAT law and charge and remit VAT to the government. Non-resident businesses will have to compulsorily register for VAT regardless of the registration threshold. In case annual supplies or taxable expenses incurred exceed AED 187,500 (voluntary registration threshold) in previous 12 months or anticipated to exceed in next 30 days during the current financial year, the businesses will have the option to voluntary apply for VAT registration. Businesses below voluntary registration threshold are not allowed to register for VAT in the UAE and to collect VAT.

VAT group registration

To save cash outflow on account of VAT between related parties, Article 14 of the UAE VAT law provides that businesses with multiple legal entities under common control may apply for VAT registration as a VAT group once all of the following conditions are fulfilled:

— each of the group members must has a place of establishment or fixed establishment in the UAE;
— must be related parties; and
— one or more persons conducting business in a partnership must control the others.

After all the entities under single control registered as VAT group, then:

— VAT is not required to be charged within the group transactions;
— a single periodic VAT return is required to be filed;

- all grouped entities are jointly and severally liable for the VAT liabilities i.e. management of any entity within the group will be held equally responsible for any fraudulent activity.

Place of supply

Goods

In the following supplies of goods, the place of supply will be the UAE and therefore, VAT at the rate of 5% will apply:

- in case of domestic supply, when goods are supplied to a recipient within the UAE;
- in case of exports, when goods are exported from the UAE to a non-GCC VAT implementing State;
- in case of imports, when goods are imported into the UAE from a place outside the UAE.

Services

The place of supply of services will be the UAE and the UAE VAT law will apply when the place of residence of the supplier is UAE. However, the place of supply will be recipient's state, if services supplied to a person in another GCC VAT implementing State who is a registrant in that State. In addition, there are certain specific rules to determine the place of supply of certain types of supplies of services such as services relating to hotels, real estate, transportation, etc.

Exemptions and zero rates

The UAE VAT Law lists some supplies which are exempt from VAT, including:

- financial services such as exchange of currency issue, advance or credit, provision of any loan, deposit or savings account and the operation of any current;
- residential building meant for human accommodation e.g., for students or school pupils, armed forces and police, nursing homes, principal place of residence, rest homes, and orphanages through sale or lease;
- bare land i.e. land which is not covered by complete buildings or civil engineering works or partially completed buildings; and
- local passenger transport.

Taxable persons will not subject to 5% VAT on exempt supplies. Moreover, input tax paid on purchase of raw material, if any, used for manufacture of VAT exempt supplies is not reclaimable.

The following specific supplies will be subject to the zero rate in the UAE:

- direct and indirect export of goods and services;

- certain means of transport, such as trains, trams, vessels, airplanes, etc;
- aircraft or vessels designated for rescue and assistance by air or sea;
- international transport of goods and passengers;
- certain investment precious metals with the metal purity of gold, silver and platinum must be 99%;
- certain health care services and related goods and services;
- first sale or rent of residential buildings;
- certain educational services and related goods and services.
- crude oil and natural gas;
- educational services; and
- healthcare Services

In respect of zero-rated supplies, taxable persons will able to adjust input tax charged on purchases against output tax chargeable on supplies and will reclaim refunds of input tax over and above output tax.

THE CHALLENGES OF VAT IMPLEMENTATION IN THE UAE

VAT systems are susceptible to VAT evasion and frequent VAT frauds, which are major sources of VAT gap. For example, according to the European Commission (EC), the EU-28 VAT gap amounted to EUR 137 billion for 2017 and within the EU member countries, VAT gap ranged from 36% in Romania (the largest) to 1% in Sweden, Luxembourg and Cyprus (the smallest) (European Commission , 2019). Inter alia, VAT frauds occur in the following forms:

- taxable persons remain out of VAT net by keeping turnover below VAT registration threshold;
- taxable persons continue supplying taxable goods and services without charging VAT;
- taxable persons establish shell companies and involve in non-existent transactions;
- taxable persons use fake and flying invoices to enhance input tax in order to reduce output tax liability;
- taxable persons understate the value of supplies or overstating the value of purchases;
- taxable persons may register dummy units using fake identity just for the purpose of issuing sales tax invoices to enable other registered taxable persons to reduce their tax liability or to claim illegal refunds; or
- taxable persons remit to the government less sales tax amount than they have charged their customers by submitting fraudulent VAT returns.

Although the UAE VAT law provides anti-fraud provisions such as reverse charge mechanism, administrative penalties and mechanism for taxation of related party transactions to prevent VAT evasion and frauds, yet the tax authorities will likely to face the following challenges while dealing with VAT evasion and VAT frauds:

- to trace taxable persons carrying out economic activities and have exceeded the registration threshold for VAT registration;
- to establish fool proof registration mechanism to ensure that shell/dummy firms shall be prevented from registration;
- to identify VAT fraudsters, VAT evaders, non-filers and short-filers to ensure VAT compliance;
- to prevent use of fake, which are being issued by dummy firms (existing only on paper) . showing either input against fake purchases or imports or issue invoices to registered persons enabling them to get illegal input tax adjustments and refunds and flying invoices, which are issued by importers, wholesalers and dealers that sell goods to one taxpayer (unregistered and end consumers) without invoices and issue invoices to another taxpayer (registered) without supplying goods, so that businesses could not be able to claim fraudulent refunds by inflating their input tax deductions;
- to conduct effective audits which are essential to discover tax evasion given VAT systems are grounded in an unsupervised self-assessment scheme; and last but not least
- to manage VAT refunds so as to ensure that timely processing of genuine refunds.

THE WAY FORWARD

Limited VAT capacity has great bearing on the revenue performance of VAT system in any jurisdiction. VAT capacity may be influenced by factors, including political institutions, level of development, trade openness, hard-to-tax supplies, etc. Political institutional determinants such as government effectiveness, regulatory quality and rule of law are statistically significant determinants of C- efficiency (Mello, 2009), which is a yardstick employed internationally for evaluating revenue performance of VAT systems. Other political institutional variables such as political stability, absence of violence (terrorism), control of corruption and perception regarding accountability are also correlated with C-efficiency. Development is associated with higher level of education, literacy and technology. Such variables raise the capacity of country to administer taxes. Last but not least are the hard-to-tax supplies such as financial services, including deposits, lending, issuance of financial securities, insurance, brokerage, advisory services, etc. also influence revenue performance of the VAT regime. Therefore, the following measures are required to enhance the capacity of the tax authorities dealing with VAT in the UAE in order to recover due amount of VAT and to broaden the VAT base essential for equitable taxation:

- training and equipping the tax authorities with knowledge of VAT and logistics for data analysis to identify and register potential taxable persons;
- using information technology (IT) for improving VAT compliance. An electronic system that handles the VAT return submission process is of crucial importance to increase the efficiency of the VAT system (Kabongo, 2017);
- implementing a certified invoicing software system is of utmost significance to deal with the invoicing problem (Lobo & Bobos-Radu, 2018);
- launching follow–up programs and devising strategies to encourage customers, including government institutions, to ask for VAT invoices from their suppliers;
- establishing automated system for quick processing of VAT refunds of exporter companies; and last but not least
- ensuring post-refund audits and verifications for preventing the issuance of fake refunds and protecting the government revenue.

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