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VAT in the GCC
Old news or new chapter?

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Since August 1, the majority of motorists in the UAE have been paying around 25% more at the pumps following a move by the government slash the fuel subsidies that have been enjoyed for so long. Aside from the impact on drivers' pockets, however, this somewhat momentous move on the part of the UAE is a clear signal that in a country facing a halving of the price of its oil exports over the long term, something had to be done to help balance the national budget. Funding deficits from cash reserves is a short-term strategy which all of the GCC countries are desperate to avoid; it is happening now, but every GCC government understands the urgent need for fiscal-sustainability.

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Top line or bottom line?

Of course, removing cost is just one approach to balancing the books. The fiscal break-even oil price (the price at which a barrel of oil needs to be sold in order to maintain a balanced budget given committed expenditure) in the UAE was estimated by the International Monetary Fund (IMF) in May this year at around US$73.1 per barrel for 2015, declining slightly to US$68.9 in 2016. The impact of removing the fuel subsidy - valued by the IMF at almost US$7 billion, or around US$730 per capita - will, inevitably, help bring this figure down further, but notwithstanding the bold move made by the UAE, an unfortunately significant gap will remain between current and estimated crude pricing and fiscal breakeven. Indeed, World Bank estimates would suggest the oil price to fiscal break-even deficit in the country would only be eliminated at some point in 2020, all other things remaining equal.

Yet removing cost is not in itself a long-term strategy either, and so it is unlikely that we will see an exact US$7 billion offset in the UAE's national budget. Notwithstanding the fact that a degree of market support will remain bearing in mind the new pricing approach that is being taken, a more likely scenario is that a large proportion of the amount eventually released will be diverted into other aspects of the economy which are proven to be associated with long term growth; primary and secondary education coverage, public infrastructure, and health initiatives.

Another approach to balancing the books is to grow the top line. If pumping more oil or injecting cash are untenable long-term options, then taxation offers a credible alternative. And that, of course, is the challenge. Taxation is alien to many living and working in the region and even contemplating it puts pressure on the "tax free" branding typically applied to anything in the Gulf. But faced with ever more pressing fiscal realities, it seems that governments are running out of alternatives; moves to remove cost at the margin and balance the books with dwindling cash reserves that could be exhausted within a generation is far from an

ideal long-term strategy. Aside from these internal pressures, the international finance community has long advocated a diversification of government income away from hydrocarbon revenues.

To VAT or not to VAT?

Tax comes in many forms. There are "direct" taxes that can be levied on profits and incomes (e.g. corporate income tax and personal income tax), levied on economic rents (e.g. mineral taxes or property taxes), and there are so-called "indirect" taxes that are levied on consumption (e.g. Value Added Tax or VAT and excise taxes). The volume of literature on the relative merits of one form of tax over another is simply staggering, yet there is one clear trend that can be observed: a general consumption tax such as a VAT is taking an increasingly larger share of the total tax take in many jurisdictions. The Organization for Economic Cooperation and Development (OECD) data indicates that in 2012 the total share of total tax revenues earned in member countries represented by corporate income tax was around 9%, with VAT more than double that figure at 20%. In 1965 the corporate tax share was broadly the same, but VAT, a relatively new form of tax at that time, stood at a mere 12%.

VAT is a popular fiscal tool for a range of reasons. It is considered to be efficient, cheaper to operate, less open to fraud, and less likely to distort investment decisions by businesses than any form of direct tax. This latter point is significant; governments do not want to generate new revenue at the expense of investment by the private sector. Bearing in mind that the majority of the cost of a VAT falls squarely on the consumer rather than on businesses, it is a rather neat way of balancing these potentially competing requirements. That is not to say that consumers will necessarily be delighted by the prospect of having to pay VAT on the goods or services that they consume. In fact, VAT is regressive in the sense that it impacts those on lower incomes more in relative terms than those on higher incomes, albeit those on higher incomes are impacted more in absolute terms.

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But assuming that a government addresses the regressive aspects of VAT through targeted social welfare spending or by removing the tax from certain goods, consider this: as a tax on consumption, a reduction in personal consumption reduces tax costs for the individual. To that end consumption taxes also put the brakes on excess, and enable governments to achieve other ambitions such as reduced carbon dioxide emissions and other green initiatives, long-term price inflation restraint and so on.

In short, faced with a need to raise additional government revenues, implementing a VAT would be a rational response by government. That is not to say that the implementation of a corporate or personal income tax can be ruled out, rather it is a reflection on the fact that a VAT, all other things being equal, seems to "tick more of the boxes" than the others. Compared to a VAT, a Corporate Income Tax (CIT) is more likely to act as a disincentive to businesses considering investment in the region and more negatively impact GDP growth as a result. A personal income tax presents an obvious challenge to the "tax-free" branding that has served the region so well in the past. Yet introducing VAT does not necessarily mean that a government would not need to introduce any other taxes. In fact, it could be argued that introducing a VAT at this point might very well make it easier and more acceptable for governments to introduce a full suite of taxes in the future.

Does it hurt?

The economic impacts of VAT are reasonably well known. Assuming a broad-based tax (i.e. one with very few exceptions to the general rule of taxation) at a low rate (i.e. around 5%) there is usually a relatively small (negative) impact on GDP growth and employment. In the short term, this impact on GDP may amount to up to 1% of real GDP; in the longer term the impact may be mitigated through increased government spending and investment. Inflationary impacts are also relatively small and typically limited to the period immediately after implementation, bearing in mind that there is not necessarily a one-to-one relationship between the rate of the tax and the price charged to consumers.

It is likely that only a limited number of differences would exist between any VAT regimes implemented. Differences in the standard rate of VAT would be highly unlikely (obvious rate differences encourage so-called "rate shopping" by consumers), although certain goods and services might be relieved from the tax for certain social or practical reasons. In short, it would be expected that VAT would be introduced at a low rate with very few exceptions to a general rule of taxation and as a consequence should avoid any major sectorial discrepancies.

Corporate tax 101

Perhaps surprisingly to some, all of the GCC countries already impose corporate taxes to one extent or another. Yet that has not stopped speculation that significant CIT reform around the region is also on the agenda. It was the UAE, which currently offers perhaps the most benign CIT conditions of any GCC country at this time, that prompted a wave of recent speculation in this regard as a result of the publication of its 2014 federal budget which included statements that were interpreted as meaning an imminent expansion of the CIT tax base.

The fact is that corporate tax reform (e.g expanding an existing CIT regime or implementing a new one) is an attractive proposition to governments operating within a trading bloc simply due to the relatively simple means by which profits can be unilaterally on-shored and taxed. When one considers that multinationals in the GCC are, most likely, paying taxes on profits generated in the region to their home jurisdiction to one extent or another, there is also a potentially neutral impact associated with the local capture of those revenues.

With this in mind it is easy to see why governments might be thinking seriously about broadening the CIT tax bases and increasing rates. However, one unfortunate reality remains; the potential economic downsides associated with a growth in CIT could very well outweigh the revenues earned as a result of the measures implemented to bring about that result. In short, taxes on profits are more likely to adversely impact investment behavior and subsequent spill-over effects than taxes on consumption - a point that is not lost on policy makers; the "easy" option of growing the CIT base might be sub-optimal when compared to the "harder" option of implementing a VAT.

In the context of the UAE in particular, CIT also presents a more obvious challenge to the "tax-free" branding that the country has leveraged so well to date. Furthermore, the six individual Emirates that make up the UAE may very well find that a CIT does not sit well with either the long-term local tax exemptions that have been promised to businesses established in increasingly prosperous free-zones or the finely-tuned tax-free economic planning strategies that have been developed over many years. That is not to say that a CIT in the UAE is impossible to contemplate, but rather the route to implementing such a tax in the country would appear to be more treacherous and uncertain than the road to VAT.

A case of 'if' not 'when'?

There have been concerns raised in the past that a single-country move to implement a VAT would necessarily disadvantage that country. Imagine for a moment a motorist faced with the choice of filling their car with fuel in a country which imposes VAT, or nipping over the border to a country that does not. Assuming a short journey time and a relatively simple border crossing, it is reasonably likely that petrol filling stations on the border of the taxing country might find their market disappear overnight. These sorts of concerns have, until recently, been driving GCC member states to achieve a simultaneous implementation of VAT.

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Yet governments in the GCC also have to deal with quite different demographics, they are not all necessarily as exposed to the vagaries of global oil pricing (i.e. they have diversified their economies away from hydrocarbons more than others), have a different level of maturity with respect to tax administration, or simply want to pursue alternative fiscal strategies to that of taxation. Clearly these facts do not sit well with the notion of a simultaneous implementation. And this is precisely the reason for the decade-long “stop-go” debate on VAT in the region.

Significantly, the Minister of Finance of Kuwait was quoted in May this year as saying that whilst the GCC members were likely to sign up to an "agreement" on VAT containing "common principles," each country would issue its own VAT law reflecting those common principles. What this seems to suggest is that the GCC has now accepted that individual countries might want to, and should be enabled to, proceed with a VAT implementation unilaterally if they so wanted, provided common issues of interest (most likely the taxation of cross-border trade, rates and exceptions from the general rule of taxation) were properly safeguarded.

The fact that the undersecretary of the Ministry of Finance in the UAE was then reported in July by Gulf News as having said that "the draft of the corporate tax law and the VAT law has been discussed with the local and federal governments," and that the laws will be finished "very soon, within the third quarter of this year," suggests that the UAE at least is moving, meaningfully, towards a decision on implementation.

All of the governments of the GCC are fully aware of the fact that the success of a VAT implementation will depend on the ability of businesses (being those ultimately responsible for collecting it from their customers) to administer it. Businesses also prefer certainty on taxes when it comes to making investment decisions. Bearing these factors in mind, any move to implement VAT in the GCC will be announced well in advance and combined with an extensive public communications program. Whilst a 12-month announcement-to-implementation timeframe shouldn't be ruled out, an 18-month to 2-year plan would be more likely.

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What would a business need to do to get ready?

The design of VAT puts businesses in charge of charging and collecting VAT, then remitting it to government at agreed times. For businesses unfamiliar with VAT, implementation can require a significant change to business operations, and will likely include:

1. Understanding the likely impact of VAT on demand for goods and services and competitor responses;
2. Understanding VAT registration obligations and going through the process of applying for a VAT registration number;
3. Ensuring that the relevant books and records are maintained in the appropriate manner by a business;
4. Revising terms of business with customers to ensure that VAT becomes a cost to customers not to suppliers;
5. Ensuring that the Accounts Payable (AP) function evidences VAT paid and that it is recovered as quickly as possible;
6. Ensuring that the Accounts Receivable (AR) function understands when VAT should and should not be charged, and that it is accurately accounted for;
7. Revising Enterprise Resource Planning (ERP) systems to ensure that they can cope with the charging and recovery of VAT;
8. Implementing manual VAT accounting processes if no central ERP system is used;

9. Changing invoicing templates to ensure that new fields relevant for VAT accounting are included; and
10. Ensuring the business is structured in such a manner as to avoid unnecessary cash-flow or absolute VAT costs arising, particularly on intercompany transactions.

Unfortunately, the nature of VAT is that whilst tax liabilities are "self-assessed" and paid over by businesses, errors are typically subject to heavy penalties. Any type of tax fraud is usually subject to heavy civil and/or criminal penalties and we would expect that the same approach be taken in the GCC.

The bottom line – A perfect storm?

It is looking increasingly likely that there will be a unilateral or multilateral move to implement VAT in the GCC in the relatively near term. Whilst no government has committed to implementing any tax at this time, the signs are that the status quo will change as a result of persistently low oil prices, the correspondingly substantial fiscal break even gap faced by most GCC countries, all of which are coupled with the need to find sufficient revenue to fund ambitious economic growth plans in the long term. The momentous decision by the UAE to slash fuel subsidies is likely to drive the decade-long GCC tax debate to a meaningful conclusion within the next six months.

Businesses should start to consider what the likely impacts on their business are going to be now, although they should also bear in mind that governments are likely to give plenty of warning prior to any implementation in order to ensure that the tax can be properly administered from day one. Understanding current readiness to adapt a business to a taxed environment is key simply as it will identify those areas which will need to be given priority in the undoubtedly hectic build-up to implementation.

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