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Chapter 1: Real estate and construction industry

The property development and construction industry – building with VAT in mind





The scale of many businesses operating in the sector, and the cost and revenue throughput that they manage, by nature creates an environment of risk associated with poorly understood or managed VAT obligations

A quick look at court cases concerning VAT matters around the world would confirm that amongst some of the most regularly heard issues are those that concern the application of VAT to the property development and construction industry.

Why, you might wonder, is this the case? The industry has been around for a long time, so surely this is one aspect of VAT that must be well and truly settled by now? Unfortunately that is not the case. Simply put, the range of transactions underpinning the planning, construction and sale of commercial or residential real estate are varied and often highly complex which, necessarily, creates the need for an extensive suite of bespoke VAT rules to cope with these challenges.

The development and construction sector is of huge importance to the GCC as a whole. It supports large numbers of livelihoods as well as delivering the necessary infrastructure, commercial and residential spaces that are so important to the continued development of the region. The introduction of VAT by the GCC member states is not an attempt to harm those future prospects; indeed, governments want the sector to thrive and make a positive tax contribution, bearing in mind the sums involved.

Equally, however, the scale of many businesses operating in the sector, and the cost and revenue throughput that they manage, by nature creates an environment of risk associated with poorly understood or managed VAT obligations.

1. Construction sector challenges

Lead times on major projects

Lead times are common in most demand-led industries, but in the case of major construction projects they can be extremely long. It is almost certain that a large number of the major projects due to be delivered over the next few years will not have had VAT factored into them, either on the cost or revenue side. To

some extent this was inevitable; the gestation of the VAT project in the region has been somewhat erratic to a number of observers and some businesses have planned for that status quo to remain for some time. Clearly that is no longer the case.

The issue associated with the duration of contracts drawn up in the sector is that many will not, at the time of drafting, have included any of the normal terms and conditions relating to VAT which one would ordinarily expect in jurisdictions where the tax has been implemented.

For the contractor in such instances, will they be in a position to charge VAT in addition to their normal contract price? On the face of it this appears to be a simple question, but in reality, it is often not.

Payment for VAT purposes is generally considered to be inclusive of VAT. That means that in our case the contractor will need to agree with their customer that they can charge VAT in addition to the price previously agreed in order to avoid the charge becoming a cost they have to bear themselves.

Bearing in mind that contracts in the region are generally struck on a tax-inclusive basis, making this change may not be as straightforward as one would hope, regardless of the position of the customer vis a vis VAT recovery.

Furthermore from a pricing standpoint, it is unlikely that the market (after the introduction of VAT) would simply reprice itself to cover the VAT charge in full. Indeed, customers may well look to their suppliers to cover some of the VAT charge themselves anyway.

There may well be some sort of a transitional regime granting suppliers the right to "grandfather" existing tax-inclusive contracts into the new VAT environment. However whilst such approaches have

been seen elsewhere, it remains to be seen whether that would be the case in the GCC.

This is, therefore, a major area of potential risk for any contracts agreed before the implementation of VAT but which will be executed or delivered after, the purchaser and vendors are unlikely to simply concede their respective positions easily given the cost of VAT must fall on one of them.

Registration of subcontractors

Another commercial issue that contractors will need to confront is the fact that many smaller subcontractors will either not be registered, or not required to be registered for VAT for the simple reason that they fall below the registration threshold. As a result of not being registered those businesses will be unable to recover VAT incurred on costs.

This being the case, it might cause the industry to seek to restructure to some degree, in order to prevent the blockage stemming from businesses unable to claim VAT refunds from unregistered sub-contractors; any such blockage would result in an element of VAT being included in the costs of construction. For subcontractors that fall below the mandatory registration threshold, but are entitled to register voluntarily, they may well need to consider that option, as failing to do so could make them uncompetitive compared to registered subcontractors that will charge VAT that the contractor can recover.

Treatment of residential versus commercial property

In the normal course of the application of VAT, the construction and supply of commercial, industrial and retail properties, in addition to the construction of infrastructure, is treated as subject to VAT at standard rate – i.e. 5% as expected in the GCC.

An issue arises when one addresses the construction and supply of residential properties. Many governments attempt to create a level playing field between the supplies related to new residential premises and those of ‘second hand’ residences (which are normally supplied by unregistered persons, and are therefore not subject to VAT). Driving this process are other factors such as the perceived requirement of giving some preferential treatment to costs of basic living necessities likely to affect the lower

There are two ways to give a relief – one is to allow a refund of VAT by the developer – this obviates the need to give a relief at the contractor level on the grounds the developer can recover the VAT charged by the contractor. The second is to relieve the actual supply of construction services, so that those services themselves are not subject to VAT. Both approaches are used around the world to differing degrees though the latter approach achieves little without supplementary reliefs for the developers.

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income households. In order to achieve this outcome, some countries will treat the first supply of residential properties as being exempt or zero-rated rather than standard rated.

It must be said that this relief is by no means a given – and each GCC country may well end up with different rules. Certainly in Europe there are countries that charge VAT on homes and this is often, but not always, a substitute for transfer/stamp taxes. It is hoped that in the GCC, given the pressure on new housing and in particular on prices, that this will not be the case.

So if there is a relief, what relief?

In either case, allowing such a relief would have the effect of supporting the local construction industry, which, as mentioned previously, is very important to the GCC economy. The effectiveness of any relief in the construction sector is of course tempered by the treatment of supplies of the real estate made by the developer – there is little point in zero-rating construction services, if the sale of the villa itself is standard-rated. There are essentially two choices here – zero-rating or exemption.

If the first sale of residential premises is zero rated, then the VAT incurred during the construction process will be recoverable, and there should be no impact on the costs of construction. ➤

As a result there is not a need to relieve the construction work itself as the VAT is a pass through (deductible by the developer).

If, however, the first supply of residential property is treated as exempt, this will mean that the developer will not be able to recover any VAT incurred during the construction of residential property, but will generally seek to recover that additional cost as well as its normal margin if it can when the property is either sold, or leased out. This in turn means that a relief at the contractor level is much more effective (as the developer avoids paying VAT that would otherwise be a cost).

As a result of the above, the ability for a construction company to pass on the full impact of VAT to property developers will very much depend on whether those developers will be eligible to claim a full input VAT credit. A developer's VAT recovery position will be determined by reference to the VAT treatment of the real estate transactions that the developer enters into.

Industry practices

Other operational issues will arise through existing industry practices and the manner in which they tend to interact with the VAT law.

Examples of this would include dealing with the time of supply where work done on construction is subject to certification. Typically a pro-forma invoice is issued, but this is in reality just the start of a process of negotiation as to what work is ultimately agreed as having been done. However, if not documented carefully, and not dealt with contractually, this could have the effect of bringing forward the recognition of supplies that could well be in dispute, with the result that the VAT payable could be substantially different from the

amounts that are reflected on the pro forma invoice.

Another area that could cause some differences in treatment would be the manner in which retention payments are ultimately dealt with. Once again, differences between what is stated in the contracts as compared to the industry practice could result in the incorrect amount of VAT being accounted for, or the treatment of the VAT occurring in the incorrect tax period.

2. Property development sector challenges

It is possible that the supply of commercial real estate either by way of sale or letting of real estate will be treated as taxable at the standard rate of VAT in most, if not all of the GCC. Charging VAT on the supply of commercial buildings should only create an additional cost to taxable persons and other bodies which are not able to recover VAT in full, for example, because those persons perform exempt or non-business activities. Consequently, vendors should be sensitive to this during price negotiations. In the context of commercial leases, landlords may wish to consider undertaking fit-out works on behalf of exempt tenants to incentivize them to occupy properties. That said, many larger institutions that are treated as exempt might incorporate taxable supplier entities to act as the landlord in respect of property used by the exempt supplier. While this does not have the effect of ridding them of the VAT burden, it can have the effect of delaying the timing of the negative effects of VAT on businesses that are not able to recover the VAT as an input tax credit.

Supplies of bare land are often treated as VAT exempt (regardless of whether the land is intended for commercial or residential use or development), in order to control the potentially inflationary

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impact of taxing such transactions (which are in essence often a form of investment, and so charging VAT serves to tax investment by private individuals). This also reflects the fact that any value that may be added on the supply of bare land is often merely an indication of the inflation of the value rather than any process by which the value may have been enhanced. It also removes the possible need for private investors to register for VAT purely as a consequence of their involvement in such transactions.

Finally, as discussed briefly above, transactions in residential real estate tend to require special treatment. Residential property development is a capital intensive business and allowing refunds is often desirable, on the other hand, charging VAT on residential property is not always sensible given the impact on pricing. As a result it is not uncommon for residential developers to be entitled to claim zero-rating on the sale of properties – in order to recover VAT on costs whilst simultaneously not impacting prices due to the absence of VAT on the sale. Often this zero-rating is limited such that other residential property sectors, such as the secondhand or leasing market, are exempt from VAT (thus suffering a VAT cost on expenses). These are complex policy options and it remains to be seen what choices the GCC governments will make.

Notwithstanding these broader challenges, a range of other considerations now face the sector:

Cash flow

One of the biggest areas of concern for the property development sector will be planning for its cash flows. The sector, which can operate on thin margins, could be under pressure in terms of meeting the additional requirement of paying 5% VAT on the purchase of goods or services each month or quarter on an accrual basis.

Therefore, it is critical for the business to perform a comprehensive impact assessment and determine the additional cash flow requirement, as this will have an impact on its working capital requirements.

Barter transactions

Property transactions often involve consideration other than, or in addition to, money, which can cause complex VAT problems. By way of example, an exchange of property interests, such as a surrender of an old lease in exchange for the grant of a new lease, or a sale and leaseback transaction, may take place without any exchange of money. These are barter transactions and it is important to analyze the VAT implications for each party and to ensure that there are no unexpected VAT costs by appropriately documenting the transactions. Failure to recognize these transactions could result in penalties.

Lease incentives

It is relatively common for property developers, particularly in the retail, office and industrial markets, to offer rent-free periods and other lease incentives to prospective tenants. This could trigger a VAT liability for both the tenant and landlord if it is determined that something has been supplied in return for the inducement (e.g. building works). Further, some jurisdictions deem a market value for rental during a rent-free period requiring the landlord to account for VAT, even though this may not apply to leases between arm's-length parties where the rent-free period is effectively subsidized by the higher rental received during the remaining term of the lease.

Mixed-use properties

For companies engaged in the supply of both exempt (e.g. residential) and taxable (e.g. commercial) units, often referred to as mixed-use properties, the impact could be significant as there will typically be complicated calculations for recovery of

proportionate input tax credit for each accounting period. Any lapses in such calculations will make VAT an additional cost for the business, impact its competitiveness and may give rise to penalties.

Construction work

The provision of construction services (including materials) is normally subject to VAT at the standard rate.

Subcontractors are also likely to be impacted. This is because many subcontractors are likely to fall below the registration threshold and therefore they will seek to pass on the cost of their irrecoverable VAT. This could then lead to a change from contracts for the supply of goods together with a service, to that of a service alone, in order to ensure that materials are purchased by the head contractor, which is then able to recover the VAT.

There will also be pressure for registered subcontractors to provide VAT invoices to head contractors on a timely basis to enable swift VAT recovery. To this end, some countries have sought to introduce special regimes for subcontractors, such as reverse charge rules, or self-billing arrangements, to facilitate higher levels of compliance.

It is clear from the selection of issues explored above that this is a complex area, and while the VAT itself is still under construction, those involved in the area would do well to review what it is that they currently do, and consider undertaking risk mitigation steps in order to protect themselves. ●



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