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Introduction
VAT, but why now?
On June 16 2016, ministers representing each of the Gulf Cooperation Council (GCC) Member States met in Jeddah, Saudi Arabia, to discuss the introduction of value added tax (VAT) in each of their nations. It was confirmed that during the meeting a multi-lateral agreement has been reached to implement the tax, but that the remaining details of the plan, or more specifically the GCC VAT Treaty, would be finalized at a meeting to be held in October this year. These developments mark the start of some of the most exciting, dramatic and far-reaching socioeconomic changes in the region since the discovery of oil reserves in commercial quantities during the 1960’s.

This news on VAT is not new, however. Rumors have been circulating for many years, occasionally coming to a head but subsiding shortly thereafter, about multilateral and unilateral efforts to implement the tax. But whilst the demand for VAT was previously driven by an overarching fiscal reform agenda within which VAT would be introduced as a “nice to have,” the volatile hydrocarbon markets coupled with larger and relatively fixed public spending commitments have, arguably, turned domestic revenue raisers like VAT into a “need to have” for many.

Around the GCC, the dependence on oil as the principal contributor to GDP (and the public purse) differs quite substantially. The UAE, having pursued fiscal diversification policies for many years, generates around a third of its GDP via the oil economy. Kuwait on the other hand turns this ratio on its head; almost 65% of its national output is derived from the hydrocarbon industry. Whilst that is not the only measure of exposure to a challenging international oil market and the consequences for a domestic economy, the fact that hydrocarbons account for around 50% of GCC output on average provides the backdrop against which policy makers are now striving to make meaningful long-term changes.

The new-normal for oil producing countries looks increasingly like US$40-60 per barrel, and as a result most countries in the GCC are now running deficits. Although these can be sustained, even in the long term in many cases (cash reserves in the GCC are estimated to exceed US$754 billion), policy-makers are faced with two options; cut spending, or raise new revenue on a sustainable basis.

The new-normal for oil producing countries looks increasingly like US$40-60 per barrel, and as a result most countries in the GCC are now running deficits. Although these can be sustained, even in the long term in many cases (cash reserves in the GCC are estimated to exceed US$754 billion), policy-makers are faced with two options; cut spending, or raise new revenue on a sustainable basis.

Cutting spending to any significant degree is unrealistic; the region is in growth mode and a range of important but costly programs of lasting significance are underway. In the alternative, imposing taxes – even if only at a very low rate – in a region that has historically remained a “tax free” outlier appears to offer the most palatable long term solution.

And so to VAT
VAT is a tax on consumption, not profits, and for many policy-makers it provides the preferred means of raising public revenue without sacrificing much private sector activity in the process. Essentially, introducing VAT is not a cost-less exercise economically speaking, but rather it is less costly than introducing a corporate or personal income tax. Across the OECD, VAT represents around 6.5% of GDP and approximately 34% of total taxes raised. Recent estimates have indicated that in the GCC a VAT at 5% would represent around 1.4% of GDP, a figure which reflects on the relatively large share of public participation in the 6 economies and the low rate being considered. Indeed, a rate of 5% is around a quarter of average rates in the OECD (19%).

To some extent, however, the rate discussion is somewhat irrelevant. The tax plans being deployed by GCC policymakers are designed to enable long term fiscal sustainability and stability; this is not an exercise in short-termism. Creating an effective tax framework, creating new administrative capacity and deploying best-in-breed administration systems is, even at a low VAT rate, a vitally important step along the road to a taxing environment that serves the needs of a fully developed non-oil economy, in time more effectively.

But why VAT?
VAT can be found in more than 160 countries today. Recent introductions of the tax into major economies have taken place in Malaysia (2015) and China (2014), whilst all of the EU Member States, New Zealand and Australia have been operating the tax or its equivalent, Goods
VAT is a tax on consumption, not profits, and for many policy makers it provides the preferred means of raising public revenue without sacrificing much private sector activity in the process. Essentially, introducing VAT is not a cost-less exercise economically speaking, but rather it is less costly than introducing a corporate or personal income tax.

and Services Tax (GST), for decades. It is relatively simple to administer due to its design around self-assessment principles, and the fairly straightforward nature of the underlying tax code compared to other tax types. A broad-based, low-rate design also limits the extent to which investment and spending decisions are distorted.

On a more basic level, the preferred “credit-invoice” version of VAT works by having all VAT registered suppliers charge VAT on most if not all of their transactions, whilst allowing registered purchasers to credit for VAT that they have paid using invoices issued by suppliers as evidence for that claim (i.e. VAT should be neutral between VAT registered businesses).

The VAT charged by suppliers is paid over to the tax authority, whilst VAT credits for VAT paid out by those suppliers is claimed by them, effectively being netted off against the VAT collected, at all stages of production. Indeed, the design of VAT is such that it is the final consumer of goods and services, generally in their private capacity, that should bear the total cost of VAT accruing along the supply chain; VAT charged by the final supplier in that chain is paid over to the authority but cannot be recovered by the person to whom it was charged.

Details, details, details!
Although the basic theory behind the operation of VAT is conceptually simple, in practice the rules can often be quite complex. In some cases this complexity is required in order to limit or prevent instances of avoidance or evasion with the intent of the tax. In other cases it is associated with the existence of exceptions from the normal operation of the tax, those exceptions being deliberately designed to achieve certain social or economic ends. These exceptions are often aimed at neutralizing the potential regressive nature of the tax, and ensuring that the primary focus is on consumers’ discretionary spend, rather than the essentials for life.

Importantly, however, self-assessment requires that businesses “get it right” in
order to avoid penalties; getting it right can be more difficult for some than others.

**Business impacts**

And so with many predicting the progressive implementation of VAT throughout the GCC from January 1 2018, the time does appear to be upon us all to start looking in detail at the potential impacts it will have on businesses, whether from an organizational, operational, commercial or financial perspective. VAT is often described as being cost-less for businesses. While as a general statement this may have an element of truth, in many (though not all) cases it is not cost-less from the perspective of a business preparing for change and managing their new obligations.

To help businesses in the GCC understand the potential impacts of the implementation of, and operation under, VAT, Deloitte Middle East is issuing a number of short papers under a number of volumes designed to provide a greater understanding of the impacts of the tax on specific industry types. We try, where possible, to outline the scenarios which are most likely and possible responses to them in order to give a fuller flavor of the changes to be expected.

This first volume provides an overview of how businesses should go about shifting from thinking to implementing, and putting themselves in a position to submit accurate, on-time VAT returns. In addition it looks at the retail, automotive, Meetings, Incentives, Conferences and Events (MICE) and financial services and insurance industries.

**Contacts**

Should you have any questions about these papers or just want to speak to us, please feel free to contact Justin Whitehouse, Middle East Indirect Tax Leader on the details listed below. If you want us to consider your particular industry as part of our series, we would be pleased to take your suggestion.

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VAT – It’s coming, so how do we go about preparing for it?
The introduction of VAT marks a major shift in fiscal thinking in a region where, for many businesses, tax is a relative unknown.

Even for those operating in Saudi Arabia, Qatar, Oman and Kuwait paying corporate income tax or ZAKAT, it has to be remembered that VAT requires a very different perspective. Being a transactional tax - rather than one which is simply levied on profits - its impact across business operations can be significant. Indeed, such is the range of its potential impact that it is hard, if not impossible, to contemplate them all in one sitting.

To some extent it is possible to break the impacts of VAT implementation down into the following categories:

• Those which have a bearing on the design of the organization;
• Those which have operational impacts relating to areas such as business processes, the underlying technology that supports them and the people entrusted to carry them out;
• Those which have a financial impact in terms of absolute tax cost, working capital implications, and which require close examination of purchase and selling pricing; and
• Those that affect operational decisions, commercial arrangements and business relationships.

There are many other ways to categorize them but these headers are helpful in terms of framing a response to the requirement to prepare for VAT and, as the case may be, moving through the process from identifying the impact to the way in which transactions should be accounted for to making meaningful efforts to prepare the business for the change.

Getting to grips with change

“Tax” tends to suffer from being a low-priority issue for many businesses. To many it is an unfortunate but necessary reality, and handled accordingly. In this regard, it is important to understand that at its foundation, VAT is often referred to as a “self-assessed” tax, meaning that the onus is on the taxpayer to get things right. Further, the tax is generally framed in such a manner that the supplier of the goods or services is responsible for the collection and payment of the tax.

As such, the tax is effectively assessed on an inclusive basis, meaning that a portion of the revenue generated by a business will be handed to government by way of the VAT collected, unless pricing revisions are made to protect revenues, or commercial arrangements take account of the need to on-charge the VAT. Likewise, purchases made by the business are likely to be subjected to VAT and, whilst that VAT may be recoverable, unless the cash-flow impact of that short-term cost has been measured and catered for, a working capital squeeze will be inevitable.

The typical design of a VAT regime also incorporates some fairly hefty penalties for getting things wrong. Sometimes these can be levied on a personal basis on the officers of the business, but perhaps more importantly, the powers granted to tax authorities that administer VAT can extend to allowing businesses to be closed down and assets liquidated in cases of persistent non-compliance. Finally, some countries will even extend to the threat of imprisonment for non-compliance, albeit this is likely to be applied only in the worst cases. Bearing this in mind, most businesses need to move quickly to make the necessary changes to their short-term planning “get things right”.
Instituting change
So how do we identify what needs to be done to take a business from its current state, to the post-VAT implementation state?

The first thing that needs to be understood is that, in the case of VAT, this is a complex 'whole of business' process. Sometimes it is difficult to see VAT as anything other than a finance process and so it is tempting to 'hand it over to finance', but this rarely works. The reasons for this are simple – as a transactional tax, VAT impacts every part of the business. The legal department needs to understand it so they get contracts right (pricing), the marketing department needs to understand it because the tax authorities rarely like some of the more inventive marketing schemes that may be used, for reasons explained in Chapter 3, the procurement function needs to think about VAT before the VAT implementation date and the list goes on.

So VAT change as a process needs to be approached in a structured way so that at completion of the process, the business owners have comfort that everything that needs to be done has been identified, and there are no major areas that have been missed out completely.

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What are the structures that we would suggest?
The best way of proceeding is therefore to identify the Project Owner or sponsor in the entity. That person should be the one that will ultimately report back to the Board - often through a Project Governance Board comprising members of the Board of Directors. It is the Project Owner that should chair the implementation Steering Committee.

Typically the Project Governance Board will include Board members and senior management that will not be directly involved in the Implementation Process, but will have an interest from the perspective that their area of responsibilities will be affected. They will therefore require that they be updated on the progress of the project, and may wish to retain the underlying decision responsibilities for when the project can move from one phase to the next. This is essential to ensure that all aspects of the completed phase have in fact been signed off.

This may, of course, not always be possible without holding up the progress of the overall project, so the Project Governance Board will typically need to be convinced that adequate alternative steps are in place to address any unresolved issues that may be preventing the completion of the phase which is to be signed off.

The Implementation Steering Committee (as distinct from the Project Governance Board) should include representatives from all of the significant functions within the business: finance, procurement, sales and marketing, HR, legal, logistics, ERP and AP/AR at a very minimum as they will need to report to the Project Owner. Being a member of the Steering Committee is not a prestigious appointment with no substance – it is an important function.

It requires that members have a deep understanding of the areas of the business which they represent. They will also have responsibility for ensuring that the discussions on processes and transactions undertaken by their area of operations are dealt with by the people that have the deepest knowledge of the practicalities of all transactions undertaken by their area of responsibility and are in a position to identify all the variations so that they can be addressed in determining the treatment under the VAT.
Having established the internal reporting structures, what is the process thereafter?
The initial stages of the process will always need to start with establishing a basic understanding of VAT amongst those that will be involved, either in the Steering Committee, or in interacting or reporting directly with members of the Steering Committee, during the implementation process. These staff members will all require a basic level of training so that they can respond to questions on structure and process around transactions and systems with an understanding of the context and importance of the question and the method of response. This will form an integral part of what is generally referred to as the Impact Assessment.

The Impact Assessment process is aimed at establishing where the business is positioned in relation to its ability to respond to the changes that will be required for the implementation of VAT. It is intended to highlight the current position so that Deloitte’s staff can then assist the business in undertaking the next stage – that is planning the process required to achieve the implementation of VAT within the business.

Deloitte typically utilizes a computer-based interactive questionnaire as a basis for ensuring that there is coverage over all aspects of the business, and in order to minimize the risk of non-standard transactions not being addressed. The responses received, when interrogated by experienced VAT consultants should ensure that the risk profile and areas of concern, or the areas requiring further focus, will be identified readily so that they can be addressed during the planning of the implementation project.

Once the Impact Assessment process is complete, this should form the foundations of the project plan that is intended to drive the business through to implementation of VAT. Without the Impact Assessment a business may understand where it needs to be by Implementation date, but it will not have an ability to determine, or understand, what needs to be achieved in the period up to Implementation date. As such, the Impact Assessment is crucial to this process.

In undertaking the Implementation process, it should always be remembered that there are defined sectors or functions within the business that drive its progress. These efforts need to be enabled through a range of business processes, technologies and a range of personnel trained to ensure a relatively smooth procure-pay-sell experience for suppliers and customers alike.

After the Impact Assessment process has been completed, the role and responsibility of the Steering Committee changes subtly, as it now becomes one of choosing the various staff members that need to take responsibility for various functions within the Implementation plan, and monitor them on that journey.

It will also need to become actively involved in ensuring that timelines are adhered to, and any issues or concerns are brought to the attention of the Project Owner so that decisions can be made as
to what alternative actions are available to the business. This may require amending the manner in which a transaction takes place, altering or updating contracts, engaging with others within the supply chain that may be impacted, or applying for clarification from the relevant authorities as to the basis upon which the transaction needs to be treated for VAT purposes.

Once the implementation process has been completed, and the ERP systems and documentation required to comply with the requirements of VAT have been amended, it is then essential that the business undertakes some form of testing in order to ensure that nothing has been missed and, when the time comes, the results will ultimately allow the business to account for VAT in the required return. Inevitably, at this stage, there will be a few loose ends identified, so it is essential that the business gives itself sufficient time to make and test any amendments that may have been required. If there is not sufficient time for the necessary ‘fixes’ to be implemented and tested, at least it gives the business time to ensure that there is a ‘work-around’ put in place so that it can account for VAT correctly.

VAT and the legacy process and system challenge

In undertaking the Implementation process, it should always be remembered that there are defined sectors or functions within the business that drive its progress. These efforts need to be enabled through a range of business processes, technologies and a range of personnel trained to ensure a relatively smooth procure-pay-sell experience for suppliers and customers alike.

Modern ERP solutions drive this experience from the centre, allowing for relatively swift (albeit sometimes costly) changes to be effected in order to comply with new VAT invoicing and accounting obligations.

In many instances, however, the experience is not quite as seamless. Email-based procurement, stand-alone Point of Sale machinery and a vast array of spreadsheets recording general ledger data for upload into a central accounting system are commonplace in any sophisticated industry. These solutions will have served businesses well in the past, but could well make complying with the new VAT rules more difficult to achieve consistently. Moreover, costly changes may well have to be made to multiple system types whilst internal service teams are re-trained on a business sector (eg AP, AR, marketing, procurement etc), rather than corporate level.

In short, legacy approaches to ordering, selling and accounting for transactions are likely to come under significant pressure from VAT. Looking carefully at options now and establishing an approach to these fundamentals which balances the needs of the business with the cost of change will be vital.

Once the Implementation process has been undertaken – What next?

Finally, and often at the same time as the testing regime is in process as indicated above, it would be advisable for the business to undertake training for all the other staff that may need to make decisions on a day to day basis, where VAT could have an impact. This goes beyond the requirement to deal with the ERP system, and will stretch from staff engaged in negotiating contracts, through to staff submitting expense claims that they wish to have reimbursed by the business.

Once all that is done, life will slowly return to normal, with the focus reverting to Finance, who will likely have responsibility for preparing the first, and subsequent VAT returns. These obviously need to be checked far more closely on the first few occasions in order to ensure that the VAT has been properly accounted for. Thereafter, accounting for VAT truly becomes a part of the life of the business.

One last comment – businesses that embrace this process, and see it as a reason to review and improve their internal processes, are the ones that succeed most with the implementation of VAT. Being dragged into the process at the last possible moment is a recipe for disaster, and it is always useful to remember – if you fail to plan – you are planning to fail. With the implementation of VAT, there is no escaping this outcome.
Chapter 3 – Retail industry

Retailers, VAT and the pricing conundrum

Quite apart from the actual implementation process identified in Chapter 2, the introduction of VAT in the GCC poses a serious question for all retailers – should they pass the additional VAT charge on to their customers?

Indeed, some would say it would be paradoxical not to: why introduce a consumption tax only for businesses to absorb it all? But it is never quite as simple as that.

Who bears the VAT cost?

One of the key principles of a VAT system is that it should be borne by the end consumer, whether an individual, or an unregistered business. Neither would be in a position to register for VAT and therefore recover VAT incurred on their purchases. As a result, VAT will represent an additional cost of living or doing business for those affected.

Retailers that are required to register because they exceed the VAT registration threshold (and those that register on a voluntary basis) are required to account for VAT on their sales. That is, they are responsible for collecting the VAT and paying the net amount of VAT that they collect to the Taxation Authorities. The reason we refer to them being required to pay the ‘net amount of VAT’ is that they are generally entitled to deduct the VAT that they have paid to other businesses for purposes relating to their conducting the business of making taxable supplies.

The concept of being required to ‘account for VAT’ on their supplies is slightly different from being required to charge VAT on their sale. This is because one of the core concepts of VAT is that it is the supplier of the goods or services that is responsible for accounting for the VAT on the goods or services that it supplies – not the purchaser. Whether the supplier is able to recover the VAT from the purchaser on the supplies that it makes (so that it does not reduce its profit margin) will be up to it to decide, and a decision that the supplier makes based on the market place that it is in.

It is common practice for retail goods, particularly those that will be sold to final consumers, to be priced on a VAT-inclusive basis, which means that the price advertised to the customer includes the VAT element within it (‘the price you see, is the price you pay’). While this is not ideal during the changeover period (from January 1, 2018), in that customers will see an immediate increase in the price, longer term it may be better in that it avoids the price shock that comes with someone buying goods for, say, Dh100, only to find that they have to pay Dh105 when they get to the checkout.
Retailers should consider undertaking a detailed price modeling analysis (at least on their large volume, or high value stock items) to understand what effect the introduction of VAT could have on demand for their product. This will help them decide how much, if any, of the VAT cost they may be able to pass on to the customer.

Based on overseas experience, in business to consumer (B2C) transactions we expect the majority of retailers to seek to increase the price of their goods to take into account the additional VAT charge that they wish to pass on to the consumer. However, retailers should consider whether this is the best thing to do, and this is not a ‘one size fits all’ decision. There will be numerous factors that each business will wish to take into account, not least of which will be the marketing impact of any such decision.

Retailers’ margins immediately after the introduction of VAT could be squeezed, in the event that there is any irrecoverable VAT in the supply chain impacting on the price of their own purchases. Therefore, it will be very tempting for retailers to pass this increased cost and the additional VAT charge on to their customers, unless there are good commercial reasons not to.

At the same time, it has been observed in other countries that have implemented VAT/GST systems, that astute marketers may increase their prices in the months running up to the implementation of VAT, for two reasons.

Firstly, they take advantage of the pre-implementation sales rush to obtain extra profits, and secondly, it allows them some leeway to ‘reduce’ prices after the implementation in order to accommodate the VAT that is to be charged. This allows them to maintain their long running average margins, while being able to take the moral high ground by claiming, post-VAT, that they will cover the additional VAT cost to the benefit of the consumer- “You pay the pre-VAT price, and we will pay your VAT!”

These sorts of schemes are typically frowned upon by the authorities, but in practice, generate a lot of goodwill amongst consumers as long as they are not aware of the pre-implementation price hike.

**Price elasticity**

Generally speaking, all other things being equal, price increases should lead to a fall in demand. Some retailers may actually be better off only passing a smaller proportion (say 50 percent) of the increased cost on to their customers and suffering 50 percent of the increase themselves in an effort to retain market share. Alternatively, many may, as an initial marketing ploy, offer to cover the full amount of the VAT in order to keep volume of sales at a reasonable level during the settling-in period. Clearly these will all be commercial decisions that need to be considered.

Much will depend on the price elasticity of the product in the market at that time. When demand is perfectly inelastic (i.e. an increase in price has no effect on demand) retailers should be able to pass on the full burden of VAT to the customer. This is, however, seldom, if ever, permanently the case as there may be a number of other factors that could have an impact, albeit for a short period only. If this is the case, however, retailers should consider undertaking a detailed price modeling analysis (at least on their large volume, or high value stock items) to understand what effect the introduction of VAT could have on demand for their product. This will help them decide how much, if any, of the VAT cost they may be able to pass on to the customer.

Such an analysis could also give the retailer the tools to be able to establish how much it could limit any price increases to, in order to ‘buy’ market share without necessarily engaging in the practices described above.
Not all bad news?

A business issue that retailers need to ponder is what will happen on the night of December 31 2017? The answer to this is that any self-respecting budget conscious shopper will consider perhaps accelerating a purchase, in order to attempt to avoid the VAT cost.

There are some VAT technical points here – will tax point rules mean that, notwithstanding a purchase being executed before January 1 2018, VAT will be due? And the answer is perhaps in cases where actual delivery of the goods is planned to take place on the January 1 2018 then there may well be special rules to address this (something an online retailer will perhaps be more conscious of, but also those that deliver large items e.g. furniture etc). However, for straightforward purchases executed before and taken home by the shopper (in a retail environment) the chances are VAT will not be due.

The fact that VAT may be briefly avoided like this could make shoppers tempted to accelerate shopping trips – particularly if they are needing to purchase higher value goods. In all, probably some businesses may well encourage this temptation in order to boost sales and accelerate income, and each business will have to review marketing plans to respond to this activity. Businesses may also want to consider product stocking levels (particularly for high value household items where there is likely to be more demand), as well as logistics including such things as how many staff will be needed in the weeks leading up to January 1 2018.

Finally, after the potential boom in the run up, things are inevitably going to be quieter, and so businesses may also need to consider the financial and operational issues associated with lower income and lower activity.

Businesses may want to consider product stocking levels (particularly for high value household items where there is likely to be more demand), as well as logistics including such things as how many staff will be needed in the weeks leading up to January 1 2018.

Other issues for retailers to consider

In many VAT jurisdictions, retailers have special rules applicable to the way in which they may transact, and these may be different to those applicable to other businesses. Similar rules may be applicable for retailers in the GCC, and could potentially include:

• Different methods of accounting for VAT (special retail VAT schemes);
• Alternative invoicing requirements for goods under a certain value i.e. a simplified VAT invoice;
• Potentially complex rules for discounts, promotion schemes, loyalty programs and vouchers;
• Special rules for paying a ‘security deposit’ for purposes of ensuring that a transaction will be completed;
• Tourist refund scheme criteria and indeed whether such a scheme will apply;
• Treatment of linked products, for example where one product is zero-rated, and the other is standard rated; and
• Additional VAT recovery considerations for goods sold on finance.

The above list is by no means exhaustive, but is useful to highlight just a few of the additional considerations that retailers need to bear in mind when considering the impact that VAT implementation will have on their business.

Retailers should start considering the impact it may have on their business as soon as possible, so that they can fully understand the implications, and plan and implement the steps required to be ready ahead of the implementation.

One final issue that retailers should consider is the possibility that there could be some ‘anti-profiteering’ regulations put in place prior to the introduction of the VAT. This could have an impact on its ability to raise prices for a period following the introduction of VAT.
Chapter 4 – Automotive industry

Gearing up for change, the view ahead for dealers and buyers
It is almost inevitable that sales of motor vehicles will become subject to VAT in the GCC upon implementation of VAT. Even though the anticipated VAT rate of 5% is low by comparison to rates of VAT applied in other countries (the average VAT rate around the OECD is 19%), for a region with a penchant for purchasing expensive motor vehicles, the imposition of VAT is likely to increase the nominal purchase price of the region's favorite luxury brands significantly, if for no other reason than that the cost of such vehicles is already substantial.

Of course, the automotive sector in the GCC does not only cover the sale of new cars, and to restrict it in this way would be to significantly underestimate its size and importance to the economies of the Member States. Some of the regions' largest players in this market are highly diversified corporates with operations extending beyond the sale of new and second-hand vehicles sales into the provision of finance, insurance, property development and sales to name but a few examples. The scale and scope of these businesses can be enormous.

The supply chain feeding the automotive retail business is also significant and includes vehicle manufacturers, the local importers, and then the distributors themselves of course. The dealer and proprietary after-sales market in parts, accessories and services comprise a vital component of the industry overall, as too is the vibrant second-hand vehicle sales market and the associated finance providers. In addition, business and personal classified listings make up a large portion of total vehicle transactions in the region, so this, together with the normal advertising, whether radio, TV or newspaper, spend by the main dealers could be significant.

In time, the full spectrum of the impact associated with VAT being applied throughout this highly evolved and diverse sector will come to light. We focus, however, on the impacts likely to be felt by those in the business of selling vehicles, and those buying them.

**Pre-implementation demand pull**

One operational issue, in common with the retail industry as referred to in Chapter 3, will be how dealers respond to a likely spike in demand in the run-up to the introduction of VAT. It has been well observed that new introductions or rate increases typically advance the buying decisions of consumers in order to “beat” the inevitable increase in the price of a car purchased from a dealer. Indeed, businesses often make a point of running ‘pre-implementation’ specials in order to capitalize on this demand and bring-on substantial stocks to fill showrooms and storage facilities so as not to disappoint eager buyers.

It has been well observed that new introductions or rate increases typically advance the buying decisions of consumers in order to “beat” the inevitable increase in the price of a car purchased from a dealer.

Manufacturers and other up-stream suppliers to the industry are also likely to be faced with a surge in demand as dealers book relatively large pre-orders. The flip side of this is that there is likely to be a glut of second-hand cars coming onto the market as consumers ‘flip’ them in order to take on their new vehicles.

To some extent the large pre-orders of new vehicles will be welcome for those looking for an outlet for production during a period of global economic uncertainty, but they will have to ensure appropriate stock is available, and that lead times and logistics arrangements are in place to ensure stock can be in the right place at the right time. Manufacturers must also assess whether there will be an impact on the lead times for new/bespoke vehicles, and how this may impact the customer purchasing decision.

Dealers will need to make sure that customers are not disappointed when trying to make a more immediate purchasing decision than normal. Stoking the right vehicles at the right specification will be key - vehicles ordered prior to, but delivered after, implementation are at risk of being subject to a VAT surcharge. Dealers need to be satisfied that appropriate resources will be available in terms of staffing the sales floor, whilst coping with (albeit temporary) increased vehicle storage and preparation needs. This could be a challenge for many, particularly in that at the same time they may well need to deal with a substantial number of second hand vehicles that will need to be accommodated within the market.

In many cases car sales depend on the ready supply of credit, whether that be working capital in the case of the dealer, or finance deals in the case of consumers. Dealers will need to consider the likely implications of this demand spike with their own banking institutions and other finance businesses so as to prevent any choking-off of demand arising simply due to the lack of availability of finance (as opposed to the lack of credit-worthiness of the borrower). If there are any dealership floor plans in place to finance the stock on hand, these may need to be reconsidered.

And finally, advertising agencies, production houses and media outlets should expect to see a flood of advertising
placements from dealers hoping to take advantage of the desire to supply vehicles prior to anticipated price increases. Dealers will need to have thought well ahead about how they want to go to market in connection with VAT, however, the messaging may not be all that simple and will need to be carefully targeted.

All in all, the impact of pre-implementation demand is likely to put a fair amount of strain on dealers and their supply chain. This is not necessarily bad news of course – the opportunity to push sales and see a major revenue uptick from car sales, bonuses/rebates, accessory and intermediary fees could perhaps offer a silver lining for Q4 2017, although they will need to be careful with the pricing on any trade in vehicles.

Stock planning for 2017 is likely to be in full force at this time of year – every dealer and associated businesses should be thinking about the pre-implementation demand pull, now. Failure to capitalize on the opportunity could result in a major revenue shock in H1 2018 as consumers take stock of pricing changes and either defer purchasing decisions, or having brought forward their purchasing requirements, are well set for some time in the future.

Adjusting to new cash and pricing realities
Most if not all new vehicles are imported into the GCC having been manufactured in third countries. As with most VAT regimes, it is likely that the importation of a car will be subject to import VAT at the time the vehicle is removed from customs control and entered into so-called “free circulation”. The same goes for other purchases made by dealers; VAT will have to be paid on purchases and the additional amount will need to be pre-financed until a credit for it can be obtained from the tax authority.

The lag between payment and credit can be substantial, (certainly during the initial phase of operations under the VAT), with the result that working capital headroom may have to be increased in order to allow for it. Of course, VAT accounting typically allows for the offsetting of VAT on costs incurred against VAT on sales on the same return and so finding a better timing balance between these two elements of the value chain is vital. Much can be done in this regard with adequate preparation.

As with any retail supplies, dealers will need to look closely at the pricing of vehicles given the likely impact that passing on the full cost of VAT may have on sale volumes. In embarking on this analysis, it should be done with the view that it is unlikely that dealers will be able to pass on the full charge of the new VAT to private consumers or unregistered businesses in the short-term. This will be exacerbated if the legislation seeks to block input tax on motor vehicles as occurs in a number of other countries, as
the same issue would then affect all vehicle purchasers.

To the extent that the products are themselves price elastic, small pricing changes, and the period over which they are granted could significantly impact purchasing decisions. Understanding the link between pricing changes and the potential impact on demand can be done at a variety of different levels of detail bearing in mind that dealer margins are not necessarily generated wholly or indeed partly at the front-end (i.e. the ticket price), but may also be impacted at the back-end instead (i.e. the bonuses and rebates granted to dealers by manufacturers for meeting targets) and so vary quite significantly by vehicle and manufacturer.

The weirder and more wonderful elements of the motor trade
Motor trade VAT accounting is notoriously complex. So far we have looked at the obvious impacts of VAT, but some of the more challenging aspects of VAT for the automotive trade can be found in the following paragraphs:

The second-hand/margin scheme
Generally applicable in some form to second-hand cars supplies where initial VAT recovery has been disallowed for the purchaser (bought-in/part-exchange vehicles) as the supplier (very often an individual consumer) is unregistered and does not charge VAT, but has previously incurred VAT when the vehicle was purchased.

To ensure that there is no ‘tax-on-tax’ cascading, VAT is chargeable on the profit margin achieved on sale by the registered dealer, for ‘margin scheme’ cars. Whilst conceptually simple, dealer systems must be ready to capture these sales, and calculate VAT on profit. Sales staff must also be trained to understand the commercial impact of their actions.

Indeed, calculations can be complicated by certain dealer practices, particularly where trade-in values are inflated by the dealer, to allow the purchaser to meet the minimum deposit for finance – a practice known as ‘bumping’. Ultimately, it will be for the GCC to decide whether a ‘margin-scheme’ will be implemented, or whether VAT at 5% will also apply to the sale of second-hand cars. The latter may be preferable for simplicity, but the extra cost would be substantial and, inevitably, would erode margins, with cars taxed multiple times as they change hands.

Financial Intermediary Services
In the EU, where a dealer introduces a customer to a provider of financial services, such as lending, and receives a commission for doing so, this commission may be VAT-exempt. Whilst no VAT is chargeable on the supply of the introductory service to the finance provider, dealers suffer a restriction on the recovery of input tax incurred in making such supplies, resulting in potentially complex ‘partial exemption’ calculations, to determine overall VAT recovery – a concept thoroughly examined in VAT ‘automotive’ case law.

It is, however, unclear whether the GCC will implement an exemption for financial intermediary services, and the impact is therefore likely only to be assessable, once the particulars of the applicable legislation are announced. In Australia, the supply of such services by what are referred to as ‘Financial Service facilitators’ would be taxable in similar circumstances. This would mean that VAT would be due on the intermediary fee – but that VAT is then unlikely to be recoverable by the finance house – leading to further erosion of margin.

It is no secret that motor vehicles have historically been treated unfavorably by tax authorities

Stock-in-trade and demonstrator cars
Recovery of input tax on demonstrator vehicles has often been restricted on the basis that those vehicles are made available for non-business/personal use, such as by sales staff. Where VAT recovery is restricted, some tax authorities assumed that the eventual sale of the vehicle would become subject to the second-hand margin scheme. It will be interesting to see whether the GCC applies the exemption for the sale of items on which initial VAT recovery was restricted, or treats these as taxable supplies. It is important to remember that, as an exempt sale, like financial services, there is a corresponding input tax restriction.

Reliefs for adapted vehicles for the disabled
Cars adapted for use by disabled persons may qualify for VAT relief, such as the application of the ‘zero-rate’ of VAT. However, in territories where similar reliefs have been applied - such as in the UK - abuse of such schemes has occurred, mostly perpetrated by criminal gangs and fronted by individuals who meet the criteria for relief. Tax authorities have previously penalized dealers for failing to ensure that the purchaser is genuinely disabled, and the vehicle is for their own personal use. Again, it remains to be seen whether the GCC states will apply a relief to such vehicles. However, with a potential VAT advantage of 5%, the incentive to perpetrate such dishonesty is likely to be low.
And what about purchasers?
It is no secret that motor vehicles have historically been treated unfavorably by tax authorities. The restrictive nature of recovering VAT on motor cars is largely related to the fact that the system has, historically, been open to abuse, with some individuals and companies having sought to recover the input tax charged in full as a business expense, despite significant ‘non-business’/private use. The potential for abuse was particularly apparent in the UK court case of Fagomatic, where the owner of a cigarette vending machine business sought to recover the VAT in full on the purchase of a Lamborghini, purportedly used only for business purposes.

Whilst the situation in Fagomatic is a particularly unique (and perhaps extreme) case, the basic rule for a business seeking to recover VAT on the purchase of a motor car has been, quite simply ‘don’t’, unless the ability to evidence sole business use is strictly unequivocal. Again, with reference to the region’s love of expensive cars, Fagomatic may once again rear its head, albeit in another guise, and is therefore an important lesson.

Early preparation is key, not only for VAT purposes, but for stocking and aftersales purposes

Concerns over whether their systems, processes and people will be able to cope with VAT on January 1 2018 are likely to be a major focus for program managers up until that time. Unless they do, accurately accounting for VAT on sales on or after that date will become a major headache and at worse, stop sales in their tracks.

Early preparation is key, not only for VAT purposes, but for stocking and aftersales purposes. The trade will shortly be submitting its 2017 sales plans. Ensuring that the impact that VAT is likely to have on customer purchasing decisions both before and after its implementation has been factored into factory orders, will be hugely important to businesses attempting to smooth revenues during the changeover period.
Chapter 5 – Meetings, Incentives, Conferences, and Events (MICE) industry

Lead times on the VAT challenge
For those that have not previously encountered this term, MICE is a descriptor of a sector of the ‘tourism’ industry in which large groups, usually planned well in advance, are brought together for a particular purpose. Accordingly, it is sometimes referred to as either the ‘meetings industry’ or the ‘events industry’.

Most components of MICE (Meetings, Incentives, Conferences and Events) are well understood, perhaps with the main exception being the incentives sector. Incentive tourism is usually undertaken as a type of employee reward by a company or institution for targets met or exceeded, or a job well done. Unlike the other types of MICE tourism, incentive tourism is often conducted purely for entertainment, rather than professional or education purposes, and as such may have different consequences for VAT purposes.

MICE events, other than incentive tourism are usually centered on a theme or topic, whether industry focused or otherwise (the Ramadan night markets in the Dubai World Trade Centre would be a classic example), and are aimed at a professional, academic or trade organizations or other special interest group. Larger MICE events may take the form of Industry or Professional conferences, or Trade Shows and similar exhibitions, or could be even more extensive as, for example Expo 2020.

From the perspective of the implementation of VAT this is an unusual commercial sector, as there are so many aspects to it. In a place like the UAE, there will be a number of businesses and activities that are likely to be impacted by the manner in which this sector will be treated for VAT purposes.

Impact on different sectors operating in the MICE space

At the outset it is useful to identify and consider some of the macro-industries that fall within the supply chain that allows the MICE sector to operate.

In short, the supply chain will typically include the transport, tourism, accommodation and venue hire commercial sectors with lesser input from, or implications for, the suppliers of ancillary services such as caterers, sound system providers, lighting technicians and the like. Accordingly, to have a full understanding of the impact of the introduction of VAT on the MICE industry, one really needs to understand the various component parts and how they are to be treated for VAT.

As a general rule, however, it can be assumed that most of the sectors identified, where the participants are either required to be registered, or are able to, and do, register voluntarily, will be subject to VAT at standard rate (probably 5%). They will then be entitled to claim back VAT incurred on costs as an input tax credit (ie they will be able to set off this VAT incurred against the VAT that they collect).

The difficulty for the industry will be when one gets to the smaller sub-contractors (including, for example, lighting technicians, sound systems technicians and the like) in the supply chain as they will either not register for VAT, or not be entitled to do so. What this will mean is that they will incur VAT on their costs, and assuming that they wish to retain their profit margins, this VAT will then be built in with the charges that they make. As they will not be able to charge VAT that the larger organizations would be able to
recover as an input tax credit, this could lead to the potential for the additional costs flowing through the system, or a significant push to bring such smaller independent contractors into larger organizations, or for some, bringing work that is currently outsourced, in house.

Dealing with lead times
Another significant issue for the industry, particularly where conferences and exhibitions are being arranged, is that there may be longish lead times between the initial contract date and the actual date of the event – as an extreme example, consider how long it takes between when a city bids for the Olympics, through to when they actually occur.

Further, due to the costs that are generally involved in preparing a conference (arranging a venue for the event, accommodation, various facilities such as lighting, sound, subsidiary events etc, as well as project management, advertising and management of potential attendees) any contract for the conference will often include periodic milestone payments during the period up to the commencement of the event.

These factors can lead to two issues that should be addressed.

Firstly, if any ongoing, or longer term arrangements are currently being put in place for multiple annual events (ie the undertaking of an annual event over the next 3-5 years), then the contracts should be reviewed in order to establish the VAT consequences, if any, of any arrangements and whether they deal with the billings that will occur after the implementation of VAT. This will be particularly important, as a failure to address this issue could end up in the VAT becoming an additional cost that will come straight out of ‘bottom line’ profits.

Secondly, the tax point, at which VAT will become payable to the revenue authorities, will typically be the earlier of the date of an invoice, or the date on which a payment (any payment – not necessarily payment of the full amount) is made. This being the case, if there are periodic milestone payments made some time before the event and, particularly, where these are not specifically linked to an activity, then unless properly structured there is a risk that VAT would need to be accounted for on the full contract value by the event manager well before it is possible to get the recipient to make payment. What this will mean, in effect is that the business will be paying out VAT on amounts that it may not yet even be entitled to charge to their client, for the simple reason that most of the contract charge is not yet due or payable. This could end up being a significant cashflow drain, particularly taking into account the fact that often the first payment is merely in the nature of a mobilization fee, and the VAT alone on the full contract value may even exceed that mobilization fee, which could have disastrous consequences for the funding structures adopted by the business.

The reality is that none of this is disastrous. All it needs is close attention to detail, a review of transaction arrangements, and making an effort to revisit contractual arrangements. Add to this the need to set up contract files to reflect the manner in which charges have been raised, and having the ability to account for the VAT correctly due and payable out of the charges will be crucial.

Contract issues
A further concern that should be addressed in any review undertaken by the organizers of MICE events would be whether the existing contracts that apply to the full process for the arrangement of the event allow the organizer (and the various subcontractors) to charge VAT on those of the supplies that are considered to be made after VAT is operational.

From the perspective of the implementation of VAT this is an unusual commercial sector, as there are so many aspects to it. In a place like the UAE, there will be a number of businesses and activities that are likely to be impacted by the manner in which this sector will be treated for VAT purposes.

In this regard, it is important to understand that the manner in which VAT legislation is typically structured is that, as a self-assessment tax system, the responsibility for accounting for the VAT on the correct amounts, and at the correct time, rests solely on the supplier of the services in question. Should they not ensure that the contracts under which their services are supplied allow them to on-charge that VAT, then they will be considered to have included the VAT charge in their fees, and they will need to account for that VAT amount whether or not it is able to recover it from the recipient in any way.
In addition, as far as the recipient of the services may be concerned, if the recipient is not required to pay an additional amount to cover the VAT impost that will not be the end of it. They will still be entitled to request that the supplier provide them with the required documentation that will allow them to claim the VAT input tax. Essentially, this has the potential to result that for every AED100 they are required to pay, the supplier will receive AED95.25, and the VAT of AED4.75 will be payable by the supplier, and refundable to the recipient of the services that were supplied.

While many businesses that are affected will consider themselves to be contractually protected on the basis that they have a ‘tax clause’ in their agreements, this is seldom the case.

Firstly, the GCC members, for the most part, do not have significant corporate tax imposts, so it is unlikely that adequate tax clauses will be found in many contracts. Secondly, standard ‘tax clauses’ that may be found in some contracts will seldom be adequate when viewed in light of the requirements of the VAT. This is because the manner in which VAT is to be administered, and the minimum requirements for an adequate VAT Clause are vastly different from the manner in which corporate taxes would be addressed.

It therefore becomes imperative that businesses protect themselves as a matter of urgency – it may be too late to do so once an agreement has been concluded.

It is important to understand that the manner in which VAT legislation is typically structured is that, as a self-assessment tax system, the responsibility for accounting for the VAT on the correct amounts, and at the correct time, rests solely on the supplier of the services in question.
Chapter 6 – Financial services and insurance industry

Why VAT, financial services and insurance are a difficult combination
Not much has been said publicly by the governments of the GCC as to how they expect VAT to apply to the financial services and insurance sectors, at least not in its totality. However, the problem for policy makers is that unfortunately trying to successfully apply normal VAT rules (i.e. to tax instead of exempting them) to a good number of insurance and financial services transactions is exceptionally difficult to achieve. Theoretically it is possible to tax all such services, but sufficient practical challenges remain as to make achieving that objective a somewhat distant prospect, despite almost four decades of governmental effort in this space.

These challenges include:

**“They are too difficult to tax”**
The “value” for VAT purposes, particularly in the context of margin-based transactions, is almost impossible to determine accurately and consistently on a transaction-by-transaction basis. Undertaxation (leaving the treasury out of pocket) or, worse, overtaxation (taking too much out of the pockets of taxpayers) could arise leaving both suppliers and consumers in an uncertain position with respect to their obligations and rights respectively.

**“Taxing financial services and insurance is to tax the wrong thing”**
Financial intermediation, and the assets underlying it, represents the means of consumption and not consumption itself. Moreover, by taxing potentially investable assets you could choke off economic activity at its genesis, something that is generally best avoided. Bearing in mind VAT is designed to be a tax on consumption, not savings or investment, an obvious tension exists in this particular context.

**“Exemption is the preferred approach. Everyone does it”**
As far back as 1918, banking transactions were exempted from turnover taxes in Germany. The 29 member states of the European Union have all implemented VAT exemption extensively as required under the Principal VAT Directive and its predecessors. The legacy of VAT exemption is vast, therefore, and well rehearsed. To some extent the inertia has at least become somewhat self-fulfilling.

Yet unfortunately VAT exemption creates as many problems as it solves. It is an imperfect answer to a difficult question and, as a result, is a topic that garners much attention from the industry’s professional advisors, governments and academics alike, all of whom object to one or more of the following impacts, amongst other things:

**Cascading**
The “locking-in” of irrecoverable VAT into a supply (i.e. it is essentially hidden within a VAT exempt cost), resulting in increased costs for borrowers even where the borrower might otherwise normally be able to deduct VAT.

**Low-tax VAT regime bias**
Encouraging financial service and insurance providers to source services from jurisdictions that apply a lower rate of VAT, or have no VAT whatsoever.

**Liability boundary disputes**
A costly issue for most businesses locked in discussions with tax authorities over what should or should not be exempted.

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1. Success is of course a subjective matter to some extent. In this case we define success as being one in which the risk of under or over-taxation of the service has been removed, and that input tax credits can be accurately attributed to the recipient of the service.
**Vertical integration bias**

VAT costs arising on outsourced services create an incentive to in-source, potentially inefficiently.

**Regulatory tension**

The financial services and insurance sectors, so often required to restructure in part in order to meet new regulatory obligations, finds itself at risk of bearing additional VAT costs brought about by reorganization efforts.

Nevertheless, we are witnessing a gradual shift in the trajectory of policy thinking that is beginning to create a new ‘normal’ for the industry, particularly in those countries that have introduced VAT comparatively recently.

Recognizing the inherent challenge of valuing, and taxing, individual transactions often sold on aggregated interest margins, one obvious place to start is with anything that is not aggregated or which is at least valued explicitly in the normal course of business. Generally speaking, agents arranging supplies of financial services and insurance do just this, charging an explicit fee for their services to the principal or the customer, as the case may be. Principals themselves also charge explicit fees for a range of financial services and insurance: cheque book issuance charges, and credit card membership and administration fees, for example.

In the alternative, or indeed in combination with this taxation approach, is the option of simplifying VAT recovery for institutions making VAT-exempt supplies of financial services and insurance. Essentially this requires the setting of a guaranteed VAT recovery rate for institutions’ and the removal of a significant portion of hitherto irrecoverable VAT costs from their financial statements. This presumes of course that the benefits of VAT recovery are indeed passed on in the form of lower costs, and that the institutions themselves revert to investing ‘normally’.

More radical approaches include enabling financial service and insurance providers to “opt to tax”\(^3\) otherwise exempt transactions, or potentially applying a zero-rate\(^4\) (the transaction is not subject to VAT but the institution is entitled to recover VAT on costs in full) on business-to-business transactions in order to mitigate the risk of hidden VAT cascading into borrowing costs and disincentivizing investment decisions.

But, no single best practice has emerged as the leading candidate for wholesale revalidation of the VAT treatment of the sector at this time. To some extent this is down to a desire to retain simplicity on the part of governments. In other cases it is due to the highly theoretical, technical and administratively cumbersome aspects of the alternatives amongst other things. In short, the alternatives to exemption create new challenges.

We are witnessing a gradual shift in the trajectory of policy thinking that is beginning to create a new ‘normal’ for the industry, particularly in those countries that have introduced VAT comparatively recently.

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2. Singapore has implemented a fixed rate recovery scheme for businesses that choose to opt into it
3. Certain countries in the EU have implemented this measure
4. Only New Zealand has implemented this approach to date
What does this mean for financial services and insurance?
As a result of the policy challenges, traditionally financial services and insurance businesses are amongst the most VAT complex businesses. They usually end up with multiple challenges all of which are practical issues.

On the sales side, businesses will usually end up with multiple VAT liabilities on their supplies and for now at least financial services and insurance businesses will need to consider a series of variables as we await the final policies.

That said, inevitably, as discussed earlier, there is a high chance of some form of exemption. That being the case, the business has to carefully review its products and consider the potential VAT liability. Inevitably this leads to a one off exercise during the implementation process of categorization and review of contracts. However, there is an also an ongoing challenge: increasingly financial services and insurance are being bundled and personalization of the products provided is becoming common – what was provided yesterday, will change tomorrow.

Unfortunately VAT law very rarely keeps pace with the speed of business change and thus categorizing new services becomes a process challenge. You could have hundreds of unique products especially if you have staff allowed a degree of latitude in what they sell to customers – this can require a dynamic decision making process and/or guidance for sales staff which may end up restricting what they can sell. Finally it is naïve to think that once a business has decided what it thinks the VAT liability is, the tax authority will agree – so it becomes a VAT technical issue with, as we mentioned earlier, liability boundary disputes being common and highly complex to deal with.

Almost always, even though there is an exemption, because financial services and insurance businesses are usually very important for foreign trade earnings, government usually allows some form of zero-rating for exported financial services and insurance (exports here probably would mean outside the GCC but this remains to be seen). This comes with the benefit of VAT recovery, but usually there are conditions attached to achieving zero-rating and identifying those supplies (in order to enhance VAT recovery) becomes an issue.

Finally VAT has an impact on the customers of the financial services and insurance businesses that has a very unique effect on them because of where they sit in the supply chain.

There are opportunities in this – many businesses will be facing cash flow and working capital demands that never previously existed and therefore demand for short term financing becomes more common place. Financial services and insurance businesses will need to consider how they respond to this – and likewise, what about, as referred to in Chapter 4, the short term demand for new cars before January 1 2018 – who is going to provide all that finance?

There are also challenges – by way of an example, insurers face a double challenge. The first of these is that if VAT is due on premiums, can they pass this cost on? And remember, insurance premium tax in Europe has long been seen as the equivalent of VAT for the insurance trade, but it is far more logical to use the VAT
system, so one must not assume an exemption will apply, though of course this is not known right now.

The second challenge for both the insurer and insured is the cost of insurance (in essence a variation on the cascading issue referred to earlier). On the retail insurance business, yesterday if you had a car accident and the insurer paid the bill for the repair, there was no VAT, tomorrow there will be. Instantly the insurable value has increased and the insurer will need to consider its premium pricing. In contrast on the business insurance side, insurers need to ask themselves – do I need to insure the VAT? Surely if the business is fully taxable it will be able to deduct the VAT it might incur on a repair work to its car fleet. If that is the case, the premium may be overstated if this is not identified and VAT excluded from the insurable value.

Once you have overcome the issues in respect of VAT on sales of services and the impact on customers, the next issue becomes the vexed question of VAT recovery. If there is an exemption, the business will not be entitled to recover VAT that relates to those supplies. The problem in the world of services and financial services and insurance in particular is that very rarely is it straightforward to identify a cost and what it directly relates to – inevitably there is some debate and a great deal of costs incurred by the business that fall into the category of ‘general overhead’. This then means the business needs a process to decide what proportion of the VAT it incurs can be recovered – this adds a further burden on the AP function.

What all this means is that along with all the challenges faced by any other business, financial services and insurance businesses inherently have their own very special issues, which are perhaps amongst the most complex in terms of VAT technicalities and business practicalities.

In many countries around the world this becomes a very complex (effectively) management accounting process often requiring negotiation and agreement with the tax authorities. In a minority of countries there are fixed industry percentages that can be applied (notably in Singapore), this is a welcome relief for those otherwise charged with doing the calculations, but often such blanket recovery rates don’t truly reflect the cost base and, whilst simple, often lead to unfairness in terms of the level of recovery achieved.

Finally, because VAT becomes a cost on purchases, financial services and insurance businesses inevitably start to think about how to reduce it. Sometimes this affects behavior in quite startling ways, and the most startling of these is vertical integration as referred to above. Essentially the benefit of vertical integration arises from the fact that, very specifically, salary costs do not incur a VAT charge. It is therefore more efficient, from a VAT perspective, to employ people directly than it is to outsource. The temptation therefore is not to outsource, and in fact to consider insourcing – or buying the business that was providing you with services and vertically integrating it thereby generating an overnight saving of 5% of the salary cost of the purchased business.

What all this means is that along with all the challenges faced by any other business, financial services and insurance businesses inherently have their own very special issues, which are perhaps amongst the most complex in terms of VAT technicalities and business practicalities. They are also faced with perhaps more complex uncertainties than many other businesses whilst we await the detail of the law and so will be more tempted to delay implementation, whilst, somewhat perversely, having the most complex VAT issues.
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