Value Added Tax in the GCC
Insights by industry | Volume 1
Automotive chapter
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.

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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. Stocking 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

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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.

With the introduction of VAT in the GCC, on the expectation that the region will follow the European model, and OECD best practice, it is likely that businesses will experience a largely restrictive environment in which to recover VAT charged on the purchase of company motor cars, which would result in an increased cost to the P&L.

Preparing for change
Even a demand driven second half of 2017 sales bonanza for new vehicles may only offer a modest amount of comfort to those charged with preparing an automotive business for its new VAT obligations in 2018, and this could well be offset by a glut of second hand vehicles on the market.

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.