SQUIRE PATTON BOGGS

Value Added Tax in the GCC
Issues in the Hospitality Industry

Value Added Tax (VAT) is Coming Soon to the Gulf Cooperation Council (GCC)

Representatives of each member state of the GCC signed a VAT Framework Treaty (the VAT Framework) in October 2016, and domestic legislation has already been published by both Saudi Arabia and the United Arab Emirates. Legislation is expected to be published by the other member states in due course. The VAT Framework (and the domestic legislation already published) broadly adopts the characteristics of the VAT system in use across the European Union and can be expected to operate in a similar way.

Although the VAT Framework forms the basis for the domestic VAT legislation being rolled out in in each GCC member state, there will inevitably be variations in the way it is implemented and applied in, and applied consistently within, each jurisdiction.

What is VAT?

VAT is a type of consumption tax. Although it is designed to be borne by the ultimate consumer of goods or services, it is charged by reference to the consideration chargeable at each stage of a supply chain.

VAT will initially be introduced in the Gulf with a (comparatively low) standard rate of 5%, but it would not be unreasonable to expect that rate to increase over the next few years.

Businesses will generally need to:

- **Pay** an amount equal to the VAT (input VAT) chargeable on any taxable supply they receive
- **Charge** VAT (output VAT) on taxable supply they make or are deemed to make, and
- **Account** for any output VAT they have collected, net of an allowable proportion of input VAT already paid, to the Tax Authority in their home country

Where services are supplied from outside the business's home country, that business may be required to operate the so-called "reverse charge", which means the recipient business is treated for VAT purposes as if it had supplied itself with the service in question.

What Will the Rate of VAT Be?

The applicable rate of VAT will be dictated by the type of supply in question. There are three types of supply:

- **Standard Rate –** The 5% rate, which will be applied to by far the majority of supplies.
- **Zero Rate –** Certain supplies, including certain supplies relating to real estate (e.g. in the UAE, the first supply of buildings converted from non-residential to residential use), will be zero-rated. Zero-rated goods and services are taxable but at a rate of 0%. This means that a supplier making zero-rated supplies does not need to account for any amount of output VAT, but is able to recover the input VAT incurred in respect of those supplies.
- **Exempt –** Certain other supplies, including certain other supplies relating to real estate (e.g. in the UAE, the supply of bare land) and local passenger transport, will be exempt from VAT. A supplier making exempt supplies does not need to account for any amount of output VAT, but will generally not be permitted to recover input VAT in relation to those supplies – in effect, the supplier of exempt services is treated as the ultimate consumer in the relevant supply chain.

The VAT Framework grants GCC member states a degree of flexibility in determining the types of goods or services should be zero-rated or exempt. It is possible that it is here that domestic regimes across the GCC will diverge most markedly and it is, therefore, an area that will need to be considered especially carefully.

How Will VAT Affect the Hospitality and Tourism Sector?

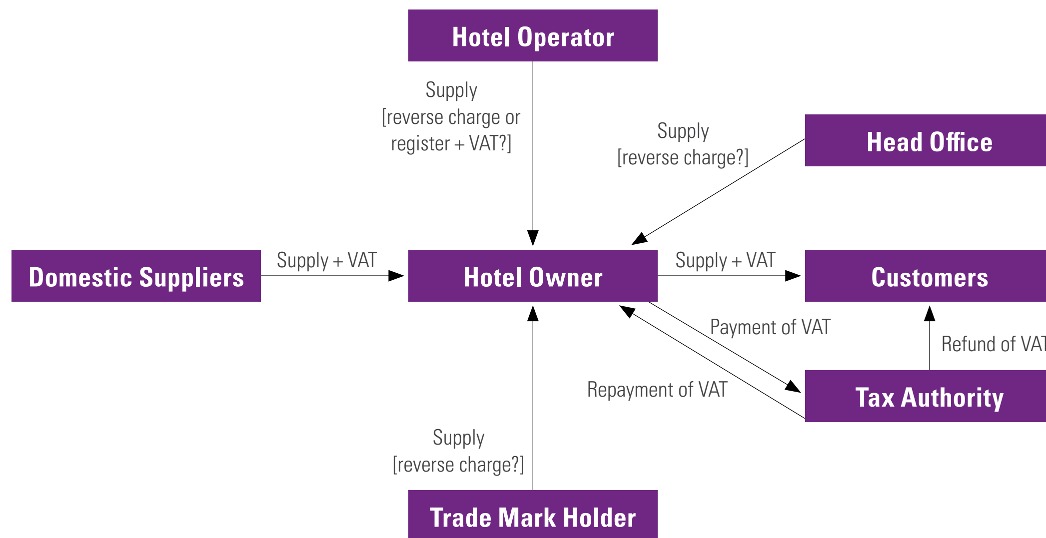
Businesses making non-exempt supplies in excess of an amount (e.g. AED 375,000 over the last 12 months or anticipated over the next 30 days in the UAE) will be obliged to register for VAT. Most businesses operating in the hospitality industry will exceed these thresholds. Given the growing importance of the tourism industry to the economies of the GCC, it is likely that the hospitality sector will generate considerable VAT revenue for the member states.

Theoretically, VAT is meant to be a simple tax. In all jurisdictions that have a VAT, difficult and complex issues arise, as evidenced by significant amounts of VAT litigation across the world.

Although some operators in the GCC are likely to have experience in dealing with VAT in other jurisdictions, the introduction of VAT in the GCC could still have an adverse impact across the tourism industry generally and give rise to unique challenges. This is because of both:

- The relative complexity of the contractual relationships between the various parties involved
- The multitude and variety of the different types of functions (and therefore supplies) potentially involved

Example: Hotel Owners and Operators



On the basis that they will generally be "fully taxable" (that is, they will make only make non-exempt supplies), businesses in the hospitality sector should not, in principle, suffer a material economic cost as the result of the introduction of VAT because they should be able to "fully recover" all or most input VAT incurred on supplies received.

The complexity inherent in the business model, however, means:

- Cash-flow disadvantages are possible
- A heavy compliance burden
- A heightened risk of unexpected tax liabilities and leakage

Areas likely to present particular difficulty (either individually or in combination) in the industry will include:

- **Registration** – Registering for VAT can be compulsory (where certain thresholds relating to the value of an entity's taxable supplies are exceeded) or voluntary.

  Registration will be vital wherever a taxable person intends to recover input VAT paid on supplies received. The obligation (or right) to register in any member state of the GCC relates to whether or not the business is "established" there. Broadly speaking, that will depend on whether they have a taxable presence (for VAT purposes) in the jurisdiction and is making (or intends to make) taxable supplies there. A hotel operator could potentially be required to register for VAT by a Tax Authority. A taxable presence in a country for VAT purposes is similar, but crucially not identical to, having a permanent establishment there for the purposes of direct taxes. As responsibility for tax compliance is often specifically allocated under agreements, such as the agreement between the owner and operator, the hospitality sector will need to look closely at how its contracts purportedly deal with VAT and whether existing provisions dovetail with the VAT legislation.

- **Place of supply** – Where a supply is made normally dictates where VAT is payable but it is common for different types of supply to have different rules determining where they are made.

  To illustrate the potential for complexity, the rules differ for supplies of goods and services, imports and exports and for supplies made within the GCC. In addition, supplies can be made in the place the supplier belongs, where they are received (or enjoyed) or, in the case of land, where the object of the supply is located.

- **Cross-border transactions** – Core services, such as a central reservation call centre and website, are often provided to the hotel owner by the head office at cost.

  In principle, the head office should not be required to charge VAT; instead, the owner will account for VAT under the reverse charge mechanism and in principle, it should be fully recoverable. Existing wording in the contract between the head office and hotel owner may, however, give rise to an unintended change in the economics of the arrangement.

- **Contracts** – As VAT is common across the world, all international hotel chains will be experienced in dealing with VAT in other jurisdictions. All contracts will still need to be reviewed carefully for any existing clauses that deal with the allocation of the cost of VAT between the parties, and renegotiated or clarified if necessary.

- **Time of supply** – The time a supply is made dictates the "tax point" (that is, when a supplier becomes liable to account for the VAT).

  In general terms, the time of a supply for VAT purposes is the earliest of payment, raising an invoice or completion of the supply. That may differ from when hotels normally receive or recognise the revenue for the supply made giving rise to cash-flow disadvantages. This will be exacerbated by the multitude of different types of supply, which will each need to be tracked and itemised.

- **Multiple and composite supplies** – different supplies can attract different VAT rates (that is, standard or zero rating) which in turn can affect the VAT recovery position of a taxable person.

  This means that characterising and distinguishing between supplies is critical. Where, as is the case in the hospitality industry, there is a mix of a number of different supplies all beginning made at the same time, it may become difficult to identify the separate elements. This is an extremely complex issue and has been the cause of many disputes and VAT litigation.

- **Tripartite supplies** – Only the recipient of a supply is entitled to recover the input VAT charged on it.

  That causes problems in (commercially common) scenarios, where one party makes a supply to a second, but payment for that supply is met by a third party. In such cases, it will be imperative to ensure that the contractual agreements accurately record and reflect the economic reality of the arrangements.

- **Loyalty schemes and reward points** – The widespread existence of loyalty schemes in the tourism industry will inevitably give rise to both tripartite supplies and issues involving multiple and composite supplies.

  The complexity inherent in the global operation of such schemes is exacerbated by inconsistencies in their interpretation by different tax authorities, leading to cross-border disputes between jurisdictions, which are generally protracted, difficult to resolve and outside the control of the taxpayer. Again, the importance of clear and accurate contractual documentation cannot be underemphasised.

- **VAT status of forfeited deposits** – The VAT status of forfeited deposits for late-cancelled hotel rooms is currently unclear. Will GCC member states treat the deposit as consideration for a taxable supply, and so subject to VAT, or not?

- **Hotel cars** – If the supply of a car by the hotel is treated as "local passenger transport", then it will be exempt for VAT purposes. Although this would reduce the cost to the customer, it would mean that the hotel owner was making mixed supplies and, therefore, could not recover its input tax in full, giving rise to uncertainty and complexity.

- **Recovery of VAT by guests** – Domestic and international hotel guests will be keen to understand the extent to which they can recover VAT. Some may ask the hotel owner to invoice a different person – the owner will need to be careful to ensure that it is not breaking the law by misinvoicing.

Other, more generally encountered, issues will include:

- Whether there has been a supply for VAT purposes
- The value of a supply
- How to maximise input VAT recovery
- How a VAT grouping works
- Maintaining proper VAT records

It is possible (even likely) that any one of these areas will result in difficulty or even dispute with either:

- With a contractual counterparty
- With a Tax Authority
- Between Tax Authorities

It will be, therefore, critical that hospitality businesses fully understand the implications of VAT being introduced in the GCC. They will need assistance on:

- The basics of how the tax operates
- Registration, possible fixed establishments and compliance obligations arising
- Establishing best practice systems and processes
- Ensuring business structures and groupings are VAT efficient
- Reviewing existing (and new) commercial contracts and adding appropriate VAT protections

When Is VAT Being Introduced?

The official implementation date for VAT systems in the GCC is 1 January 2018. Although it is likely that both the United Arab Emirates and Saudi Arabia will implement on time other member states are now likely to introduce the VAT at a later date. Under the VAT Framework, however, the new tax VAT *must* be fully implemented by all GCC countries by 1 January 2019.

Time is, therefore, already running short. Businesses across the hospitality sector should already be well advanced in their preparations for VAT.

What Is Our Expertise in VAT and Hospitality?

VAT is a long-established tax across the European Union and in the UK. As a firm with strong representation across Europe, we are highly experienced in dealing with all aspects of VAT, technical, transactional and disputes, across the industrial sectors that will be most directly affected by the implementation of VAT.

The co-heads of our Gulf VAT practice are Jeremy Cape and Lindsay Fainé. The head of our global Hospitality & Leisure Practice is Elias Hayek.

- Jeremy is based in our London office but regularly travels to the Gulf region to assist clients on various tax issues. He has 18 years of experience advising on domestic and cross-border VAT matters in a number of jurisdictions.
- Lindsay is based in our Abu Dhabi office. She has 15 years of advising clients in the Gulf on tax issues.
- Elias is based in our London and Dubai offices. He is a widely respected hospitality lawyer with over two decades of cross-jurisdictional professional experience in the hospitality sector.

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