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Newsletter
4th Edition - March 2020

MIDDLE EAST TAX NEWSLETTER

Optimizing your cash flow and managing VAT in contract cancellations

The COVID-19 pandemic continues to have a heavy impact on the global economy. The spread of the virus is constraining the supply and demand of goods and services. As a result, companies are considering the potential cancellation of contracts and the impact on their cash flows.

In this special edition of the Middle East Tax Newsletter, we set out the VAT aspects of the potential cancellation of contracts. We also provide suggestions to optimize cash flow positions from a VAT perspective.

Cancellation

If either party cancels a contract, there cannot be a supply from a VAT perspective. Therefore, if the supplier had already issued an invoice for the supply of goods or services, the supplier will be required to issue a credit note to the customer. The supplier can then offset the output VAT on the credit note against the VAT payable for the relevant period.

Any payment made in consequence of a cancellation may however still be subject to VAT. This depends on the nature of the payment for the cancellation, including whether there was a supply of goods or services.

The UAE Federal Tax Authority (FTA) has clarified, in its first Public Clarification, its view on the VAT treatment of compensation type payments. The FTA states that liquidated damages to compensate a party for the loss of earnings is outside the scope of VAT. However, a payment to enforce a contractual term may be subject to VAT. Cancellation fee payments are generally subject to VAT whilst "true" fines and penalties are not.

Companies should analyze their contracts to determine whether the supplier has provided the goods or services in return for the payment.

Optimizing cash flow

To understand the impact of VAT on cash flow, it is important to know that VAT is due with respect to each VAT return for the period in which the supply of goods or services took place. The supply takes place on the earliest of the i) date of issuance of the tax invoice; ii) date of payment; or iii) date the goods or services are provided. If a supplier/taxpayer issues the tax invoice in a VAT return period that is earlier than the period when it receives the payment, the supplier/taxpayer would be pre-financing the VAT. This is because the supplier would have to pay the VAT before it would have received the payment from its customer.

There are several ways for a supplier/taxpayer to optimize its cash flow from a VAT perspective.

Timing of issuance of the tax invoice

If a supplier issues a tax invoice in a period before it delivers the goods or service, then VAT will be due for the VAT return for that period.

In the immediate short-term, it may be beneficial to postpone the issuance of the tax invoice to the next month. The supplier may issue a pro-forma invoice in the meantime. A supplier/taxpayer that observes monthly VAT return periods will have one additional month to pay the VAT, whilst a supplier/taxpayer that observes quarterly VAT return periods with a stagger ending in March will have 90 additional days to pay the VAT.

It is important to note that suppliers are effectively required to issue a tax invoice within 14 days from the earlier of the receipt of payment or the provision of the goods or services.

Amending the length of the VAT return period

The standard tax period is three calendar months. However, as an exception the FTA may assign a shorter (one month) or longer tax period.

A taxpayer that is in a payable position should consider requesting an extension of their VAT return period. By doing so, the payment of VAT can be postponed. The FTA has set out a procedure to request for change of the length of the tax period, which can be viewed in the VAT Administrative Exceptions Guide.

For individuals (including board members, property owners and freelancers) and SMEs (including SMEs funded by the government and SMEs with taxable supplies in the preceding 12 months equal to or less than AED 9 million), it is possible to extend the length of the VAT period to 6 months.

VAT grouping

A taxpayer that is part of the same VAT group is not required to charge VAT on supplies made to other VAT group members, thereby reducing the need to pre-finance VAT. Unfortunately, a VAT grouping is only available to group companies that are sufficiently associated in economic, financial and regulatory perspectives. It may also take some time to set up a VAT group (applicants need to submit a request to the FTA).

Bad Debt Relief

A supplier may utilize the Bad Debt Relief provisions to improve its cash flow with regard to unpaid tax invoices. A taxpayer can claim Bad Debt Relief subject to the following conditions:

(i) It has supplied goods or services, charged VAT and paid the VAT to the tax authority.

(ii) It has written off the consideration for the supply in full or part as bad debt in its accounts.

(iii) More than six (6) months has passed from the date of the supply.

(iv) It has notified the customer of the amount of consideration for the supply that it has written off.

However, if a taxpayer is certain that the purchaser will not pay the debt, then it may also opt to issue a credit note for the unpaid amount. By issuing a credit note, the taxpayer can reduce its output VAT payable for the period in which it issued the credit note. This way, there will be no need to meet the requirements for Bad Debt Relief.

For previous editions of the Middle East Tax Newsletter and other resources, you can visit our Middle East Insights blog:

- http://me-insights.bakermckenzie.com/

To speak to us in relation to any tax issues in the Middle East, please feel free to contact one of the lawyers below, or your usual Baker McKenzie contact.

Contacts

Reggie Mezu
Baker McKenzie Habib Al Mulla
Senior Counsel, Tax, UAE
Reggie.Mezu@
bakermckenzie.com

Bastiaan Moossdorff
Baker McKenzie Habib Al Mulla
Senior Tax Adviser, UAE
Bastiaan.Moossdorff@
bakermckenzie.com

Laya Aoun-Hani
Baker McKenzie Habib Al Mulla
Senior Associate, Tax/Customs, UAE
Laya.Aoun@
bakermckenzie.com

www.bakermckenzie.com

Abu Dhabi
Level 8, Al Sila Tower
Abu Dhabi Global Market Square
Al Maryah Island
P.O. Box 44980
Abu Dhabi, UAE

T: +9712 6123700
F: +9712 6581811

Dubai - Business Bay
Level 14, O14 Tower
Al Abraj Street
Business Bay
P.O. Box 2268
Dubai, UAE

T: +9714 4230000
F: +9714 4479777

Dubai - DIFC
Level 3, Tower 1
Al Fattan Currency House
DIFC
P.O. Box 2268
Dubai, UAE

T: +9714 4230005
F: +9714 4479777