



UAE PUBLIC CLARIFICATION COMPENSATION PAYMENTS

2018 August



UAE Public Clarification no. VATP001

With the release of Public Clarification no. VATP001 on the VAT treatment of compensation-type payments, the Federal Tax Authority (FTA) of the United Arab Emirates (UAE) has raised further questions about the consistency of their approach to the treatment of similar penalty type fees charged by say, Banks and Hotels.

Should, for example;

- An early settlement fee imposed by a bank for the early settlement of an interest-bearing loan be regarded as consideration for a supply? Or could it be considered compensation for a breach of contract and therefore, based on the clarification, be treated as out of scope of VAT?
- A cancellation or “no show” fee charged by a hotel be treated as consideration for a supply?

The following sections shall address the possible views in respect of how such payments may be treated from a VAT prospective;

VAT treatment of compensation-type payments

The clarification from the FTA addresses the question of whether a compensation-type payment is consideration for a supply. It further states that where a payment is not consideration for a supply, then no VAT should be due on the payment. The key factor in determining this is whether is a taxable supply is if the recipient of the payment has supplied anything in return for the payment.

The VAT Decree-Law defines a taxable supply as a supply of goods or services by a taxable person for consideration. A supply of services is subsequently defined as anything which is not a supply of goods.

Based on guidance provided by the FTA, this should be interpreted very broadly and it could entail conducting an activity, but also agreeing to not conduct an activity by a taxable person. Anything a taxpayer receives in return for such activities should, in principle, be seen as consideration for a supply and subject to VAT under the normal rules.

The Hotel Sector

The Clarification guidance suggested the following in relation to the Hotel Sector:

“...Liquidated damages are predetermined amounts that parties to an agreement designate during the formation of the agreement for the injured party to collect as compensation upon a specific breach - for example, for an early termination of a contract... The purpose of such payment is not to provide consideration for a provision of any goods or services but to compensate a party for loss of earnings. As such, the payments are outside the scope of VAT.

That does not, however, include where a contract allows a hotel guest to cancel a booking in return for a cancellation charge, as such charges are considered a cessation of a right, which are a supply of services and hence subject to VAT. This is regardless of whether the hotel room remains available to the guest or not.”

At best this appears contradictory as the very nature of a cancellation charge in this instance is to compensate the hotel for loss of earnings and it is, like liquidated damages, a charge that is usually stated on the booking conditions and predetermined, and at times measurable, at the time of entering into the booking. Further we do not see what right has been ceased by virtue of the cancellation charges and therefore see no supply being made that has a direct and immediate link to the payment.

We would expect to see the FTA’s position in these instances be challenged by the Hotel Sector on the grounds of breaching VAT Neutrality on the basis of inconsistent application of the VAT laws, as for example on page 54 of the FTA’s Aviation Awareness Session Manual, they consider that cancellation charges, for a prior airline booking, is outside the scope of VAT.

The Banking Sector

To determine whether VAT should be due on the early settlement fee, or any other compensation type payment for that matter, banks would need to determine whether the payment received in this respect is seen as further consideration for a taxable supply.

However, where a payment is not deemed as consideration for a supply it would be regarded as being outside the scope of VAT. Examples provided by the FTA in the clarification include payments received in respect of a breach of contract and payments that are compensatory in nature.

Given the above, the main argument for treating the early settlement fee as outside the scope of VAT would be for a bank to argue that the fee would only be imposed when a customer breaches the contract and decides to settle the loan before maturity (i.e. a customer decides to settle the remainder of a -10year loan after 6 years). As a consequence of the early settlement, the bank would suffer the loss of -4years' worth of interest. The fee would be imposed to compensate for the interest the bank would otherwise have been able to charge its customer. Based on this rationale, the early settlement fee could, under these circumstances, be considered to be of a compensatory nature and, as such, outside the scope of VAT.

Surprisingly the FTA has adopted a different approach by classifying early repayment fee on mortgages as a taxable supply as indicated on page 46 of the Financial Services Awareness Session Manual. The supporting argument is that the early settlement fee could actually be viewed as consideration for providing the customer with an option to close off and settle a loan facility during the course of its maturity. As the customer would typically know beforehand how much it needs to pay the bank to settle the loan before maturity, this could be an indication that there is a separate supply from a VAT perspective. The early settlement fee would then be seen as consideration for the supply of an early termination of a loan, on which the bank would need to charge and account for VAT. This is a very curious position taken by the FTA especially since in the KSA the GAZT tax authority has taken a completely different view and on page 51 of its Financial Services Guidance Manual specifically classifies early repayment fees on loans as outside the scope of VAT.

Conclusion

Whilst the FTA has provided valuable clarifications on the issue of compensation-type payments, its application to certain sectors is still not as clear-cut as taxpayers and advisors would have hoped as contradictions still persist. It could be viewed that the FTA has strayed from one of the fundamental principles of VAT, namely that, "a taxable supply is the supply of goods or services by a taxable person for a consideration".

In light of the above definition, we fail to see what goods or services are being supplied by a hotel in return for a cancellation charge especially in cases where no specific room was being held and the option to cancel was already in existence at the time of entering the contract. Equally within the banking sector, the option to pay off a loan early, for a fee, is normally provided at the initial contract stage and serves as compensation for the loss or earnings should the option be taken up.

It is therefore our opinion that hotel cancellation charges and early termination fees in the scenarios cited above should be considered as outside the scope of VAT. Any other treatment may give rise to a legal challenge and litigation. This is a hot topic area and we would expect to see further news and updates as the VAT law develops and evolves driven by disputes and appeals from tax payers in both the UAE and KSA.

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Please contact any one of our VAT specialists
who will be able to help you navigate the complexities of VAT.

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