VAT in the UAE – what does this mean for your construction contract?

Benjamin Franklin rightly stated “In this world, nothing can be said to be certain, except death and taxes”.

The United Arab Emirates, a popular tax haven, will succumb to its first direct tax- the value added tax. The New Year will ring in a VAT in the UAE at a moderate rate of 5% (worldwide VAT levels range from 0% to 25%). In the wake of falling oil prices, the six states forming the Gulf Cooperation Council agreed to implement the VAT on advisement from the IMF for GCC governments to reform their finances. In the UAE, the VAT is expected to generate between AED 10 billion and AED 21 billion in tax proceeds in the first year of its implementation. The GCC states have agreed that about 94 food products, as well as healthcare and education sectors will be exempt. A new law is yet to be released to specify which items are non-taxable.

As expatriates we are well familiar with VAT in our home countries and the moderate rate of 5% is unlikely to act as a deterrent to investment in the UAE. However, it is interesting to see how the VAT will impact the construction industry and particularly construction contracts. This article will examine the impact of VAT on the operation of pre January 2018 construction contracts and what construction contracts post January 2018 need to consider.

How will your current construction contract deal with the introduction of VAT?

Undoubtedly, by the time VAT is introduced there is likely to be a considerable number of construction and consultancy contracts under execution in the UAE. These contracts may or may not have any provision for recouping any direct or indirect costs levied under the new tax legislation. As such for contracts without adequate provisions for recouping costs, the costs will likely be absorbed into the project accounts which could potentially result in loss making projects where profit was once forecast. On the other hand, if contracts have sufficient provision to enable contractors to recover costs from employers, there may be a rise to legitimate claims for VAT on top of historic
payment entitlement. With six months to go, it is advisable for contractors and subcontractors alike to get their construction contracts reviewed by lawyers to understand their exact position.

The FIDIC standard forms are commonly used across the construction sector in the UAE particularly the FIDIC Conditions of Contract for Construction 1999 (Red Book). Under the Red Book, the contractor is obliged to pay all taxes as required under the law and thus the contract price is deemed to include these taxes and duties based on the rates applicable at the ‘Base Date.’ However, there are provisions in the Red Book that allow a contractor to claim an increase in costs due to a change in the laws of the country where the permanent works are being executed.

Clause 14.1 (b) of the General Conditions of the Red Book states that,

“the Contractor shall pay all taxes, duties and fees required to be paid by him under the Contract and the Contract Price shall not be adjusted for any of these costs except as stated in Sub-clause 13.7 [Adjustments for Changes in Legislation].

Clause 13.7 of the General Conditions the Red Book helpfully provides,

“The Contract Price shall be adjusted to take account of any increase or decrease in Cost resulting from a change in the Laws of the Country (including the introduction of new Laws and the repeal or modification of existing Laws) or in the judicial or official government interpretation of such Laws, made after the Base Date, which affect the Contractor in the performance of obligations under the Contract.”

Clause 14.1 (b) confirms that a contractor pays duties and taxes under the contract and that the Contract Price is deemed to include these taxes and duties. The Red Book defines the Base Date as “the date 28 days prior to the latest date for submission of the Tender.”

A key point to note is that Clause 14.1 starts of by saying “Unless otherwise stated in the Particular Conditions...” Therefore, if the particular conditions do not otherwise amend clause 14.1 (b) and for that matter clause 13.7, there appears an argument for a contractor to claim adjustments in the Contract Price from the employer because of the introduction of VAT.

A key point to note is that Clause 14.1 starts of by saying “Unless otherwise stated in the Particular Conditions...” Therefore, if the particular conditions do not otherwise amend clause 14.1 (b) and for that matter clause 13.7, there appears an argument for a contractor to claim adjustments in the Contract Price from the employer because of the introduction of VAT. For a contractor to make such a claim for extension of time and/ or costs, the contractor should be wary of the notice requirements under clause 13.7. It is also recommended for employers and contractors to carefully examine the relevant particular conditions. Employers when considering the contractor’s claims should be
careful of a risk of double counting as a result of the provisions of sub-clause 13.8 - *Adjustments for Changes in Cost* and should check if the particular item claimed by the contractor as an increase in cost has been indexed under this clause or not.

The above position would likewise be true for the other members of the FIDIC 1999 rainbow suite - the plant and design-build and EPC standard forms. For construction contracts still using the FIDIC Conditions of Contract 1987, clause 70 of the general conditions similarly provides for adjustments to the Contract Price to be considered if there is a change in law and for such adjustments to be determined by the engineer. Again this interpretation is subject to the position set out in the particular conditions.

 Contractors engaged with Dubai Municipality are likely to be in a different position and may need to absorb any consequent additional costs arising out of the introduction of VAT in their project accounts. This is because the Dubai Municipality standard terms and conditions do not provide for adjustment to the Contract Price due to cost changes to the contractor arising out of changes in the applicable law. Neither do the Dubai Municipality standard terms provide for adjustments to the Contract Price in respect of the rise and fall in the cost of labour and/ or materials. In this case, it will be for the contractors to negotiate and try and achieve some sort of middle ground with government employers, with limited success I expect.

For bespoke construction contracts, contractors, employers, subcontractors, consultants should be cautious of change in law provisions and variation clauses in their contract to establish their position.

It is not uncommon for clauses in construction contracts to state that the contractor will only be entitled to an extension of time and/ or cost arising out of a change in law which is not foreseeable at the Base Date. This is nearly always an amendment to the Red Book and is often a clause in bespoke construction contracts. The question then arises- is the introduction of VAT a foreseeable change of law? For recent contracts it obviously is but for long term projects commencing before the government’s announcement it is unlikely. The position at the Base Date therefore should be considered. In any event, it brings some uncertainty to payment entitlement which needs to be considered and resolved.

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Construction contracts post January 2018

Quite simply, VAT will impact the contract price in construction contracts. Going forward, employers and contractors should be clear as to whether the VAT is to be paid on top of the tender price or if it is included in the Contract Price. The FIDIC Red Book deems all taxes to be included in the Contract Price unless otherwise amended. Therefore, parties need to be on the same page with the pricing before entering into contracts.

The importance of construction contracts stating whether or not VAT is payable on top of the contract price was considered in the 2012 UK case of E-Nik Ltd v Department for Communities and Local Government. In this case the Court held that in the absence of the contract price not stating it is exclusive of VAT the contract price is deemed inclusive of VAT. It is unlikely that a UAE court faced with such an issue would reach a dissimilar decision. Therefore, contractors need to be alert to clearly state whether or not their tender price is inclusive of VAT or if VAT is to be paid over and above. This is to avoid contractors being in a position where, if not expressly stated, they find themselves giving employers an unexpected discount.

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