VAT and PPP contracts in the GCC
Public-private partnerships

Substantial investment in infrastructure by Gulf Cooperation Council (GCC) governments has led to an increased interest in public-private partnerships (PPP). This method of procurement involves companies in the private sector delivering public infrastructure capacity under long-term arrangements, bringing increased efficiencies and leveraging expertise from specialists working outside of the government. PPP providers will take on a share of the project risk from the government. In return, the private sector party will secure a reliable future stream of revenue.

Kuwait and Dubai were the first in the GCC to embrace this model of procurement by establishing legal frameworks to encourage and facilitate PPP. With Saudi Arabia’s Vision 2030 aiming to reduce reliance on oil and increase private sector participation in the economy, PPP is likely to become a vital delivery method for some of its planned megaprojects.

Value Added Tax

The implementation of VAT is well underway in the GCC, with Saudi Arabia and the United Arab Emirates (UAE) implementing their legislation on 1 January 2018. Bahrain has announced the introduction of its VAT system from the start of 2019.

Many businesses have been surprised by the wide-ranging impact of VAT, and it has given rise to unique challenges across different industry sectors. Key provisions of the GCC VAT legislation create challenges for providers and procurers of PPP projects. Given the variety in PPP structures, each structure should be assessed on a case-by-case basis when looking at the potential VAT implications.
The PPP project lifecycle

**Identification**
The public sector procurer assesses whether a PPP arrangement fits the needs of the project.

**Bidding**
The procurer issues a request for proposal, and potential providers carry out detailed assessments and submit their bids.

**Construction**
The winning bidder acquires funding and constructs the infrastructure asset.

**Operation**
The winning bidder provides a managed facility, earning income from unitary charges made to the procurer, and/or charges made directly to users.
Infrastructure projects are typically associated with large costs and long lead times, and VAT will be payable by the project company on the construction costs.

A key principle of a VAT system is the ability for a business to offset the VAT incurred on purchases (input tax) against the VAT charged on sales (output tax). Under this concept, VAT is generally meant to fall as a cost to the end consumer. In the GCC VAT system, if a business’s input tax exceeds its output tax it should be entitled to a VAT refund from the relevant tax authority.

Applying this principle, a newly established PPP project company should be able to obtain periodic VAT refunds from the tax authority throughout the duration of the construction process. There is a high risk of fraud associated with VAT reclaims, and tax authorities may be hesitant to reimburse businesses without first carrying out extensive due diligence.

Following the construction phase, the PPP provider will operate the infrastructure and receive payments that reflect the services delivered. If we take the example of a power plant, the provider may be paid directly through user charges (e.g., the sale of power), by the procurer via a unitary charge (e.g., capacity payments), or by a combination of the two.

The GCC has opted for a wide VAT base, with limited exemptions and zero ratings when compared to other jurisdictions. Despite this, PPP providers will still need to consider the nature of their services to determine the appropriate VAT treatment.

Unitary charges paid by the procurers are normally for general services, and are likely to be standard-rated at 5%. However, the user charge made to individuals has the potential to be zero-rated or exempt, as illustrated by the examples overleaf.

The distinction between zero-rated and exempt income is an important concept in VAT. Input tax relating to exempt income is not recoverable, and will represent a cost to the business. Input tax that relates to taxable income (which includes standard-rated and zero-rated income) is generally deductible, and can be offset against the output tax charged to customers. Where suppliers receive a high proportion of zero-rated income, they could find themselves in a regular VAT refund position.

The possibility of different VAT treatments will mean additional analysis for prospective PPP providers at the bidding stage. In the case of a zero-rated supplier, they will again have to consider the impact of delayed VAT refunds and increased financing costs. A provider who expects to make exempt supplies exclusively will not be entitled to register for VAT, and all VAT incurred on purchases through the lifecycle of the project should be factored in as a cost. For a bidder who anticipates generating a mixture of taxable and exempt income, it may be difficult to forecast input tax attribution on a project as early as the bidding stage.

The GCC framework includes a number of transitional provisions that regulate the process of VAT coming into operation and effect. Included here is what is known as a “grandfathering clause” for contracts that overlap the VAT implementation date. Under such a clause, if a PPP contract meets the relevant conditions, the provider may be able to continue making unitary charges with no VAT. It is worth noting that this relief does automatically apply to the life of any eligible contract, and will expire at the end of 2018 in Saudi Arabia and UAE. Interestingly, the recently published Bahrain VAT law includes a grandfathering clause which specifically relates to government contracts, allowing them to be zero-rated until the end of 2023. This five-year grace period is quite a long one, and should benefit any existing PPP procurers in Bahrain.

Companies bidding for PPP projects will have to consider the additional uncertainty that VAT creates, and should seek to insert revenue protection clauses in the agreement during the negotiation phase.
For PPP providers to plan their working capital needs on a project, it will be vital to determine the correct liability of user charges at the bidding stage. For example, a provider making zero-rated charges may fall into a VAT refund position, and could be subject to delays in receiving repayments from the tax authorities. To plan for this potential cash flow issue, the procurer should be aware of the need to source additional financing from the outset.

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<th>Potential VAT treatment of charges made by PPP providers</th>
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The term “taxable person” from the GCC VAT legislation refers to “any person conducting an economic activity for the purpose of generating income, who is registered or obligated to register for VAT”. Any person who is not a taxable person will fall out of the scope of VAT, and will not be entitled to charge output tax or deduct input tax in relation to these activities. Government entities could meet the definition of taxable persons, but additional provisions in the domestic VAT legislation should also be considered.

In Saudi Arabia, activities carried out by a government body in its capacity as a public authority are not considered as an economic activity. The implication here is that there is generally no VAT on statutory government charges, such as visas, permits and license fees. The UAE has similar provisions, but refers to government entities acting in a “sovereign capacity” instead. In both countries, activities that compete directly with the private sector will be considered as economic activity, and therefore subject to VAT at the appropriate rate.

Government entities in PPP arrangements will pay unitary charges to the providers, which should carry a 5% VAT charge. Given the nature of PPP projects, the procurer is likely to be acting in its capacity as a public authority, and will, therefore, be deemed to not carry out an economic activity.

A lack of economic activity normally means no input tax recovery, and that the VAT on unitary charges would represent an absolute cost to PPP procurers. However, for government entities in Saudi Arabia, there is a special VAT refund mechanism available when carrying out activities in a public capacity, but this is at the discretion of the Ministry of Finance. In the UAE, public sector entities can generally deduct input tax relating to their sovereign activities, but again this is subject to Ministry approval.

Public sector entities should assess their VAT position by looking at their activities and the potential reliefs available. This will be key to reducing the risk of an additional VAT cost.

PPP is still a relatively new concept in the GCC when compared to other jurisdictions, and is not equally favored across the six countries in the region. However, the move to drive more private sector engagement is expected to increase their use in the near future.

With VAT now in the picture, PPP providers will face increased complexities and uncertainty. On the other side, procurers seeking to lessen the risk associated with infrastructure construction may have to face the reality of increased costs and irrecoverable VAT.

Parties involved in PPP procurement should take a proactive approach to VAT analysis, and seek advice if necessary at the primary stages of the project lifecycle. By identifying potential VAT risks and inefficiencies early, steps can be taken to address these.
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