Now that you paid a tax penalty – have you looked at your tax indemnification agreements for recourse?

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Scene

You are a services or goods provider registered as a taxpayer with the Federal Tax Authority.

You are facing liquidity and cash flow difficulties.

You have customers; you have issued tax invoices, but your invoices are unpaid.

In consequence, due to liquidity issues, you are late in paying your due taxes.

A few weeks or months pass since the end of your tax period until invoices are paid.

You now have the liquidity to pay your taxes, but shortly after, the Federal Tax Authority issues an administrative penalty assessment against you for late payment of taxes.

Late tax payment penalties of 2% immediately, 4% after the first week, and 1% per day, of the value of the unpaid taxes are applied.

Did you draft a comprehensive and enforceable tax penalty indemnification agreement against the late-paying customers to indemnify you against any tax penalties you incurred?

What are tax indemnification agreements against tax penalties?

A tax indemnification agreement against tax penalties (whether standalone or as part of a contract) may grant the taxpayer protection Dirham-for-Dirham for unexpected tax penalties that arise due to a customer's late or non-payment, without necessarily the need for the taxpayer to evidence loss.

The incorporation of a tax indemnification agreement into your standard contracts provides a claim by contract, with proven values, allowing for speedier recovery and enforcement against the customer.

Contracts – in the UAE or otherwise – may generally include a tax respective provision along the lines of the following:

"The First Party agrees to bear any current or future tax or increase to any current or future tax."

The language of such provision could be in various forms, length, or complexity, but the crux of it usually obligates one of the parties to bear the tax liabilities that arise out of a transaction. However, as a general matter, such provisions do not obligate a party to reimburse another party against tax penalties levied by the Federal Tax Authority.

Administrative tax penalties applied by the Federal Tax Authority against a taxpayer are issued in a 'Notification of Administrative Penalty Assessment' pursuant to Article 21 of the Executive Regulations to the Tax Procedures Law.

In an administrative penalty assessment issued by the Federal Tax Authority, the penalties are applied in an itemized list corresponding to the applicable tax return periods (monthly or quarterly) with details on the formulas used pursuant to Cabinet Resolution No. 40/2017 to calculate the penalties; highlighting the values which have formulated as late penalties.

A statement of account provided by the Federal Tax Authority also itemizes the taxes due and penalties in detailed

chronology.

These details allow the taxpayer to correlate the tax penalties to the tax invoices issued in a respective time period, and subsequently, be able to allocate the late payment penalties to the unpaid tax invoices and the respective clients with the outstanding debts.

Are indemnification payments against tax penalties taxable?

In its public clarification VATP001, the Federal Tax Authority states that predetermined amounts that contractual parties designate during the formation of the agreement for an injured party to collect as compensation upon a specific breach are not considered consideration for a provision of any goods or services but to compensate a party for loss.

Consequentially, tax indemnification payments against tax penalties levied by the Federal Tax Authority would arguably fall outside the scope of VAT.

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