Tax Trials & Construction Disputes: Considerations of VAT on Liquidated Damages (UAE)

March 21, 2021

VAT on Liquidated Damages

Construction litigation is generally segmented into two claims. The first is a claim for sums that are due but unpaid, whether contractually or on *quantum meruit* basis, generally for a transaction which has concluded. The second type of claim is compensation for a transaction that has not taken place, i.e. no underlying service or good has been provided.

In respect of the second type of claim, the UAE Civil Transactions Law permits the parties to set a compensatory amount for liquidated damages. Notwithstanding, the law also permits a court *"…at the request of one of the parties, amend such an agreement, in order to make the amount assessed equal to the prejudice*."

Often before a competent court or an arbitration tribunal, litigants trigger the right to reassess compensation for liquidated damages which entails various applications, hearings, pleadings, and expert work that litigants should manage efficiently for any subsequent VAT liability concerns or tax trials.

The UAE Federal Tax Authority's public clarification on the matter titled 'VAT treatment of compensation-type payments' explains that liquidated damages for loss of earnings – not for the provision of any goods or services – are outside the scope of VAT.

In its public clarification, the Federal Tax Authority describes 'liquidated damages' as "*predetermined amounts that contractual parties designate during the formation of the agreement for the injured party to collect as compensation upon a specific breach – for example, in case of early termination of a contract or performance delay. The purpose of such payments 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.*"

Litigation Considerations

The litigation commences with the dispute notice which sets out the allegations that create the basis for the claim. In this sense, the notice describes the allegations and heads of damages, it is a considerable piece of evidence to determine the taxation treatment of the construction dispute proceeds received, and any expenses that may be incurred.

The complaint then materializes into a construction dispute before an arbitration tribunal or competent court and may have consequential effects in a subsequent tax trial before any of the Abu Dhabi, Dubai, or Sharjah tax dispute resolution committees, or before the tax disputes circuits at the federal courts.

With VAT liabilities in mind, litigants should maintain a holistic approach during submission of documentation in a construction dispute to ensure that the segmentation of the claims allows for determination of the tax treatment of the moneys that will ultimately be awarded.

Ultimately, the judgement or award issued in the construction dispute may or may not specifically allocate the award moneys clearly and consequentially hinder a litigant from identification of the tax treatment that should apply. Litigants should be vigilant in their analysis of how the judgement or award is detailed and follow any necessary

applications before the courts or arbitration tribunal to obtain evidentiary documentation of how the awarded moneys are allocated.

Set-Off / Nomenclature

The respective public clarification by the Federal Tax Authority explicitly considers and elaborates on nomenclature in determining whether a payment is consideration for a supply or not. The public clarification states verbatim that *"…it is important to ignore the labels or titles the parties give to a payment."*

For employers, this should be accounted for where the employer is the recipient of liquidated damages and applies rights of set-off. Although the treatment of liquidated damages would be outside the scope of VAT, employers must account for potential VAT liability in cases where payment of liquidated damages by a contractor are set-off against contractor invoices.

Evidence

Upon receipt of the judgement or award, the taxpayer (e.g. the contractor) will determine the tax treatment that shall be applicable to the moneys awarded. The treatment should be in line with the Federal Tax Authority's public clarifications and general tax legislation. Article 48 of the Tax Procedures Law places the burden of proof on the taxpayer to evidence the justification of the tax treatment.

Litigants would be prudent in considering the tax treatment of the ultimate judgement (or award) at the outset of the litigation and plan accordingly, with tax litigation expertise involved in the case management process, in case of a potential subsequent tax trial.

The outcome of the construction dispute will also provide evidence on whether the compensation can be attached to an underlying service or good – even if they are considered

liquidated damages by the parties – at which point a VAT liability may be incurred (such as the case of set-off rights noted above).

The taxpayer will have to evidence that the moneys received are indeed compensatory in nature for liquidated damages before the Federal Tax Authority, or a tax dispute resolution committee, or the federal courts, in a potential tax trial.

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