UAE Judgment on Creditors Claiming Tax Penalties from Debtors

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Wasel & Wasel has represented clients in over two hundred tax dispute procedures in the United Arab Emirates, gaining valuable experience in protecting taxpayers from tax penalties.

The tax consequences arising out of deficient payments by debtors in commercial transactions has consistently grown more important as more taxpayers face tax penalties. A recent Dubai judgment introduces a novel perspective to this dynamic. This judgment, which potentially empowers creditors to claim tax penalties from their debtors, represents a significant shift in the commercial and tax law landscape. This development is particularly noteworthy given the evolving tax regime in the UAE, underscoring its potential implications for future commercial interactions.

Liquidity Shortfall and Tax Penalties: The Age-Old Dilemma

When creditors issue invoices, they anticipate timely payment. However, delays in these payments can lead to a liquidity shortfall, preventing the creditor from meeting their tax obligations. This can result in penalties from the Federal Tax Authority (FTA). These penalties, often substantial, further strain the creditor’s finances, essentially penalizing them for the debtor’s delay.

The New Test Established by the Judgment

The recent judgment has introduced a potentially groundbreaking test for creditors. The creditor was subject to tax penalties imposed by the FTA and claimed those tax penalties from the debtor. The three-member tribunal addressed the claim over the tax penalties as follows:

“Regarding the request for the value added tax penalty, the plaintiff demands that the defendant be obligated to pay the VAT penalty…and whatever accrues until the date of paying the VAT. Given that the plaintiff did not provide evidence of paying the value of this penalty to the Federal Tax Authority, he cannot claim its payment from the defendant.”

This implies that if a creditor can provide evidence of having paid the respective tax penalty, they might be able to claim it from the debtor. This test, while seemingly straightforward, could have profound implications for commercial transactions, especially when considering the broader context of the UAE’s evolving tax landscape.

Understanding the Scope of Damages

The Civil Transactions Law recognizes both direct and indirect damages. If a particular head of damage encompasses both direct and indirect elements, the direct aspect takes precedence. Nevertheless, this does not preclude the possibility of claiming other heads of damages that are indirect alongside those that are direct.

The distinction between direct and indirect damages is further clarified in Articles 283 and 284 of the Civil Transactions Law. Direct damages necessitate a guarantee without any conditions. In contrast, indirect damages require an offence, intent, or an action that leads to harm. If both direct and indirect causes coexist, the ruling leans towards the direct cause.

Given this legal framework, it is evident that creditors have a viable avenue to claim tax penalties from their debtors. If a debtor’s delay in payment (the act) leads to a creditor facing tax penalties (the damage), and there is a clear causal relationship between the delay and the penalties, the debtor could be held responsible.

UAE Federal Decree-Law No. 47 of 2022: Implications for Companies and Their Debtors

The introduction of the UAE Federal Decree-Law No. 47 of 2022 on the taxation of corporations and businesses marks a significant shift in the UAE’s tax regime. With corporations now having to pay taxes on their profits, the financial landscape for businesses has undeniably changed.

In this new environment, the judgment’s potential to allow creditors to claim tax penalties from their debtors becomes even more relevant. Companies, now burdened with tax obligations on their profits, might face penalties due to liquidity issues arising from delayed payments by debtors. This judgment provides them with a potential avenue to recoup these penalties.

In essence, companies can utilize this legal avenue to ensure that they are not doubly penalized – first by the delay in payments from debtors and subsequently by the tax penalties arising from the new corporate income tax law. This development not only provides a safety net for businesses navigating the new tax regime but also serves as a deterrent for debtors, emphasizing the importance of timely payments in the broader context of the country’s tax obligations.

Flexibility of Courts and Evidence Consideration

The judgment’s statement, ” Given that the plaintiff did not provide evidence of paying the value of this penalty to the Federal Tax Authority, he cannot claim its payment from the defendant,” opens the door to a broader discussion on evidence. While evidence of payment is a clear route to claiming penalties, the courts’ flexibility in considering other forms of evidence is crucial.

For instance, would enforcement actions by the FTA, despite the liquidity of the creditor, be sufficient evidence? This could be particularly relevant in cases where the creditor has made arrangements with the FTA or is contesting the penalty. Other forms of evidence might include communication with the FTA regarding the penalty, documentation of the liquidity shortfall directly resulting from the debtor’s delay, or even evidence of the debtor acknowledging their role in the creditor’s financial strain.

Such flexibility would be in line with the pragmatic approach by the UAE courts, focusing on the real-world implications and fairness of the law, rather than a rigid adherence to form.

Pragmatic Implications and the Way Forward

From a pragmatic standpoint, this judgment, especially when viewed in the context of the UAE’s new tax law, could be transformative for creditors. It offers a potential remedy against the financial strain of delayed payments and the new tax obligations. Moreover, the potential flexibility of the courts in considering varying evidence further strengthens the creditor’s position.

However, this potential remedy is not without challenges. Debtors could contest the validity of claims, and the exact nature and type of evidence accepted will likely be refined over time through subsequent judgments.

Conclusion

This judgment represents a significant development in the commercial and tax law landscape of the UAE. As the country’s tax regime evolves, this judgment offers a potential safety net for businesses, ensuring they are not unduly penalized due to the actions of their debtors. The road ahead will undoubtedly see further clarifications and refinements, but for now, creditors have a new avenue to explore when faced with tax penalties..

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