VAT in the GCC

The ‘Gulf Cooperation Council’ (GCC) states are gearing toward the introduction of a ‘Value Added Tax’ (VAT) in the region, with VAT being live since 1 January 2018 in the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA). VAT taxes most goods and services with a limited number of specifically exempt or zero rated supplies.

VAT registered businesses that supply goods and services subject to VAT at a standard rate or zero-rate are entitled to claim a ‘credit’ for VAT paid on their business expenses (input VAT). However, in the supply of exempt goods and services, no input tax credit is available. Therefore a final VAT cost is borne by those businesses carrying out VAT exempt activities.

VAT impact on financial institutions

Most of the supplies made by ‘financial institutions’ (banks) are traditionally exempt from VAT. A VAT exemption means that no VAT is charged on the supplies performed while VAT charged on expenses incurred in relation to making these supplies cannot be reclaimed (i.e. financial institutions incur a final cost of VAT).

Financial supplies generally include the acceptance of deposits, the provision of loans or granting of credit, the operating of any current, deposit or savings accounts, the issue, transfer or disposal of securities among others. In addition, services provided in an intermediary capacity to facilitate the making of a financial supply are generally also considered as financial services. For example, acting as an intermediary by arranging for a customers to be granted a loan.

UAE and KSA have decided to apply a VAT exemption for the financial sector but have limited its scope to financial services remunerated by way of implicit margin or spread. The granting of financing (i.e. interest income in conventional finance and the equivalent in Islamic Finance) is also VAT exempt.

On the other hand, in both UAE and KSA, financial services remunerated by way of an explicit fee, commission or rebate are treated as taxable supplies.

Conventional Finance and Islamic Finance follow the same VAT treatment. The outcome for VAT purposes should be the same for equivalent conventional products and Shariah compliant products.

Irrecoverable VAT

Given that financial institutions supply both taxable and exempt supplies, VAT incurred on their common costs and general overheads (such as marketing and promotional expenses, utilities, professional fees, purchases of office furniture) is not fully claimable and need to be apportioned between ‘recoverable input VAT’ and ‘irrecoverable input VAT’. Only the VAT incurred on expenses or portion of expenses used for the need of taxable supplies is claimable.

The apportionment computation has to follow a specific method enacted by the VAT Law and its Implementing Regulations, usually referred to as the ‘standard method’. Businesses, under specific circumstances, can submit an approval request with their relevant tax authorities to apply a different apportionment method, usually referred to as a ‘special method’.

Historically, experience in VAT jurisdictions that exempt financial services shows that financial institutions tend to recover only a small percentage of total VAT incurred. Thus costs are expected to increase for financial institutions as a result of VAT. These costs are further compounded by the higher compliance costs faced by financial institutions to ensure correct tracking and attribution of all inputs and VAT claims.

The irrecoverable VAT may constitute an important cost for financial institutions and potentially impact their pricing policy. An early assessment of the VAT cost and impact to the bottom-line is required to ensure that prices and margins are rebalanced as early as possible to maintain the current levels of profitability.
Situations where determining the VAT treatment can be a challenge

Below are some of the challenges facing financial institutions in implementing the tax.

Input VAT allocation – A complex issue for financial institutions is often the tracking and allocation of their taxable expenses between their taxable supplies and their exempt supplies. A major area of challenge is to correctly identify taxable expenses which are directly used for taxable supplies, those which are directly used for exempt supplies and those used for both types of activities (such as office rental, utilities and IT systems).

 Outsourced services – It is common practice for financial institutions to outsource non-core activities (such as general administrative tasks, data processing and telephone help desk facilities) to third party service providers. Many of these outsourced activities are taxable to VAT. Financial institutions need to make an early assessment as to which outsourced services carry a VAT charge and whether that VAT charge can be fully claimable.

Where VAT becomes a significant cost, the outsourced arrangement may need to be reviewed to assess its viability and start considering any restructuring.

Multi-component supplies – Some financial services may comprise of a number of components (‘packaged services’), which if supplied separately, may be subject to different VAT treatment. For example, in the case of a motor vehicle sale via instalment payments with a separately disclosed interest charge, the sale of the motor vehicle is considered as taxable supply of goods, whereas the supply of credit is treated as an exempt service.

In order to establish the correct VAT treatment of such packaged services, certain characteristics need to be assessed to determine whether different VAT treatments will apply.

Challenges of VAT compliance requirements

VAT is a self-assessed tax where each taxable person has to report and pay VAT to the State by submitting VAT returns on a regular basis.

The standard Tax Period for a VAT return is quarterly for both UAE and KSA. However, ‘large payers’ in both UAE (i.e. generally with annual taxable supplies exceeding AED 150m) and KSA (i.e. with annual taxable supplies exceeding SAR 40m) are usually allocated a monthly Tax period. VAT returns have to be submitted and related payment done no later than by the 28th of the month following the end of the Tax Period in UAE and no later than by the last day of the month following the end of the Tax Period in KSA. Late submission and submission of incorrect VAT returns may trigger the application of penalties.

It is therefore crucial for financial institutions, which usually use multiple systems, to have control processes in place so as to prepare accurate VAT returns, capturing all the relevant data from the various systems, and to file them on time. Collection and verification of data can be challenging and time-consuming for financial institutions especially when subject to a monthly filing obligation.

Financial institutions are also required to issue Tax Invoices for their taxable supplies. Tax Invoices must feature a certain number of mandatory ‘quotes’ in order to be considered as valid Tax Invoices and must be issued within a certain time-frame. Non-compliance with these requirements may trigger the application of penalties as well as some commercial push back from customers which would not be in a position to claim VAT back if not in possession of valid Tax Invoices.

The issuance of valid Tax Invoices within a given timeframe may be a challenge for financial institutions with the necessity to update their multiple systems so as to enable them to generate automated valid Tax Invoices in due time.

In summary

The above are just a sample of the many issues that impact financial institutions under a VAT system. Addressing your stakeholders’ concerns is critical.

It is essential that your staff are fully cognizant of VAT. It is difficult to ‘systemize’ the VAT rules for all supplies made by you: nuances in the VAT law or slight changes in fact scenarios can lead to varying VAT outcomes, as described above.

‘Will the banks interest margins increase as a result of VAT?’ As financial institutions costs are expected to rise under the VAT, it is critical that decisions are made early as to whether a rebalancing of fees or interest margins (or both) will take place. If not already done, decisions need to be made as to which customers (retail, wholesale or both) will bear any increases and communications to impacted stakeholders need to be issued.

At PwC, we have a strong indirect tax team with many years of experience in VAT matters impacting financial institutions, both in the Middle East and abroad, and we are in an excellent position to help you during this transitional period.