

# How VAT impacts you

## Financial institutions



### **VAT in the GCC**

The 'Gulf Cooperation Council' (GCC) states are gearing toward the introduction of a 'Value Added Tax' (VAT) in the region commencing on 1 January 2018. The proposed VAT will tax 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 usually 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 will be available. Therefore the VAT cost will be borne by these businesses.

### **VAT impact on financial institutions**

Most of the supplies made by 'financial institutions' (banks) are traditionally exempt from VAT and this may be the case in the GCC as well. Exemption means that no VAT will be charged on the provision of such exempt supplies and VAT incurred in relation to making these supplies can not be reclaimed. The exempt 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, any services you provide acting in an intermediary capacity to facilitate the making of a financial supply, are generally also exempt. For example acting as an intermediary by arranging for your customers monies to be invested in a fund to purchase exempt securities.

To further complicate matters some services provided by financial institutions are traditionally taxable e.g. advisory fees, debt factoring services, managing and safekeeping of physical securities.

The likelihood in the GCC context is that financial institutions will make exempt as well as taxable supplies.

This means that VAT incurred on common costs and general overheads (such as marketing and promotional expenses, utilities, professional fees, purchases of office furniture) will not be fully claimable and would need to be apportioned.

It is likely that only a portion of VAT incurred on such expenses, in proportion to the amount of taxable supplies made over total supplies made (standard method of apportionment), will be claimable.

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

As a result, some jurisdictions adopted different models, aiming at reducing the complexity and the economic distortions that arise under the exemption system. As an example, Australia treats financial services as exempt from GST (Goods and Services Tax) but allows a recovery of 75% of GST incurred on costs; Singapore treats financial services as exempt and allows a fixed recovery percentage of GST based on the type of financial institutions (reflecting the proportion of business and offshore customers), notably to reduce the cost of financial services in business to business transactions.

### **Irrecoverable VAT**

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 in time for 1 January 2018 to maintain 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 credit allocation** – A complex issue for financial institutions is often the tracking and allocation of input credits between taxable supplies and exempt supplies. A major area of risk will be correctly identifying inputs which are 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. Under the VAT, many of these outsourced activities will be taxable. Financial institutions will need to make an early assessment as to which outsourced services will carry a VAT charge and whether that VAT charge will be fully claimable.

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

**Mixed 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 will need to be assessed to determine whether different VAT treatments will apply.

**Services incidental to financial services** – The provision of a particular financial service provided in connection with exempt financial supplies (often referred to as 'incidental supplies') are also likely to be exempt.

For example, the provision of a loan (exempt supply) may require the processing of a loan application form for which there is a fee. Without the loan application (and it being approved), there can be no provision of the loan. Such supplies are 'incidental' to the principal supply and treated in the same manner for VAT purposes.

In contrast, stand-alone discrete, explicit fees (fee charged to the account holder for the cost of printing bank statements for their account) may be treated as taxable.

## Systems, procedures and people

An early assessment of which core banking systems will be impacted by VAT will be required. This should include an assessment of the capabilities of these existing systems to cater to the VAT requirements.

In many cases, significant changes will be required to IT platforms and present workflows and processes. Depending on the number of core banking systems impacted and the number of change requests necessary to comply with the VAT requirements, the IT system work stream (design, implement, test, roll-out) may take anywhere between 3-9 months to complete.

### In summary

The above are just a sample of the many issues that will impact financial institutions under the VAT. Addressing your stakeholders' concerns in advance of the VAT will be critical.

It is essential that your staff are fully cognizant of VAT. It will be 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. Decisions will need to be made as to which customers (retail, wholesale or both) will bear any increases. Communications to impacted stakeholders will need to be prepared and issued well before the VAT start date. This process can only begin once a thorough analysis of the VAT treatment of inputs and outputs has been made.

The expected start date for VAT implementation is 1st January 2018. Given the complexity and volume of transactions undertaken by financial institutions, it is expected that the identification and determination of the appropriate VAT treatment for every discrete business transaction will require significant lead time. An early start will be critical to ensuring a successful VAT implementation.

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.

## How we can help – VAT implementation

1	Conduct VAT awareness briefings	2	Assist with classification of your business transactions
3	Review your long term contracts and propose VAT specific changes	4	Undertake a VAT cost financial analysis
5	Provide a VAT implementation plan	6	Advise and support on systems, compliance and training

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