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VAT in the financial services and insurance industry in the GCC
Considerations for the banking sector

Since 1 January 2018, Value Added Tax (VAT) is applicable to the supply of all goods and services in the United Arab Emirates (UAE) and Saudi Arabia (KSA), unless an exemption applies. This document summarizes the current situation as it applies to the major positions in these countries and a high level take on the issues to be aware of in the financial sector.

Context – GCC Framework Agreement

The treaty on VAT in the Gulf Cooperation Council (GCC), commonly referred to as the GCC VAT Framework Agreement– signed by each GCC State (Bahrain, Kuwait, Oman, Qatar, KSA and the UAE) – is the ultimate base on which VAT is charged across the GCC (similar to the European Union (EU) VAT Directive): although as an agreement between the respective governments, it is aimed at setting the bounds for the treatment of VAT through the domestic legislation, but does not have direct effect on taxpayers in each of the GCC Member States unless specifically included in that domestic legislation. This agreement includes one article dealing with financial services at a broad level:

GCC Agreement Article 36[1] - Financial services[1]

1. Financial services performed by banks and financial institutions licensed according to the laws applicable in each Member State shall be exempt from the Tax. Banks and financial institutes may reclaim Input Tax pursuant to refund rates determined by each Member State.
2. As an exception to clause (1) of this Article, each State may apply any other mechanism to financial services.

As such, it suggests a number of potential principles for the GCC (that financial services will be exempt, that licensing may be a requirement to apply exemption, and that pre-determined refund rates may apply instead of proportional recovery) – but leaves each Member State the ability to depart from those principles and choose to apply any other approach. No definition of "financial services" is provided in the GCC VAT agreement – requiring Member States to set out the scope of this term in their domestic laws.

What services will be exempt?

Both KSA and the UAE have restricted the exemption of VAT on financial supplies to charges made on the basis of an implicit margin, and to the supply of life (re-) insurance. Viewed another way, exemption will not apply to any services (other than Life (re)insurance) for which an explicit fee is charged[2].

This approach aligns with more recently introduced global VAT systems (such as Australia, Singapore and Malaysia) – and proceeds from the premise that financial services should be taxed unless there is a clear rationale to not do so (in the case of margin based transaction, this rationale is the difficulty of accurately and consistently determining an appropriate value for taxation purposes).

The definition of 'financial services' broadly aligns with familiar concepts in the EU and other global systems. The published KSA and UAE VAT regulations do not exhaustively define 'financial services', but instead provide an inclusive list (and then examples of where these would be considered exempt). The KSA have now issued a financial services guide that defines a number of the concepts that will be dealt with when considering the impact of VAT on financial services. These tend to confirm that their thinking on financial services is aligned broadly with expectations.

Neither the UAE nor KSA have indicated that the VAT exemption on the supply of financial services will be restricted to licensed providers only, meaning that all entities can, in principle, make exempt financial supplies (including, for example, group treasury businesses and other businesses that make financing charges as a secondary part of their activities).

How is Islamic finance treated?

Whilst providers offering Shariah compliant supplies of financing will, in form, often enter into contracts to buy and sell taxable goods – the principle is that VAT should apply on a basis that aligns the outcome with that of non-Shariah product with an interest or margin charge. Thus, the implicit profit earned by Islamic finance providers on these products should be treated as an outcome of an exempt supply, and the buy/sell supplies of product in the process should effectively be ignored in order to ensure that providers of both products should (in theory) have an equivalent overall VAT position.

The KSA regulations seek to achieve this by expressly providing that an underlying transfer of goods as part of a Shariah-compliant product may be disregarded where the financing product does not intend that possession of the goods be transferred (such as in a commodity Murabaha). This rule places substance over form in specific circumstances to avoid an unanticipated VAT charge. Moreover, General Authority of Zakat and Tax (GAZT) has confirmed that Ijara and Murabaha transactions, where the purpose is to acquire assets, are subject to VAT.

The complexities of many of these products gives more importance to the details of individual arrangements being considered:

both in addressing the extent of the exemption, and any potential disregarding of the 'supply' of goods transferred as part of a financing product.

Approaches to VAT recovery

Both the KSA and UAE require VAT recovery to be performed on a direct attribution and pro-rata basis: without any pre-determined recovery rates for the financial sector. As in many global systems, a direct attribution of input tax to exempt and to taxable supplies must be performed as a first step, at least to the extent possible. However, the rules for calculating recovery of residual overhead input tax differ between the countries.

KSA

KSA sets out that by default, the recovery ratio is calculated on a 'value of output' basis:

$$\frac{\text{Value of taxable supplies in the last calendar year}}{\text{Value of taxable and exempt supplies in the last calendar year}^{3}}$$

An alternative method to the default method may be applied for, provided that this is proportional and this more accurately represents the use of inputs than the default method. No restrictions are provided on alternative proportional methods, but all such methods must be agreed in advance with GAZT before use.

In practice, this may preclude taxpayers from being able to use an alternative method upon the introduction of VAT. GAZT may also direct the use of an alternative method where it believes the standard or existing method does not accurately represent use.

UAE

In the UAE the standard recovery method is based on inputs – which would be calculated using this fraction:

$$\frac{\text{Annual value of inputs attributed to taxable supplies}}{\text{Annual value of inputs attributed to taxable and exempt supplies}}$$

Please note that all taxpayers carrying out exempt supplies are required to carry out an 'actual use' test (also known as the standard method override) at the end of the tax year and compare the recovery on the basis of actual use with the standard method and pay the difference in case the difference exceeds AED 250,000.

The UAE also allows for alternative or special methods – including the output values base used by the KSA as a default, transaction count or a sectoral method. We expect, however, that the UAE's Federal Tax Authority (FTA) will specify methods which are generally approved for use in each sector. However, we also expect that any special method will require express approval before use. Moreover, the FTA has indicated that taxpayers cannot use a special method in the first year (2018). In all cases, a reasonableness test will still apply to any method used – and the FTA will be able to direct the use of a method where the standard or alternative method used is not reasonable.

Grouping and cost sharing

In both the UAE and KSA VAT grouping is possible for locally established related entities (the UAE requires common control whilst KSA has indicated that 50% control is sufficient for grouping – allowing 50:50 joint ventures to join a group).

Cross-border VAT groups are not permitted in the GCC, but an overseas branch or establishment of a GCC entity can in principle form part of a VAT group in both the KSA and UAE, subject to this establishment meeting the VAT grouping conditions in that country. It is however unclear how activities between an establishment in one country (e.g. a branch) and an establishment in another country (e.g. the head office) are treated if one of the establishments is VAT grouped. It is possible that the UAE and KSA tax authorities might follow jurisprudence in the European Union in this regard and consider the VAT grouped establishment and the other establishment as two separate entities.

As an anti-avoidance measure, the KSA law requires VAT to be charged on services purchased by a non-KSA establishment and transferred in for use by a KSA establishment (by way of a reverse charge, as if the KSA establishment had purchased from the overseas supplier). The UAE law does not include such a requirement.

The GCC agreement does not allow for the concept of relieving VAT on cost sharing activities between unrelated parties. The absence of the exemption for cost sharing activities means that outsourcing results in an increase of the costs by 5% (on the labor element of the service). In contrast, it might now become more economic to begin a process of selectively in-sourcing services that have previously been outsourced, however the economics of doing so should still form the basis for any decision.

As at the date of drafting this paper, the other four countries of the GCC are still to release drafts of their law and regulations and there is no indication as to how they may align with, or differ from, the treatment in the KSA and the UAE in regards to the VAT treatment of financial services. That said, the trend within the GCC seems to follow the recent trend of distinguishing between fee-based services (as taxable) and margin based services, or their Shariah compliant equivalents as being treated as exempt, and we see no reason to believe that the other GCC States would adopt a different approach. On this basis, it is likely that the differences between what has been dealt with in the UAE and KSA and what may be identified in the other GCC States, is likely to be in the detail, rather than on the fundamental approach.

References:

1. Unofficial translation of Arabic text, for information purposes only.
2. The KSA regulations restrict their financial services exemption in this way: stating that exemption does not apply "where the Consideration payable in respect of the service is by way of an explicit fee, commission or commercial discount."
3. This ratio excludes capital assets but includes some supplies which are treated as outside of KSA for VAT purposes.