VAT brief – Islamic financial services

1 August 2017, Kingdom of Bahrain

Following on from the release of the GCC VAT framework, Saudi Arabia's General Authority of Zakat and Tax (GAZT) has released a draft version of the law as well as a bilingual version of its VAT implementing regulations. All businesses must now be actively preparing for VAT - 1 January 2018 is less than 100 working days away.

What is VAT?

- VAT is a tax on consumption, not income or profits.
- The GCC countries have agreed a standard VAT rate of five percent.
- Goods and services can be exempt, zero-rated or standard-rated.
- Registered suppliers will add VAT to the price of a good or service they supply, collect the tax and pay it to the tax authority on a regular basis.
- Registered businesses should (where the supplies they make are either standard or zero-rated) be able to recover the VAT they have incurred in the course of making those supplies.
- Registered businesses that make supplies that are exempt from VAT will not be able to recover the VAT they have incurred in the course of making those supplies.
- Registered businesses that make supplies that are zero-rated will usually be in a refundable position.

How will VAT affect the Islamic financial services sector?

- Under the GCC framework, each GCC country has the right to exempt financial services.
- Based on the draft VAT implementing regulations which have been released by Saudi Arabia's GAZT, the VAT treatment for Islamic financial services will be aligned with that of conventional financial services. However, complexities may arise due to differences in the nature of the products and their revenue streams.
- Margin-based products – such as interest on loans and fixed deposits - are to be exempt from VAT.
- Fee-based services, such as management fees, commissions, and *shari'a* advisory services, are to be standard-rated.
- Loans provided to a place outside the GCC may potentially be zero-rated. Service fees charged on such loans could also be zero-rated.
- Profits from spreads resulting from the difference between buying and selling currencies is exempt from VAT.
- Mixed supplies –multiple supplies with different VAT rates and treatments - will need to be accurately apportioned.
- Exemptions increase costs as Islamic financial institutions will not be able to recover the VAT paid on making exempt supplies.
- On some 'business as usual' practices, such as property leases or the acquisition of services (such as IT or professional advisers) or office supplies and equipment, Islamic financial institutions will be end users and so face additional costs of up to five percent.
- Islamic financial institutions will want to maximise the recovery of input tax credits, requiring them to carefully consider all their purchases of goods and services and determine how best to minimise any input VAT they cannot claim.
- Islamic financial institutions may ultimately decide to increase the costs they charge their customers – but will need to be wary of regulatory constraints and the impact on their competitive advantage.

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- VAT may be a significant commercial opportunity for Islamic banks as their clients are likely to have substantial new working capital requirements.
- We may see increased consumer spending in the run-up to the implementation of VAT, increasing demand for Islamic lending products.

Type of transaction	Likely VAT treatment
Provision of financing, advances or similar (such as *murabahah* or *musharaka*)	Exempt
Income from *wakala*	Standard-rated
Realized gains from *sukuk*	Exempt
All other fee-based services (such as arrangement and amendment fees and brokerage commissions)	Standard-rated
Punitive fees (such as early withdrawal or overdue safe deposit fees)	Out of scope
Services rendered to customers abroad	Zero-rated

What still needs to be clarified?

- Will the fixed input tax recovery rate be prescribed on input tax credit claims in lieu of the apportionment method?

Important note

These briefs are based on a translation of Saudi Arabia's draft VAT laws and general VAT principles and are provided for information purposes only. This document is not a substitute for professional advice. You should seek appropriate professional advice from a tax advisor before making any decision relating to your particular circumstances.

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