VAT brief | Islamic finance

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Saudi Arabia and the UAE implemented VAT on 1 January 2018, with the other GCC countries expected to follow in the next 12 months. Key decision makers should now be more aware than ever that we are entering into a new tax era. Key decision makers at businesses in the UAE and Saudi Arabia need to ensure their processes and systems are VAT-compliant, while their counterparts in the other GCC states need to start preparing now for the implementation of VAT.

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 (5%).
- Supplies of goods and services are generally standard-rated but can also be zero-rated, exempt or out of scope.
- Registered suppliers will account for VAT on the price of a good or service they supply and pay VAT to the tax authority on a regular basis.
- Registered businesses should (where the supplies they make are either standard- or zero-rated or out of scope) be able to recover most of the VAT they incur in 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 predominantly zero-rated will usually be in a VAT refund position.

How will VAT affect the Islamic financial services sector?

- Under the GCC framework, each GCC country has the right to exempt financial services.
- Saudi Arabia and the UAE have said that the VAT treatment of Islamic and conventional financial services should be aligned. However, differences in the nature of the products and their revenue streams may complicate matters.
- Margin-based products – such as interest on loans and fixed deposits – are exempted from VAT.
- Fee-based services, such as management fees, commissions, and shari'a advisory services, are standard-rated.
- For Islamic financial institutions (IFIs) in Saudi Arabia and the UAE, non-domestic loans – subject to certain criteria – are zero-rated. Service fees charged on such loans should also be zero-rated.
- Profits from spreads resulting from differences between buying and selling currencies are exempt.
- Mixed supplies – multiple supplies with different VAT rates and treatments – must be accurately apportioned.
- VAT paid on making exempt supplies cannot be recovered.
- On some 'business as usual' practices, such as property leases or the acquisition of services, supplies and equipment, IFIs are end users and so face additional costs of up to five percent.
- Maximising the recovery of input tax credits requires carefully analysing purchases of goods and services and minimising unclaimable input VAT.
- Following the implementation of VAT in the UAE and Saudi Arabia, some IFIs have increased customer charges – but should be wary of regulatory constraints and any impact on their competitive advantage.
- VAT is a significant commercial opportunity for Islamic banks as their clients are likely to have substantial new working capital requirements.
- Consumer spending increased in the run-up to the implementation of VAT in the UAE and Saudi Arabia, increasing demand for Islamic lending products.

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What should IFIs and other Islamic financial service providers be doing now?

- Review all supply activities to determine VAT treatments and the scope of any exemptions.
- Consider the impact of exemptions, non-recoverable input taxes and the effect of VAT on pricing.
- Ensure all systems comply with VAT regulations.
- Understand how VAT impacts Islamic products as the underlying VAT treatment may differ significantly from the conventional equivalent.

Important note

These briefs are based on a translation of the UAE and Saudi Arabia's VAT legislation, the relevant regulations and general VAT principles and are provided for information purposes only. Saudi Arabia and the UAE implemented VAT on 1 January 2018 and the other GCC countries continue – as of the date of release of this brief – to work towards implementation in the next 12 months. This brief 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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