VAT brief | Islamic finance

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Saudi Arabia and the UAE implemented VAT on 1 January 2018. Bahrain has confirmed implementation on 1 January 2019, with the other GCC countries expected to follow over the next 12 months. Business leaders should now be more aware than ever that we have entered a new tax era. Key decision makers in the UAE, Saudi Arabia and Bahrain need to ensure their processes and systems are - and remain - 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.
- The GCC countries have agreed a standard VAT rate of five percent.
- The supply of goods and services can be exempt, zero-rated or standard-rated (five percent), or out of scope.
- The mandatory registration threshold is the equivalent of US$100,000 - as set out in the GCC VAT treaty. The voluntary registration threshold is the equivalent of US$50,000.
- Registered businesses account for VAT on the price charged for the goods or services they supply 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 or out of scope with recovery) 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 cannot recover the VAT they have incurred in the course of making those supplies.
- Registered businesses may not be able to recover the VAT they have incurred on certain purchases that are deemed to have a private element.
- Registered businesses that make supplies that are predominantly zero-rated are likely to be in a VAT refund position.
- Businesses that make both exempt and taxable supplies can only recover a proportion of their input VAT.

How does VAT affect the Islamic financial services sector?

- Under the GCC framework, each GCC country has the right to exempt financial services.
- Saudi Arabia, the UAE and Bahrain have chosen to exempt margin-based financial services.
- Saudi Arabia and the UAE have, in principle, aligned the VAT treatment of Islamic and conventional financial services. It is expected that Bahrain (currently silent) will follow suit when it publishes its regulations. However, closer analysis of the underlying transactions of Islamic products - such as the *ijara* purchase of a home from a non-taxable seller and local *tawarruq* arrangements - complicates neutrality.
- Margin-based products – such as interest on loans - are VAT-exempt. Similarly, in the UAE and KSA, profit margins on equivalent Islamic products has been confirmed as exempt.
- Fee-based services, as well as percentage-based fees such as management fees, commissions, and *shari'a* advisory services, are standard-rated.
- Loans (and equivalent Islamic products) provided to a customer outside the GCC are in principle zero-rated. Related fees charged on such loans could also be zero-rated, where exported from the territory.
- Profits from spreads resulting from differences between buying and selling currencies are exempt.

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- Mixed supplies – multiple supplies with different VAT rates and treatments – will need to be accurately apportioned.
- Making VAT-exempt supplies increases costs, as the VAT incurred on expenses relating to the making of those supplies cannot be recovered.
- On some 'business as usual' practices, such as property leases or the acquisition of services, supplies and equipment, Islamic financial institutions (IFIs) will be end users and so face additional costs of up to five percent.
- IFIs will want to maximise the recovery of input VAT, requiring them to carefully consider and plan any purchases of goods and services and minimise any input VAT they cannot recover.
- VAT on supplies, as well as increased costs as a result of any non-recoverable VAT on expenses, will increase costs for IFIs - which may drive them to increase charges to customers. However, IFIs should be mindful of any regulatory constraints and the impact price changes may have on their competitive advantage.
- VAT may be a significant commercial opportunity for Islamic banks as their clients are likely to have substantial new working capital requirements.
- We have seen increased consumer spending in the run-up to the implementation of VAT, increasing demand for Islamic lending products.

What should Islamic financial services providers be doing now?

- Consider the VAT treatment of each individual element of finance arrangements and determine the relevant VAT treatment and its impact on VAT recovery.
- Where an IFI takes title to assets as part of an Islamic financial arrangement, it incurs VAT on the purchase price of the asset. IFIs must determine whether VAT is recoverable on the acquisition and whether VAT is chargeable on the onward supply to the customer – which is unclear with *tawurruq* arrangements, for example.
- Where fiscal neutrality (with conventional equivalents) can not be easily protected and guidance is lacking, IFIs may wish to consider approaching the relevant tax authority as an industry group.
- Examine any long-term contracts spanning the date of implementation and decide whether VAT can - or should - be charged to customers.

Important note