VAT brief | Islamic finance

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We have entered a new tax era. Saudi Arabia and the UAE implemented VAT on 1 January 2018. Bahrain implemented - for businesses with taxable turnovers above BD5m - on 1 January 2019 - with other businesses going live on 1 July 2019 or 1 January 2020. Other GCC countries are expected to follow. Key decision makers in the UAE, Saudi Arabia and Bahrain need to ensure their processes and systems are - and remain - VAT-compliant, while their peers in other GCC states need to start preparing now for VAT's implementation.

What is VAT?

- The GCC countries have agreed a standard VAT rate of five percent.
- Supplies of goods and services can be exempt, zero-rated or standard-rated (five percent), or out of scope.
- The mandatory registration threshold (MRT) is the equivalent of US$100,000. The voluntary registration threshold is the equivalent of US$50,000. Bahrain has staggered VAT's introduction.
- Registered businesses account for VAT - a consumption tax - on the price charged for the goods or services they supply and regularly pay the VAT to the tax authority.
- Where registered businesses make supplies that are standard- or zero-rated or out of scope with recovery, they should be able to recover the VAT they have incurred in making those supplies.
- Registered businesses making supplies that are exempt from VAT cannot recover the VAT they have incurred in the course of making those supplies.
- Registered businesses may be unable to recover VAT incurred on purchases that are deemed to have a private element.
- Registered businesses making 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 businesses in the Islamic finance 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, the UAE and Bahrain have, in principle, aligned the VAT treatment of Islamic and conventional financial services. 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, Saudi Arabia and Bahrain, 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.
- 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 – 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) are end users and so face additional costs of up to five percent.
- To maximise the recovery of input VAT, IFIs should carefully consider and plan purchases of goods and services, minimising unrecoverable input VAT.
- VAT on supplies, as well as increased costs as a result of any non-recoverable VAT on expenses, increases 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.
- Consumer spending in the run-up to implementation grew in Bahrain, Saudi Arabia and the UAE, boosting demand for Islamic lending products.

What should businesses in the Islamic finance sector 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) cannot 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

The information in this document is based on translations of the VAT legislation of the UAE, Bahrain and Saudi Arabia, the GCC VAT framework and general VAT principles. **It is provided for information purposes only.** Any omissions or errors are inadvertent. This document should not be relied upon in making any decisions. You should seek appropriate professional advice from a tax advisor before making any decision relating to your particular circumstances.