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VAT in the financial services and insurance industry

Considerations for the banking sector

After a long period of speculation, some of the details surrounding the treatment of VAT for the financial services sector have started to emerge: in particular, authorities in the UAE and KSA are publishing finalized laws and increasing communications with taxpayers. This document summarizes the major positions known so far in these countries and the issues to be aware of in the sector.

Context – GCC Framework Agreement

The GCC Agreement – signed by each GCC state (Bahrain, Kuwait, Oman, Qatar, KSA and the UAE) – provides the general rules under which VAT is charged across the GCC (similar to the EU VAT Directive), although as an Agreement it does not automatically have direct effect in each domestic country. To address financial services, this Agreement simply includes one broad provision – shown below:

> **GCC Agreement Article 36 - 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.

This article suggests a number of potential principles to applying VAT to financial services in GCC countries (i.e. 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 it also leaves each member state the ability to depart from those principles and choose any other approach. No definition of "financial services" is provided, thus 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 signaled that their domestic laws will restrict VAT exemption to charges made on the basis of an implicit margin – or, in another sense, that exemption will not apply to any services for which an explicit fee is charged[2]. This approach aligns with more recently introduced global VAT systems (such as South Africa, Singapore and Malaysia) and starts 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 transactions, this rationale is the difficulty of accurately and consistently determining an appropriate value for taxation).

The definition of financial services themselves is expected to align broadly to familiar concepts in the EU and other global systems. The published KSA VAT Regulations do not exhaustively define financial services, but instead provide an inclusive list (and then examples of where these would be considered exempt).

Neither the UAE nor KSA have indicated that VAT exemption on 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 Sharia'-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 the same basis that would apply for a non-Sharia' product with an interest or margin charge. Thus, the implicit profit earned by Islamic Finance providers on these products should be treated as an exempt supply – and providers of both products should (in theory) have an equivalent overall VAT position.

The KSA Regulations expressly provide that an underlying transfer of goods as part of a Sharia'-compliant product may be disregarded where the 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.

The complexities of many of these products places more importance on the details of individual arrangements being considered in detail: both on the extent of exemption and any potential disregarding of goods transferred as part of a financing product.

Approaches to VAT recovery

Both KSA and the UAE intend to require VAT recovery to be performed on a direct attribution basis, with a pro-rata calculation for non-attributable costs (therefore without any pre-determined recovery rates set for the financial sector). As in many global systems, a direct attribution of costs to exempt and to taxable supplies must be

performed as a first step, to the extent possible. However, the rules for calculating recovery of residual overhead costs 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 to the default method may be applied for, provided that this is proportional and more accurately represents the use of inputs compared to the default method. No restrictions are provided on alternative proportional methods, but all such methods must be agreed in advance with the KSA tax authority (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

The UAE has announced that a standard recovery method will be based on inputs, which would be calculated using this fraction:

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

The UAE will also allow alternative or special methods, including the output values base used by KSA as a default, a transaction count or sectoral method. We expect, however, that the UAE's tax authority (FTA) will specify methods that are generally approved for use in each sector: however, we expect that any special method will still require express approval before use. In practice, this means that it is likely that no special methods will be able to be used during the first year. 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

Both the UAE and KSA have indicated that VAT grouping will be possible for locally established related entities (the UAE requires common control whilst KSA has indicated that 50% control will be sufficient for grouping, allowing 50:50 joint ventures to join a group).

Cross-border VAT groups are not expected to be permitted in the GCC, but an overseas branch or establishment of a GCC entity will in principle form part of a VAT group in both KSA and the UAE. 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, as applied in Europe.

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.

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