



The impact of Public Clarification no. VATP001 on the Banking Industry

With the release of Public Clarification no. VATP001 on the VAT treatment of compensation-type payments (the clarification), the Federal Tax Authority (FTA) of the United Arab Emirates (UAE) has sparked a discussion within the banking industry on the clarification's applicability to similar penalty-type fees charged by the banks to their customers.

Should, for example, an early settlement fee – imposed by a bank on an early settlement of an interest-bearing loan by a customer – be regarded as consideration for a supply? Or could it be considered compensation for a breach of contract and therefore, based on the clarification, be treated as out of scope of VAT? The following sections shall address the possible views in this respect.

It should be noted that Public Clarifications, while having general application and providing assistance to businesses seeking guidance on how to apply the VAT Decree-Law, will seldom deal with all possible permutations of transactions of the nature being addressed. Essentially, this means that businesses still bear a responsibility for ensuring that their transactions are VAT compliant, and the guidance given by these clarifications should be viewed in the context of the transactions that are actually being undertaken.

VATP001 – VAT Public Clarification on the VAT treatment of compensation-type payments

The clarification addresses the question of whether a compensation-type payment is consideration for a supply. It further states that where a payment is not consideration for a supply, no VAT should be due on the payment. The key factor in determining this is whether the recipient of the payment has supplied anything in return for the payment.

Whilst the clarification provides for various scenarios to illustrate the basis of determining the treatment and indicates where the FTA shall draw the line regarding what constitutes genuine compensation, it does not provide examples applicable to the banking industry, or the broader FSI (Financial Services & Insurance) industry, where payments resembling compensation payments are a common occurrence.

Applicability to the Banking Industry

To determine whether, in the previous example, VAT should be due on the early settlement fee (or any other compensation-type payment for that matter), banks would need to determine whether the payment received in this respect is seen as consideration for a taxable supply.

The VAT Decree-Law defines a taxable supply as a supply of goods or services by a taxable person for consideration. A supply of services is subsequently defined as anything which is not a supply of goods. Based on guidance provided by the FTA, this should be interpreted very broadly and it could entail conducting an activity, but also agreeing to not conduct an activity by a taxable person. Anything a taxpayer receives in return for such activities should, in principle, be seen as consideration for these supplies and subject to VAT under the standard rules.

Only where a payment is not deemed as consideration for a supply could it be regarded as being out of scope of VAT. Examples provided by the FTA in the clarification include payments received in respect of a breach of contract and payments that are compensatory in nature.

Given the above, the main argument for treating the early settlement fee as out of scope of VAT would be for a bank to argue that

the fee would only be imposed when a customer breaches the contract and decides to settle the loan before maturity (i.e. a customer decides to settle the remainder of a 10-year loan after 6 years). As a consequence of the early settlement, the bank would suffer the loss of 4-years' worth of interest. The fee would be imposed to compensate for the interest the bank would otherwise have been able to charge its customer. Based on this rationale, the early settlement fee could, under these circumstances, be considered to be of compensatory nature and, as such, out of scope of VAT.

Penalty-type fees as taxable supplies

It is to be seen whether the FTA will follow the rationale portrayed above, as there are also arguments to consider the fee constitutes a taxable supply.

In the example above, the early settlement fee could actually be viewed as consideration for providing the customer with an option to close off and settle a loan facility during the course of its maturity. As the customer would typically know beforehand how much it needs to pay the bank to settle the loan before maturity, this could be an indication that there is a separate supply from a VAT perspective. The early settlement fee would then be seen as consideration for the supply of an early termination of a loan, on which the bank would need to charge and account for VAT.¹

This view also seems to be supported by the FTA as – based on the [VAT awareness session](#) materials for the banking industry released back in December 2017 – it was indicated that an early repayment fee with respect to a mortgage should be considered a separate taxable supply, rather than out of scope for VAT purposes.²

In line with the above, the same arguments could also be used for other penalty-type fees

imposed by banks, like late payment fees or overdraft fees with respect to personal banking services. Should these fees be seen as a separate or additional services provided by the bank, or should these be considered compensation for a breach of contract? The moment a customer opens an account with a bank, it is normally provided with a schedule of charges. The aforementioned penalty-type fees are typically just an item of the schedule like any other fee imposed by the bank, which could indicate that these fees should be seen as taxable supplies from a VAT perspective.

It should be noted that a bank could also charge penalty-type fees, which are considered to be outside the normal course of business. An example in this respect could be a fee charged in relation to a returned cheque, as the bank was not able to process the cheque (on time) due to an invalid entry by the customer. Assuming the bank does not normally charge for cheque processing, it could be argued that in these cases the additional fee should be seen as compensatory in nature for the additional activities the bank had to undertake and arguably out of scope of VAT. However, it is to be seen whether the FTA will follow the same rationale.

Industry guidance and a way forward

It becomes clear that whilst the FTA has provided valuable clarifications on the topic of compensation-type payments, its applicability for the banking industry is still not as clear-cut as taxpayers would have hoped. Most likely there is no one correct answer for all compensation-type fees charged by a bank and a further differentiation and categorization of these fees would be required.

The expected release of the Financial Services Guide by the FTA will likely, amongst other questions, provide the necessary clarity for taxpayers on this topic.

¹ There is a separate question to be answered on whether the fee/penalty could be considered as exempt from a VAT perspective. From a tax neutrality point of view, it could be argued that the charge is effectively to cover for the interest lost by the bank, which would have been exempt should the loan reach maturity. However, considering the rationale to tax

financial services charged by way of explicit fee, commission, rebate or similar, it is likely that the fee should be considered taxable in the UAE (art. 42 (4) of Cabinet Decision (52) of 2017).

² It should be noted that the VAT Awareness sessions, as well as Public Clarifications released by the FTA, are solely for guidance purposes and cannot be relied upon in a court of Law.

Deloitte Financial Services VAT contacts

Our Financial Services VAT experts listed below would be happy to support you through a one-on-one discussion to further address the abovementioned topics or other VAT related matters impacting your business.

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