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Value Added Tax in the GCC

Insights by industry | Volume 1

Financial Services & Insurance chapter

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Ninety years in
the Middle East

Chapter 6 – Financial services and insurance industry

Why VAT, financial services and insurance are a difficult combination

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Not much has been said publicly by the governments of the GCC as to how they expect VAT to apply to the financial services and insurance sectors, at least not in its totality. However, the problem for policy makers is that unfortunately trying to successfully[1] apply normal VAT rules (i.e. to tax instead of exempting them) to a good number of insurance and financial services transactions is exceptionally difficult to achieve. Theoretically it is possible to tax all such services, but sufficient practical challenges remain as to make achieving that objective a somewhat distant prospect, despite almost four decades of governmental effort in this space.

These challenges include:

"They are too difficult to tax"
The "value" for VAT purposes, particularly in the context of margin-based transactions, is almost impossible to determine accurately and consistently on a transaction-by-transaction basis. Undertaxation (leaving the treasury out of pocket) or, worse, overtaxation (taking too much out of the pockets of taxpayers) could arise leaving both suppliers and consumers in an uncertain position with respect to their obligations and rights respectively.

"Taxing financial services and insurance is to tax the wrong thing"
Financial intermediation, and the assets underlying it, represents the means of consumption and not consumption itself. Moreover, by taxing potentially investable assets you could choke off economic activity at its genesis, something that is generally best avoided. Bearing in mind VAT is designed to be a tax on consumption, not savings or investment, an obvious tension exists in this particular context.

"Exemption is the preferred approach. Everyone does it"
As far back as 1918, banking transactions were exempted from turnover taxes in Germany. The 29 member states of the European Union have all implemented VAT exemption extensively as required under the Principal VAT Directive and its predecessors. The legacy of VAT exemption is vast, therefore, and well rehearsed. To some extent the inertia has at least become somewhat self-fulfilling.

Yet unfortunately VAT exemption creates as many problems as it solves. It is an imperfect answer to a difficult question and, as a result, is a topic that garners much attention from the industry's professional advisors, governments and academics alike, all of whom object to one or more of the following impacts, amongst other things:

Cascading
The "locking-in" of irrecoverable VAT into a supply (i.e. it is essentially hidden within a VAT exempt cost), resulting in increased costs for borrowers even where the borrower might otherwise normally be able to deduct VAT.

Low-tax VAT regime bias
Encouraging financial service and insurance providers to source services from jurisdictions that apply a lower rate of VAT, or have no VAT whatsoever.

Liability boundary disputes
A costly issue for most businesses locked in discussions with tax authorities over what should or should not be exempted.

1. Success is of course a subjective matter to some extent. In this case we define success as being one in which the risk of under or over-taxation of the service has been removed, and that input tax credits can be accurately attributed to the recipient of the service.

Vertical integration bias
VAT costs arising on outsourced services create an incentive to in-source, potentially inefficiently.

Regulatory tension
The financial services and insurance sectors, so often required to restructure in part in order to meet new regulatory obligations, finds itself at risk of bearing additional VAT costs brought about by reorganization efforts.

Nevertheless, we are witnessing a gradual shift in the trajectory of policy thinking that is beginning to create a new 'normal' for the industry, particularly in those countries that have introduced VAT comparatively recently.

Recognizing the inherent challenge of valuing, and taxing, individual transactions often sold on aggregated interest margins, one obvious place to start is with anything that is not aggregated or which is at least valued explicitly in the normal course of business. Generally speaking, agents arranging supplies of financial services and insurance do just this, charging an explicit fee for their services to the principal or the customer, as the case may be. Principals themselves also charge explicit fees for a range of financial services and insurance: cheque book issuance charges, and credit card membership and administration fees, for example.

In the alternative, or indeed in combination with this taxation approach, is the option of simplifying VAT recovery for institutions making VAT-exempt supplies of financial services and insurance. Essentially this requires the setting of a guaranteed VAT recovery rate for institutions[2] and the removal of a significant portion of hitherto irrecoverable VAT costs from their financial statements. This presumes of course that the benefits of VAT recovery are indeed passed on in the form of lower costs, and that the institutions themselves revert to investing 'normally'.

More radical approaches include enabling financial service and insurance providers to "opt to tax"[3] otherwise exempt transactions, or potentially applying a zero-rate[4] (the transaction is not subject to VAT but the institution is entitled to recover VAT on costs in full) on business-to-business transactions in order to mitigate the risk of hidden VAT cascading into borrowing costs and disincentivizing investment decisions.

But, no single best practice has emerged as the leading candidate for wholesale revalidation of the VAT treatment of the sector at this time. To some extent this is down to a desire to retain simplicity on the part of governments. In other cases it is due to the highly theoretical, technical and administratively cumbersome aspects of the alternatives amongst other things. In short, the alternatives to exemption create new challenges.

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This table deals with the supply-side of the transaction, not the treatment of VAT on purchases

Principal or Agent	Charge type	1978 European Union	1997 Singapore South Africa Australia	1985-2014 China New Zealand*
Principal	Implicit margin	Exempt/ Option to Tax**	E	T
	Explicit fee	E/OTT**	T	T
Agent	Explicit fee	E/OTT**	T	T

* Partly through Z/R B2B
** Recent development

Tax model development trajectory

2. Singapore has implemented a fixed rate recovery scheme for businesses that choose to opt into it
3. Certain countries in the EU have implemented this measure
4. Only New Zealand has implemented this approach to date

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What does this mean for financial services and insurance?

As a result of the policy challenges, traditionally financial services and insurance businesses are amongst the most VAT complex businesses. They usually end up with multiple challenges all of which are practical issues.

On the sales side, businesses will usually end up with multiple VAT liabilities on their supplies and for now at least financial services and insurance businesses will need to consider a series of variables as we await the final policies.

That said, inevitably, as discussed earlier, there is a high chance of some form of exemption. That being the case, the business has to carefully review its products and consider the potential VAT liability. Inevitably this leads to a one off exercise during the implementation process of categorization and review of contracts. However, there is an also an ongoing challenge: increasingly financial services and insurance are being bundled and personalization of the products provided is becoming common – what was provided yesterday, will change tomorrow.

Unfortunately VAT law very rarely keeps pace with the speed of business change and thus categorizing new services becomes a process challenge. You could have hundreds of unique products especially if you have staff allowed a degree of latitude in what they sell to customers – this can require a dynamic decision making process and/or guidance for sales staff which may end up restricting what they can sell. Finally it is naïve to think that once a business has decided what it thinks the VAT liability is, the tax authority will agree – so it becomes a VAT technical issue with, as we mentioned earlier, liability boundary disputes being common and highly complex to deal with.

Almost always, even though there is an exemption, because financial services and insurance businesses are usually very important for foreign trade earnings, government usually allows some form of zero-rating for exported financial services and insurance (exports here probably would mean outside the GCC but this remains to be seen). This comes with the benefit of VAT recovery, but usually there are conditions attached to achieving zero-rating and identifying those supplies (in order to enhance VAT recovery) becomes an issue.

Finally VAT has an impact on the customers of the financial services and insurance businesses that has a very unique effect on them because of where they sit in the supply chain.

There are opportunities in this – many businesses will be facing cash flow and working capital demands that never previously existed and therefore demand for short term financing becomes more common place. Financial services and insurance businesses will need to consider how they respond to this – and likewise, what about, as referred to in Chapter 4, the short term demand for new cars before January 1 2018 – who is going to provide all that finance?

There are also challenges – by way of an example, insurers face a double challenge. The first of these is that if VAT is due on premiums, can they pass this cost on? And remember, insurance premium tax in Europe has long been seen as the equivalent of VAT for the insurance trade, but it is far more logical to use the VAT

system, so one must not assume an exemption will apply, though of course this is not known right now.

The second challenge for both the insurer and insured is the cost of insurance (in essence a variation on the cascading issue referred to earlier). On the retail insurance business, yesterday if you had a car accident and the insurer paid the bill for the repair, there was no VAT, tomorrow there will be. Instantly the insurable value has increased and the insurer will need to consider its premium pricing. In contrast on the business insurance side, insurers need to ask themselves – do I need to insure the VAT? Surely if the business is fully taxable it will be able to deduct the VAT it might incur on a repair work to its car fleet. If that is the case, the premium may be overstated if this is not identified and VAT excluded from the insurable value.

Once you have overcome the issues in respect of VAT on sales of services and the impact on customers, the next issue becomes the vexed question of VAT recovery. If there is an exemption, the business will not be entitled to recover VAT that relates to those supplies. The problem in the world of services and financial services and insurance in particular is that very rarely is it straightforward to identify a cost and what it directly relates to – inevitably there is some debate and a great deal of costs incurred by the business that fall into the category of 'general overhead'. This then means the business needs a process to decide what proportion of the VAT it incurs can be recovered – this adds a further burden on the AP function.

What all this means is that along with all the challenges faced by any other business, financial services and insurance businesses inherently have their own very special issues, which are perhaps amongst the most complex in terms of VAT technicalities and business practicalities

In many countries around the world this becomes a very complex (effectively) management accounting process often requiring negotiation and agreement with the tax authorities. In a minority of countries there are fixed industry percentages that can be applied (notably in Singapore), this is a welcome relief for those otherwise charged with doing the calculations, but often such blanket recovery rates don't truly reflect the cost base and, whilst simple, often lead to unfairness in terms of the level of recovery achieved.

Finally, because VAT becomes a cost on purchases, financial services and insurance businesses inevitably start to think about how to reduce it. Sometimes this affects behavior in quite startling ways, and the most startling of these is vertical integration as referred to above. Essentially the benefit of vertical integration arises from the fact that, very specifically, salary costs do not incur a VAT charge. It is therefore more efficient, from a VAT perspective, to employ people directly than it is to outsource. The temptation therefore is not to outsource, and in fact to consider insourcing – or buying the business that was providing you with services and vertically integrating it thereby generating an overnight saving of 5% of the salary cost of the purchased business.

What all this means is that along with all the challenges faced by any other business, financial services and insurance businesses inherently have their own very special issues, which are perhaps amongst the most complex in terms of VAT technicalities and business practicalities. They are also faced with perhaps more complex uncertainties than many other businesses whilst we await the detail of the law and so will be more tempted to delay implementation, whilst, somewhat perversely, having the most complex VAT issues.

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