VAT brief | Islamic finance

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With less than a month to go before VAT is implemented in both the Kingdom of Saudi Arabia and the United Arab Emirates, legislation and regulations have been finalised. As business across the GCC move into a new tax era, key decision makers must ensure that their people, their systems and their technologies are sufficiently prepared – and sufficiently agile – to deal with a new business paradigm.

What is VAT?

- VAT is a tax on consumption, not income or profits.
- The GCC countries have agreed a standard VAT rate of five percent (5%).
- Supplies of goods and services are generally standard-rated but can also be zero-rated, exempt or out of scope.
- Registered suppliers will account for VAT on the price of a good or service they supply and pay VAT 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) be able to recover most of the VAT they incur in making those supplies.
- Registered businesses that make supplies that are exempt from VAT will not be able to recover the VAT they have incurred in the course of making those supplies.
- Registered businesses that make supplies that are predominantly zero-rated will usually be in a VAT refund position.

How will VAT affect the Islamic financial services sector?

- Under the GCC framework, each GCC country has the right to exempt financial services.
- Saudi Arabia's VAT IRs align the VAT treatment of Islamic and conventional financial services. However, differences in the nature of the products and their revenue streams may complicate matters.
- Margin-based products – such as interest on loans and fixed deposits - are exempted.
- Fee-based services, such as management fees, commissions, and shari'a advisory services, are standard-rated.
- Loans provided to a place outside the GCC may be zero-rated. Service fees charged on such loans could also be zero-rated.
- Profits from spreads resulting from differences between buying and selling currencies are exempt.
- Mixed supplies – multiple supplies with different VAT rates and treatments - will need to be accurately apportioned.
- Exemptions increase costs as the VAT paid on making exempt 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 tax credits, requiring them to carefully consider any purchases of goods and services and how best to minimise any input VAT they cannot claim.
- IFIs may decide to increase costs charged to customers – but should be wary of regulatory constraints and the impact 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 may see increased consumer spending in the run-up to the implementation of VAT, increasing demand for Islamic lending products.

What still needs to be clarified?

- Will the fixed input tax recovery rate be prescribed on input tax credit claims in lieu of the apportionment method?

Important note

Keypoint's VAT briefs are based on a translation of the Unified VAT Agreement for the Cooperation Council for the Arab States of the Gulf (the GCC VAT treaty), Saudi Arabia's VAT legislation, the UAE federal law, the Saudi implementing regulations, the UAE's executive regulations and general VAT principles and are provided for information purposes only. Saudi Arabia and the UAE continue – as of the date of release of this brief – to work towards an implementation date of 1 January 2018. This brief is not a substitute for professional advice. You should seek appropriate professional advice from a tax advisor before making any decision relating to your particular circumstances.

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