Impact of VAT on Islamic Finance in the GCC
Introduction

Financial services tends to be one of the more complex areas of value-added tax (VAT). Additionally, VAT systems have originated in jurisdictions with conventional financial services, leading to added complexities in the treatment of Islamic finance transactions for VAT purposes.

In this paper, we have considered the potential impact of VAT on the provision of financial services in the Gulf Cooperation Council (GCC) and assessed how such transactions could be treated in the expected VAT system. As the United Arab Emirates (UAE) Executive Regulations had not been released at the time when this document is being written, any comments we make are based on the information available to us in the recently released UAE and Kingdom of Saudi Arabia (KSA) VAT laws, from other sources and the global best practices in terms of the VAT treatment of Islamic finance products, which we assume could be observed in the GCC as well.
Key questions in relation to Islamic finance

Islamic finance products are Shariah-compliant financial products. Similar to conventional finance markets, Islamic finance covers a wider range of products from deposit and savings accounts to, capital markets products, leasing and commodities. Thus, an Islamic counterparty can be found for most conventional financial products.

The special characteristics of Islamic finance separate the products from conventional finance services. These include, for example, avoidance of uncertainty-based transactions and gambling, as well as aversion towards certain products and industries.

While not the only difference, the key distinction between Islamic and conventional finance from VAT perspective is the lack of interest in the Islamic finance products. For VAT purposes, this may create complexities due to interest being generally deemed consideration for exempt services, when a similar Islamic finance product may not include an evident exempt component.

If the individual transactions that constitute Islamic finance products are considered strictly from VAT perspective, there tend to be several differences when compared to the conventional counterparties. Such differences may give rise to unintended VAT costs within the product, which are not generated in the conventional finance product. Often the increased VAT cost is due to the component corresponding to interest being acquired by selling goods for profit in the Islamic finance product. As a sale of goods is generally a taxable transaction, the supplier is required to charge VAT on the sale, unless a special treatment is granted.

If the customer is a VAT-registered business and is allowed to recover input VAT in full, any VAT incurred in the transactions will lead only to a cash flow impact for the customer. However, in case the purchaser of the services is not allowed to recover VAT in full, charging VAT on the underlying transactions often leads to a higher cost than that associated with a conventional finance product.

VAT should not contribute to any unfavorable treatment between similar supplies that serve the same purpose. In order to maintain the equal treatment of Islamic and conventional finance products, this generally means that certain transactions that form a part of the Islamic finance product, e.g., the profit element corresponding to interest in the conventional finance product, are deemed exempt or granted other special treatments. For example, as a number of Islamic finance products tend to include a supply of goods to create the profit element, it may be necessary to disregard certain transactions, which would otherwise be subject to VAT, to treat these not as supplies for VAT purposes.
If unmanaged, value-added taxation can undermine Islamic finance competitiveness

The Islamic finance industry has developed many products that achieve similar economic outcomes as interest-based debt transactions. However, the methods used to structure transactions to meet both shariah and commercial expectations may incidentally create structural differences for many Islamic finance products that trigger unintended tax consequences which impact the financial returns relative to interest-based transactions.

The primary driver of the tax issues between conventional interest-based and Islamic finance transactions is a VAT, also called a goods and services tax (GST). The aim of the VAT is to link taxation to the creation of economic value in business and consumer activities, and so there are specific exclusions of the interest in debt transactions.

The amount of reconciliation in how the tax system treats Islamic finance products versus equivalent conventional products will determine the overall impact of VAT on the growth of Islamic banking. In countries where there has been specific legislation to equalize the two, like Malaysia and the UK, it should not create a specific issue as long as the taxing authorities are capable of managing returns filed by Islamic financial institutions. In countries where there is not tax neutrality, Islamic banking could be placed at a significant disadvantage.

As an example of how Islamic banking would be affected by VAT if legislation did not create tax neutrality, consider the outcome of two transactions, one using an interest-based loan and another using murabaha. In the first case, a person buys a computer on credit for $1,000 and is charged 5% interest from financing the transaction. The amount they would pay in VAT (assessed at 20%) would be $200 because the $50 paid in interest would be excluded from calculation. The total cost of the computer would be $1,250.

In a country without any tax accommodation for Islamic finance, the transaction would have higher cost because the customer would have to pay VAT on the full price of the computer, including financing costs. This would mean VAT of $210 (20% of $1,050), making the cost of using Islamic finance $10 higher. Although this represents a small difference in the example, it is significant when taken in context of the financing cost – it would be equivalent to paying a 6% rate for Islamic finance instead of 5% for a conventional transaction.1

A similar, but potentially more severe tax difference occurs in a commodity murabaha transaction with a non-business. In this type of transaction, there is VAT charged when the commodity is purchased by the bank, when it is sold to the end customer but, unless the customer is a business, it is not able to recover VAT when the commodity is sold to the end customer. This creates a potential wedge in the economic returns from a commodity murabaha when compared with an otherwise equivalent interest-based loan.2

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1 The example was described in more detail by Mohammed Amin, “How should VAT systems treat Islamic finance transactions?” Tax Notes International, May 16, 2016. mohammedamin.com/Islamic_finance/TNI-VAT-systems伊斯兰-finance-transactions.html
2 Ibid.
The most common way to manage the additional burden that a VAT places on Islamic finance transactions is to specifically exempt transactions undertaken as part of an Islamic financing arrangement from VAT. This can be done explicitly in countries that have specific legislation covering Islamic finance, or without specific references to Islamic finance in countries where legislation specifically mentioning religion would not be possible.

In the former case, Malaysia serves as a relevant example where the GST legislation exempts “where any person makes a supply of goods or services under an Islamic financial arrangement” from being subject to VAT. For the latter, the UK (which has a VAT system harmonized with the European Union) defines the transactions as being “where goods are sold with title to the asset passing from the bank to the customer the sale is treated in the same way as a credit sale.” The treatment under VAT then splits the treatment between the cost of the underlying asset (the computer in the example above) and the profit (equivalent to interest) which is exempt as a consideration for financing.

The challenge for Gulf Cooperation Council, as it unveils the specifics of VAT implementation, will be to reconcile the potential issues created by VAT for an Islamic finance system across the region that makes up a large proportion of the overall financial system. In addition to the simple issues (to reconcile) like murabaha, there are significant additional challenges from transactions that have a more distinct structure from conventional finance (like commodity murabaha or sukuk).

In the context of the GCC VAT, Fitch Ratings noted the difficulty specific to “a region with little history of taxation” but put forward the “expectation that the GCC authorities will make Islamic finance tax equality a priority.” However, Fitch noted that there were few details yet available about the VAT exemptions for Islamic finance which will compound the uncertainty depending on the speed at which different countries roll out the VAT rules. Although it is planned to be introduced simultaneously, there is speculation the UAE will introduce it earlier if other countries face delay.

With draft guidelines recently released by the Saudi General Authority of Zakat & Tax (GAZT), it is possible to see the attempt to differentiate between different activities that will be subject to VAT differently. For example, fee- and commission-based products will be subject to VAT at the standard rate while “margin-based products” as well as capital markets and life insurance activities will be exempt from VAT. In theory, this could present an opportunity for a gap between the VAT treatments attributable to Islamic finance transactions but the intent of the regulations is to treat Islamic finance transactions the same as their conventional equivalent.

VAT can provide a significant wedge in the pricing between Islamic and conventional finance. In many countries where Islamic finance has been encouraged, necessary steps have been taken to provide tax neutrality for Islamic finance. This provides a template to allow for competitive markets between Islamic and conventional finance as more countries open to Islamic finance and as financial institutions introduce new products.

5 Fitch Ratings. “GCC VAT a test for Islamic finance,” February 6, 2017. reuters.com/article/idUSF1888803
Impact on GCC financial institutions’ IT systems

VAT is notoriously complex for financial institutions around the world to manage due to the fact that part of the services they provide are exempt from VAT (typically margin-based services such as interest) and the other part is taxable at a standard rate (fee- and commission-based services) as seen above in this paper.

This means from an IT system perspective, core banking and other reporting systems have to be able to identify the taxability of each transaction and its correct reporting treatment for VAT.

It becomes even more complex when it comes to Islamic finance, as interest is forbidden under shariah, so multiple transactions have to be identified to make up for one single transaction under conventional banking (under the neutrality principle).

Ultimately, it comes down to the level of details financial institutions can identify and report in and out of their core banking and other source systems.

One of the unique challenges of the GCC region is its IT landscape – unlike most other VAT-ready regions, around 80% of IT systems still in place today are either legacy or in-house built systems. These systems usually have very few VAT capabilities, which poses an immediate threat for financial institutions to get ready for VAT in the GCC.

The first step should be to identify what VAT capabilities these systems have and what level of VAT compliance data can be extracted to produce a VAT return. The quadrant on the next page can help one position itself in terms of VAT-capable systems and in-house VAT knowledge in order to manage that process internally. If not, technology options have to be looked at and decided upon to avoid the risk of being non-compliant.

The other challenge is around invoicing – clients might ask financial institutions for VAT-compliant invoices on certain transactions in order to claim their rightful input VAT, but very few core banking and other source systems have this ability today in the region.

Typically, financial institutions have at least one core banking system and a reporting system – VAT logic needs to be coded as often as the source systems are impacted by VAT and will need to be continuously maintained when the tax legislation changes. The VAT regime is a new concept to the GCC region and organizations should expect modifications to the tax legislations over time and will need to adjust their operating model accordingly.
Where implementing third-party VAT engines and VAT reporting software makes sense

Low VAT knowledge in the business  High

Low Ability to set up VAT in the IT systems  High

- Build VAT logic in the ERP/IT systems
- Outsource key VAT advisory processes and controls
- Outsource VAT compliance reporting

- Build an in-house VAT compliance function
- Configure VAT logic in the ERP/IT systems
- Implement VAT auto returns software

- Outsource key VAT advisory processes and controls
- Implement a “plug & go” tax engine for VAT
- Implement VAT auto returns software

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Expected treatment in the UAE

The Unified VAT Agreement for the Cooperation Council for the Arab States of the Gulf ("Agreement") grants the Member States flexibility on the VAT treatment of financial services. The Agreement presumes that financial services will be considered exempt of VAT, but the Member States are allowed to opt for alternative treatments. The Agreement does not include a specific mention of the treatment of Islamic finance. Furthermore, the recently released UAE VAT law does not provide guidance on the treatment of Islamic finance specifically.

Prior to the release of the UAE VAT Executive Regulations, some uncertainty in relation to the VAT treatment of Islamic finance products exists. The UAE Ministry of Finance (MoF) has released some information on the potential treatment under the VAT page on its website.

The MoF has confirmed that fee-based financial services will be taxed, but margin-based products are likely to be exempt from VAT. Additionally, in terms of Islamic finance, the MoF has indicated that there should be no inconsistencies between the VAT treatment of standard financial services and Islamic finance products and, therefore, the treatment of Islamic finance products will be aligned with the treatment of similar standard financial services.

Based on the responses provided, the intended treatment in the UAE appears to align with the principles commonly adopted in many other jurisdictions. Nevertheless, the MoF has not indicated the manner in which the treatment will be aligned. We expect that the VAT Executive Regulations will include references in this respect, with more detailed information following in any subsequent guidance issued by the Federal Tax Authority.
Treatment in other jurisdictions

VAT and Islamic finance exist parallel to each other in a number of jurisdictions, including, for example, South Africa, Singapore, Malaysia and the United Kingdom. The end result of the selected VAT treatments in each jurisdiction tends to be similar, leading to the Islamic and conventional financial products to be treated equally, but the means for achieving this may differ.

In Malaysia, the VAT legislation includes provisions on the supply of Islamic finance, stating that where any person makes a supply of goods or services under an Islamic financial arrangement, any supply made in such arrangement other than the provision of financing shall be treated as neither a supply of goods nor a supply of services. Such treatment effectively excludes any VAT charges in relation to the underlying transfer of goods as a part of the Islamic finance product.

Further, the Malaysian Customs Department has issued rather detailed guidance on Islamic finance, describing the treatments applicable to a number of different products, categorizing the supplies made to standard rated, exempt and taxable. The outcome generally corresponds to the treatment applicable to conventional finance products, with the profit element in Islamic finance products being deemed consideration for an exempt supply.

Conversely, the VAT regulations in the United Kingdom do not specifically comment on the treatment of Islamic finance transactions. The VAT legislation in the UK is based on the EU VAT Directive, which also does not include any specific provisions in this regard, as Islamic finance has until recently contributed quite marginally to the European financial sector.

Also, the UK tax authority Her Majesty’s Revenue and Customs (HMRC) has issued guidance on the treatment of Islamic finance products for VAT purposes. The approach taken by the HMRC is to compare the products with the respective Western finance product and to ensure that the outcomes are similar. For instance this is achieved by considering that the profit element is a separate supply of deferral of payment and, therefore, exempt.
Conclusions

While a confirmation on the applicable VAT treatment of Islamic finance products requires the release of the final executive regulations in each country, we consider it likely that the principles to be applied will closely resemble those opted for in other jurisdictions. Consequentially, the use of an Islamic finance product should not lead to any increased VAT cost or added complexities.

This outcome will likely be achieved by treating the profit element as exempt, in comparison to interest in conventional finance. Further, where there is no actual supply of underlying goods in certain financing arrangements, but only a temporary transfer of the title to the goods, this is likely to be disregarded for VAT purposes. We understand that this is the approach selected by the KSA in the recently released VAT regulations and consider it likely that the UAE would select a similar approach.

Contact us

For further guidance on VAT in the GCC region, please contact the following tax experts:

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