VAT treatment of various financial services
Likely VAT treatment of various financial services

- **Exempt (nil)** – Financing (e.g., interest spread), profit on security trades (e.g., share trades), forex spread, margin on financial derivatives and life insurance/family takaful
- **Standard Rated (5%)** – Arrangement fees, brokerage fees, custodian fees, investment management fees, underwriting fees, processing fees, sharia advisory fees and general insurance/general takaful
- **Zero rated (0%)** – Trade financing for export (e.g., LC) and financing outside GCC (e.g., property located outside GCC)
- **Out of scope (nil)** – Financing – principal amount, dividends, buy/sell of underlying asset for Islamic transaction and penalty charges e.g., early settlement fee

VAT impact on financial services

- As per KSA VAT law financial services supplies, including Islamic finance products are exempt from VAT. Consideration received for services rendered by banks by way of an explicit fees, commission or commercial discount, will be subject to standard VAT rate. KSA has adopted a narrow exemption model with respect to Financial Services in which margin based services will be exempt and fee based services will be taxable. KSA will not adopt a fixed rate of recovery method (as used in Singapore/Malaysia).
- KSA aims to achieve competitive neutrality between Islamic and conventional products by treating Islamic products the same way as their conventional equivalent. According to KSA VAT Implementing Regulations, Islamic finance products which simulate the intention and achieve the same results of conventional finance products will be treated in the same manner as conventional products. With respect of insurance, life insurance/family takaful will be exempt and general insurance/general takaful will be taxable.

Issues

- Input tax directly attributable to taxable supplies will be recoverable while those relating to exempt supplies will be irrecoverable. Input tax recovery has to be apportioned on the above mentioned basis when supplies are a mix of exempt and standard rated items. The default recovery rate calculation method suggested in KSA VAT Implementing Regulations is taxable supplies divided by total of taxable and exempt supplies. In case alternate methods will more effectively calculate the apportionment banks can work out their own recovery rate according to a reasonable method as agreed with the authorities.
- Financial service providers like banks usually have a variety of products with VAT liabilities with multiple tax treatment. Similarly bundling of financial services and insurance products may give rise to complex VAT scenarios. Hence financial services industry with its unique products having a varied mix of taxable supplies require robust tax technical decision making capabilities. Identification and apportionment of costs related to taxable and exempt supplies is a key area that require attention as possibility of passing on VAT cost to the customer might be limited in the case of certain products.

Opportunities and challenges

- Implementation of VAT presents a mixed bag of opportunities and challenges. For example more businesses will need short term finance to meet increased working capital requirements because of VAT and this will trigger increased demand for bank loans. However immediately after the implementation of VAT there may be a slump in consumer spending and this can affect the movement of left over stock. This situation makes the determination of optimum stock to meet pre-implementation spike in demand a critical exercise.
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