FSI under VAT

VAT is imminent in Bahrain and the GCC. The financial services industry should be asking itself: 'How is VAT going to affect my business?'

The GCC VAT unified framework agreement (UFA) sets out the common principles on which the VAT law and regulations in each GCC country will be based. Under the UFA, each country has the right to exempt financial services from VAT. However, "financial services" or "financial supplies" is not defined. Generally, a financial supply occurs when you:

- Lend or borrow money
- Provide credit to a customer
- Buy or sell shares, securities or derivatives
- Deal in money (foreign exchange transactions)
- Provide trade credit facilities
- Create a charge or mortgage over property
- Provide insurance products
- Provide a guarantee
- Provide services that are incidental to the above
- Provide intra-group financing – such as when a holding company provides financing

Expected treatment of financial services and insurance

While VAT is new to the GCC, it has been a fact of life in many other economies for some time. This gives a considerable amount of precedence and has allowed GCC policy makers the advantage of learning from other systems. We expect, based on VAT laws in other countries, that interest on loans, margin-based products and foreign exchange transactions will be exempt from VAT. However, we do not expect fee-based services provided by a financial institution to be exempt.

It seems likely - again based on precedent - that life insurance products will be exempt from VAT but all other non-life insurance products are likely to be standard-rated (that is, five percent). The Malaysian model suggests that Islamic finance products will be treated similarly to their equivalent, conventional products to ensure no arbitrage in either direction.

It is important to remember that each GCC country might choose to apply different VAT treatment to different financial supplies.

Consequences of making exempt supplies

If you are providing financial supplies that are exempt from VAT, no VAT is charged on the financial supplies you make. However, this means you get no input tax recovery. The seller cannot charge VAT on an input tax supply and cannot recover any VAT incurred on purchases in relation to that supply. Financial supplies are typically input taxed because they are difficult to value as they are often charged by way of a margin.

Challenges for the FSI industry

VAT poses a unique challenge for financial institutions in Bahrain – and across the GCC – as they will generally have to absorb the VAT costs passed on to them by their suppliers. They will not be able to pass these VAT costs on to their customers in the same way that a business that is making supplies that are subject to VAT.

Financial institutions will, in effect, be treated as the end user which means they will bear up to an additional five percent on top of the business costs they would otherwise incur - costs such as property leases, the acquisition of services (such as IT or professional advisors), office supplies and equipment. There should be no input VAT costs associated with salary and wages. Therefore, for example, if a financial institution is considering outsourcing, as opposed to employing people, to provide IT services, this additional VAT input cost will need to be taken into account in the cost benefit analysis of the decision.

To discuss how VAT will impact your business, email vat@keypoint.me and our market-leading team will contact you.

Maximising the recovery of input tax credits will be a key issue for financial institutions - and could be approached in a number of different ways:

1. Financial institutions may decide to increase the costs they charge their customers. For example, a bank may increase its margins or the fees it charges to its customers to cover input VAT costs. Any 'over recovery' of input taxes will not find favour with the Central Bank - and may fall foul of other regulations put in place to safeguard customers, causing significant reputational damage.

2. Financial institutions may decide to minimise input VAT they cannot claim as a credit, requiring careful reviews of all the financial supplies they provide to see if any can be re-characterised as subject to VAT (whether zero-rated or the standard five percent). Where financial advice is being provided, the financial institution will need to determine if the financial advice is an incidental financial supply (which is not input VAT recoverable). If the advice was not incidental, input VAT costs will probably be recoverable.

3. Financial institutions may apportion input VAT costs to financial supplies that are subject to VAT. For example, input recovery may be available on non-life products as these are likely to be subject to VAT but not on life products as these will probably be exempt from VAT. If premises or computer hardware or software are used for all insurance products being supplied, the insurance business will need to apportion the input VAT cost of acquiring those supplies between the two activities and maximise input VAT recovery related to non-life products.

VAT is going to be a significant challenge for the financial services industry. While there are still a number of 'grey' areas, it is critically important that banks, asset management companies and insurers start their VAT journey now. The consequences of not getting this right - in terms of reputational, not just financial, damage - could be substantial.

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