The government succeeded in introducing VAT in the UAE with effect from 1 January 2018, against challenging timelines. The UAE VAT Decree-Law was released in late August 2017 with the corresponding Executive Regulations only published on 28 November 2017.

The standard rate of VAT is five percent with some goods and services qualifying to be either zero percent or exempt of VAT. Saudi Arabia is the only other GCC member state that went live with a VAT system on the same date, and the remaining Gulf States are expected to follow suit from early 2019.

Many financial services are VAT-exempt. As a general rule, margin-based products, such as those generating interest income (loans, mortgages, provision of credit, and operation of bank accounts) are exempt of VAT. This will have no direct impact on the end consumer as they will not be charged VAT. However, there could potentially be a substantial impact on the profitability of the banks since banks will not be able to claim credit for any VAT incurred on expenses related to the making of these exempt supplies.

The UAE VAT law also specified services on which customers will be charged five percent VAT. These are any financial services where an explicit fee, commission, discount or rebate is levied. Fees for account applications, money transfers, check books, account statements, ATM charges are now subject to VAT. Favorably for the banks, VAT incurred on costs directly related to making these taxable supplies will be recoverable.

Cost of VAT?
Our global experience indicates that banks tend to recover only a small fraction of the total VAT incurred on expenditure as a result of their exempt income, as it can be very difficult for banks to directly attribute their costs to specific revenue streams. The vast majority of costs therefore fall into the overhead category, which includes general expenses such as lease of premises, utilities, professional fees and marketing, to name a few.

An added complexity is that the UAE VAT legislation’s standard method for apportioning VAT incurred on overhead costs to determine the recoverable VAT is based on the use of the VAT paid on expenses (see diagram for an illustration of how this works in practice). The legislation does not allow a change in apportionment method to achieve a ‘fair and reasonable’ VAT recovery until January 2019, at the earliest.

Future acquisitions of Capital Assets (from a VAT perspective, where the VAT-exclusive value paid exceeds AED 5m) will result in an increased administrative burden as the use of these assets will need to be monitored over their VAT economic life (ten years for buildings, five years for any other capital asset). Any change in use could result in either a payment or repayment of VAT to or from the Federal Tax Authority (FTA).

The new value-added tax legislation has serious implications for banks’ profit margins. Clare McColl examines what banks can do in terms of pricing and other measures.
Pricing issues
As banks grapple with the new VAT regime and the high compliance costs associated with mandatory VAT registration, it will be interesting to see how they manage their pricing policy from now on. International trends would indicate that the banks will increase their fees to compensate for the additional, hidden costs.

Where banks suffer significant, irrecoverable VAT costs, and/or treat existing taxable fees as VAT inclusive, there may be incentives to cut costs in other areas. As there is no VAT charge on employee salaries or using own resources, banks that currently outsource services, such as back-office activities or call centers, may elect to bring these services in-house to mitigate potential, irrecoverable VAT costs. We believe it quite probable that banks will eventually be forced to increase prices to their customers to maintain their current profitability.

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Clare leads our indirect tax practice in the Lower Gulf. Previously, she led the Scottish indirect tax practice for KPMG in the UK. Clare has over 25 years’ experience in indirect taxes and sits on the indirect tax committee for ICAS (the Institute of Chartered Accounts for Scotland). Having trained initially with the UK tax authority, she conducted VAT inspections, investigations and implemented the VAT legal and technical program. She has led a number of international indirect tax projects, delivering proactive and reactive advice. She works with a portfolio of clients across financial services, oil and gas, technology, manufacturing, and real estate and has assisted over 600 entities with implementation of VAT in their business.