VAT

هيئة الزكاة والضريبة والجمارك
Zakat, Tax and Customs Authority

Guideline

VAT Exemption of Real Estate Supplies and its Effect on the Proportional Deduction Formula

The Zakat, Tax and Customs Authority ("ZATCA", "Authority") has issued this Tax Circular for the purpose of clarifying certain tax treatments concerning the implementation of the statutory provisions in force as of the Circular's issue date. The content of this Circular shall not be considered an amendment to any of the provisions of the Laws and Regulations applicable in the Kingdom.

Furthermore, the Authority would like to highlight that the clarifications and indicative tax treatments prescribed in this Circular, where applicable, shall be implemented by the Authority in light of the relevant statutory texts. Where any clarification, interpretation or content provided in this Circular is modified - in relation to unchanged statutory text - the updated indicative tax treatment shall then be applicable prospectively, in respect of transactions made after the publication date of the updated version of the Circular on the Authority's website.

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1. Subject Matter of this Circular

The Circular outlines the method, requirements, and obligations for exempting real estate supplies from VAT and its effect on the proportional deduction formula as set forth in the Tax Laws and Implementing Regulations issued by ZATCA.

This Circular also provides an explanation for the definition of a Real Estate Financier and the alternative method of proportional deduction of input tax that can be used by some Taxable Persons.

2. Definitions

The following words and phrases, wherever they are contained in this Circular, shall mean the definition described in front of them, unless the context of the text states otherwise.

A. The Authority:

Zakat, Tax and Customs Authority.

B. Tax

Value Added Tax.

C. Law:

Value Added Tax Law issued by Royal Decree No. M113 dated 2/11/1438H, including any amendments that may follow it.

D. Implementing Regulations

Value Added Tax Implementing Regulations issued by GAZT (formerly) Board of Directors Resolution No. 3839 dated 14/12/1438H, including any amendments that may follow it.

E. Unified Agreement:

Common VAT Agreement of the States of the Gulf Cooperation Council (GCC) issued in

November 2016.

F. Circular:

Tax Circular related to the VAT exemption of real estate supplies and its effect of the proportional deduction formula.

G. Taxable Supplies:

Supplies on which Tax is charged, whether at the standard rate or zero-rate, and for which input tax is deducted.

H. Exempt Supplies:

Supplies on which no Tax is charged, and for which associated input tax is not deducted.

I. Taxable Person:

Any natural or legal person, public or private, or any other form of partnership.

J. Real Estate Financier:

According to the provisions of Article 1 of the Real Estate Finance Law, issued by Royal Decree No. M50 dated 13/03/1433H, the Real Estate Financer shall include commercial banks and finance companies licensed to engage in real estate finance activities.

K. Real Estate Transaction:

Any legal transaction entailing the transfer of the real estate ownership or acquisition, for the purpose of owning it or owning its benefit/usufruct, including without limitation contracts that are subject to the transfer of the usufruct right or long-term lease right, including sale, set-off, gift, will, barter, lease, financial lease, transfer of shares in real estate companies, or acknowledgement of usufruct right for more than (50) years.

3. Overview of the Correct VAT Treatment of Real Estate Supplies

With effect from 4 October 2020, the VAT treatment of the real estate supply has been changed from taxable supplies to exempt from tax by Royal Order No. (A/84) issued on 14/2/1442H. As such, the real estate transaction became subject to the Real Estate Transaction Tax (RETT) at the rate of 5% of the total value of the real estate transaction, whatever its condition, form, or use was at the time of the transaction.

This change resulted in a reduction of the proportional deduction ratio of residual input tax for businesses engaged in supplying Shariah-compliant financing products which involve the purchase and sale of real estate. Consequently, the Authority was keen to clarify the provisions of the Law and the Implementing Regulations, which regulated the special provisions for the alternative proportional deduction method so that it is applied in cases where it would be difficult to apply the default method.

For the purposes of VAT, a supply of Real Estate is made where a supplier sells or rents Real Estate located in the Kingdom of Saudi Arabia ('KSA') as part of his economic activity.

As such, the sale of all types of real estate in the Kingdom (including commercial, residential, or bare land) is exempt from VAT. The real estate transactions are, however, subject to RETT at 5% of the total transaction value at the transaction date, pursuant to implementation of the provision of the RETT Implementing Regulations issued under Ministerial Resolution No. 712 dated 15/02/1442H.

It should be noted that the supply of leasing commercial or other non-residential real estate is subject to VAT at the rate of (15%), and the rental of residential properties is exempt from VAT.

The following table provides an overview of the VAT Treatment of the most common types of Supplies of Real Estate.

<table>
<tr><th colspan="4">Commercial Real Estate</th><th colspan="4">Residential Real Estate</th></tr>
<tr><td colspan="4">
- Commercial premises and locations (offices and factories)
- Vacant/Bare land
- Farmland
- Partially completed construction work
- Hotels and short-term accommodation
</td><td colspan="4">
- Permanent Dwellings
</td></tr>
<tr><th colspan="2">Sale</th><th colspan="2">Rental</th><th colspan="2">Sale</th><th colspan="2">Rental</th></tr>
<tr><th>VAT</th><th>RETT</th><th>VAT</th><th>RETT</th><th>VAT</th><th>RETT</th><th>VAT</th><th>RETT</th></tr>
<tr><td>Exempt</td><td>5%</td><td>15%</td><td>N/A</td><td>Exempt</td><td>5%</td><td>Exempt</td><td>N/A</td></tr>
</table>

For detailed guidance on the applicability of the VAT treatments set out above, please refer to the VAT Guideline for the Real Estate Sector.

3.1 Input Tax Deduction

In principle, any VAT incurred by a taxable person on the purchase of goods or services supplied to him is deductible, provided the goods or services are used for the purpose of carrying out an economic activity in the course of making taxable supplies. For example, a bank may charge an explicit fee for issuing cheque books to account holders, and this fee would be taxable at the standard rate of VAT. Consequently, input tax on expenses which are fully and directly attributable to this supply, such as the printing costs of the cheque books, would be fully deductible. The taxable person is required to obtain and retain a tax invoice to document the input VAT amount paid or payable.

Input tax incurred by a taxable person which is wholly attributable to exempt supplies is not deductible and represents a business cost component. For example, a bank making an exempt supply of financial services may incur explicit fees specifically relating to that supply. Such fees would be wholly attributable to the exempt supply and therefore the input tax incurred on the legal fees would be fully non-deductible.

The input tax which cannot be wholly attributed to only taxable or exempt supplies (residual input tax) is required to be apportioned to accurately reflect the use of goods or services in the taxable portion of the business. For example, a business making both taxable and exempt supplies would be unable to wholly attribute overhead costs or expenses such as office utilities or internet expenses or stationery or software costs to either taxable or exempt supplies and the input tax which is deductible on such overhead costs would need to be determined pursuant to the following apportionment:

Supply	Eligibility for Input Tax Deduction
Input tax directly attributable to taxable supplies	Deductible in full
Input tax directly attributable to exempt supplies	Non-deductible
Input tax that cannot be directly attributed to taxable or exempt supplies (Residual input tax)	Partially deductible based on apportionment - method for calculation of proportional deduction - for the taxable part only

3.2 Method for Calculating the Input Tax Proportional Deduction

Pursuant to the Unified Agreement and the Implementing Regulations, a Taxable Person can apply for the proportional deduction method if the input tax is related to goods and services used to make taxable and exempt supplies, and input tax cannot be deducted save within the limits of the proportion referable to the taxable supplies[1].

The default method to apportion residual input tax is based on the value of taxable supplies as a proportion of the total supplies made by the business, as provided below:

$$\frac{\textbf{Taxable}\text{ supplies}}{\textbf{Taxable}\text{ supplies} + \textbf{Exempt}\text{ supplies}^{2}}$$

1. Article 46 of the Unified Agreement
2. Article 51 of the Implementing Regulations

Once a percentage is computed based on the formula above, the amount of residual input tax is multiplied by the said percentage to determine the amount of residual input tax which is deductible by the business. VAT relating to the restricted elements listed in Article 50 of the Implementing Regulations[3] should not be deducted.

Some companies may engage in an economic activity consisting of partially taxable and partially exempt supplies. Examples of such businesses include the activities of real estate companies, financial or banking institutions.

Example (1):

A company's economic activity involves the lease of - taxable - commercial real estate - and the lease of - exempt - residential real estate:

Taxable Supplies
SAR 400,000

Exempt Supplies
SAR 100,000

SAR 60,000
(Commercial real estate)
The company is entitled for full deduction

SAR 50,000
(Internet and software expenses) Input tax that cannot be directly attributed to taxable or exempt supplies

SAR 15,000
(Residential real estate)
Non-deductible

As shown in the example above, the company is entitled to deduct input tax in full for the taxable part of the supply of (60) thousand riyals. The company cannot deduct the input tax related to exempt supplies amounting to (15) thousand riyals. The proportional deduction calculation method shall be applied to supplies that cannot be directly attributed to taxable or exempt supplies estimated at (50) thousand riyals as shown below:

3. Article 50 of the Implementing Regulations

$$\frac{400.000}{400.000 + 100.000} = 80\%$$

The remaining input tax amount estimated at (50) thousand is multiplied by (80%) to determine the remaining amount of input tax that is deductible by the company.

4. Impact of Exemption of Real Estate Sales on Proportional Deduction

The change in the VAT treatment of sales of Real Estate from taxable to exempt affects the default proportional deduction calculation resulting in an overall reduction in the proportional deduction ratio and lower deduction of residual input tax.

The banks and financial institutions that are engaged in providing Islamic financing products (which involve the purchase and sale of Real Estate) have in many cases experienced a particular impact on their input tax deduction position, despite the purchases making up residual input tax being used in a similar way.

ZATCA accepts that the objective of banks and financial institutions is to provide financing to their customers, rather than to sell real estate. The purchase and sale of real estate by such banks and financial institutions is carried out in accordance with Shariah principles for financing, and solely in order to facilitate the financing activity.

While the sale of real estate is a regular feature of a financier's activity, the high value of exempt real estate supplies in the denominator could be distortive and result in a recovery percentage which does not reflect the use of goods or services comprising residual input tax in the taxable portion of the business.

ZATCA may review the proposed alternative method of proportional deduction pursuant to an application filed by the taxable person where the default method does not accurately reflect the

4. Article 51 of the Implementing Regulations

taxable person's use of goods and services supplied to it[4]. Consequently, ZATCA may approve or reject the proposed alternative method of proportional deduction. It should be noted that Real Estate Financiers licensed by the Saudi Central Bank can apply for an alternative method of proportional deduction in order to exclude the amount of exempt supplies of Real Estate made as part of a financing arrangement for the purposes of the proportional deduction calculation, and ZATCA may approve the use of such a method.

5. Alternative Method of Proportional Deduction for Real Estate Financing

This alternative method is the same as the default method, except that the supplies of real estate by way of transaction/disposal are excluded from the value of exempt supplies. Therefore, the following formula would apply for the proportional deduction percentage:

$$\frac{\textbf{Taxable}\text{ supplies}}{\textbf{Taxable}\text{ supplies} + (\textbf{Exempt}\text{ supplies} - \textbf{Exempt Real Estate}\text{ supplies as part of financing products})}$$

It should be noted that exempt real estate supplies which are not a part of the supply of a Shariah compliant financing product are not eligible for exclusion from the denominator in the alternative method.

Example (2):

If a bank owns a property development subsidiary that is in the business of developing and selling real estate, the exempt real estate supplies would not be excluded from the denominator under the alternative method as they do not relate to a financing product.

The alternative method prescribed for use by taxable persons in this Circular does not prejudice the general rights of other businesses supplying real estate to request approval from ZATCA to apply an alternative method of proportional deduction.

Example (3):

The Bank has taxable revenues estimated at SAR 100 million, exempt revenues estimated at SAR 200 million, and additional exempt revenues relating to sales of real estate as part of financing products estimated at SAR 750 million. Under the default method, the bank's proportional deduction ratio would be as follows:

$$\frac{\textbf{SAR 100 million}}{\text{SAR 100 million + 200 million + 750 million} = \textbf{SAR 1,050 million}}$$

Accordingly, the recovery ratio under the default method would be as follows:

SAR 100 million / SAR 1,050 million = 9.5%.

Under the alternative method, the exempt revenue relating to supplies of real estate made as part of financing products would be excluded from the denominator, and the proportional deduction ratio would be as follows:

$$\frac{\textbf{SAR 100 million}}{\text{SAR 100 million + SAR 200 million} = \textbf{SAR 300 million}}$$

Accordingly, the recovery ratio under the alternative method would be as follows:

SAR 100 million / SAR 300 million = 33.3%.

6. Clarification of Real Estate Financing as a VAT Exempt Supply

The real estate financing principle is based on providing funds to the person to whom finance is provided, with many financiers providing Shariah compliant real estate financing where real estate is bought and sold as part of the financing product provided. As such, tax-exempt real estate supplies will therefore become high, and it is likely that the application of the default method of proportional discount would give a different reflection of the use of overhead costs for taxable and exempt supplies.

Therefore, any real estate financier licensed by the Saudi Central Bank that makes real estate supplies as part of a financing product can apply the alternative method referred to above after the, and such after the real estate financier submits a request to ZATCA to apply this alternative method, taking into account the time period specified in Article 51 (9) of the Implementing Regulations[5].

For the purpose of applying the alternative method, the Licensed Real Estate Financier shall meet the following:

- be a Taxable Person;
- be a Bank or a Financial entity that is licensed to provide Real Estate financing by the Saudi Central Bank; and
- make supplies of Shariah-compliant financing products that involve the purchase and sale of real estate to the recipient who is benefiting from the funding.

Where the taxable person meets the aforementioned criteria as a Real Estate Financier after October 4, 2020, the date of eligibility for using the alternative method will be the date that the taxable person met such criteria. Conversely, where a Real Estate Financier ceases to meet the aforementioned criteria (for example, due to change in its regulatory licensing), the taxable person will no longer be able to use the alternative method from the date on which it ceased to meet such criteria.

Therefore, ZATCA was keen to clarify the provisions of the law and the implementing regulations which allow the use of an alternative deduction method where the value of the exempt real estate supply can be excluded from the proportional deduction formula.

5. Article 51 of the Implementing Regulations

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