03

Governing and regulating

Oman value added tax (VAT): tax reform in the midst of a pandemic

After the UAE, KSA and Bahrain, Oman is now the fourth country in the Gulf Cooperation Council (GCC) to have introduced VAT. Aabha Lekhak describes its impact on the banking sector.

The economics of VAT in Oman[1]

Despite the challenges posed by the pandemic, Oman successfully implemented VAT with effect from 16 April 2021. The Oman State Budget of 2021 estimates the collections from VAT and excise tax for this year at over USD 1 billion. VAT is expected to be a significant contributor to Oman's GDP, which is targeted to grow by 2.3% in 2021. On the flip side, the one-off effect of the introduction of VAT is also likely to contribute to inflation, estimated to be 3.8% in 2021.

The framework

The law published on 18 October 2020 was followed by the Executive Regulations, released on 14 March 2021. While the law took effect 180 days from the date it was published i.e. 16 April 2021, like KSA and Bahrain, the implementation was staggered. Only businesses with annual supplies exceeding USD 2.6 million were compulsorily required to register with effect from 16 April 2021. Businesses with annual supplies between USD 1.3 – 2.6 million must register effective 1 July 2021, USD 0.6 – 1.3 million effective 1 October 2021, and USD 0.1 – 0.6 million effective 1 April 2022.

The filing of VAT returns as well as the payment of VAT is quarterly and due before the 30th of the month following the tax quarter.

Even though KSA increased the VAT rate from 5 % to 15% last year, Oman followed the GCC VAT Framework Agreement and introduced VAT at the modest rate of 5%, while allowing for several exemptions and zero ratings. One such exemption is for financial services.

Spotlight on the banking sector

Keeping with the global trend, margin-based financial services supplied by licensed financial institutions in Oman are exempt from VAT. These, among others, include provision of loans, extension of credit in rental or 'lease to own' transactions and issuance of financial instruments (such as derivatives, options, shares, bonds and securities) that yield interest or profit. Same supplies that are made outside Oman are zero rated.

Fee-based financial services supplied by licensed financial institutions in Oman are subject to VAT at 5%. The same supplies, if made to an overseas customer benefitting from these outside Oman, are zero rated.

Costs of irrecoverable VAT

Only VAT on certain inputs used to make taxable supplies i.e. both standard and zero rated, is recoverable. VAT on inputs used to make exempt supplies is not recoverable. VAT on certain common inputs i.e. expenses incurred to make taxable as well as exempt supplies, is only partially recoverable.

To determine the recovery percentage of common inputs, a supplier must consider the standard apportionment method i.e. ratio of taxable turnover to total turnover, or apply for a special apportionment method that reflects the actual, fair application of the inputs.

A study in the UK estimated USD 5.8 billion in irrecoverable VAT for the UK banking sector in 2017. While there is no definitive estimate of the irrecoverable VAT suffered by the banking sector in the GCC, owing to exempt supplies that account for a significant part of any bank's revenues, this number could well be eye-watering.

There is also the added compliance cost that acquisition of capital assets brings. Where capital assets are used for making taxable as well as exempt supplies, the use of these assets needs to be monitored over time and the VAT recovered on the assets needs to be adjusted to reflect the use.

Globally, banks are only able to recover a small fraction of the cost of irrecoverable VAT from customers by increasing their fee. Most of it is borne by the banks which tends to dent their profits. As banks in Oman grapple with the new VAT regime and the costs associated with irrecoverable VAT and compliance, it will be interesting to see how they manage their pricing policy in the current market.

Other challenges

Like in any other jurisdiction that introduced VAT for the first time, in the absence of sector specific guidance from the tax authorities the banking sector in Oman too faces some teething issues.

The taxability of various receipts and expenses like late payment fees, early termination fees, credit protection policy fees, and interchange fees have been, and in the absence of specific guidance, continue to be a vexed issue.

The requirement to use the average buy and sell rate published by the Central Bank of Oman (CBO) to determine the VAT liability on transactions in foreign exchange poses a practical challenge. Most banks do not use CBO rates for their transactions. Further, unlike several other countries where the central bank publishes the exchange rate at a specific time every day, the trend suggests that the CBO may publish the rate any time during business hours.

Moreover, the IT landscape in banking institutions can be complicated with multiple peripheral systems not necessarily capable of tax determination. The requirement to issue tax invoices for any supply adds to the host of system-related complications.

Coping with the evolving tax landscape

The tax landscape in Oman is becoming more complex and intricate than ever. With the same tax authority responsible for administration of corporate tax, withholding tax and VAT, the tax positions of, and tax filings by, taxpayers will have to be consistent. The tax department's role in an organization cannot be relegated to the sidelines. To practically manage tax risks and cope with the evolving landscape, organizations should integrate tax reporting into their finance and tax governance frameworks. This is particularly important as non-compliance could have penal consequences and risk reputational damage.

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Tax governance and compliance in the new normal

The year gone by has seen Oman introduce several milestone reforms. Rakesh Jain delineates key changes to tax laws that are relevant to the country's banking industry.

Recently, Oman's tax sector has seen a slew of new developments, including fiscal stability initiatives, consolidation of the state's sovereign wealth fund, strategic reorganization of ministries, enhancing social security, promotion of public private partnerships, liberalization of the foreign investment law and an economic stimulus plan to spur growth.

These were supported with a specific focus on tax policies dealing with automatic exchange of information (AEOI), legislative reforms in the tax law, international tax developments and the implementation of VAT.

Activating the AEOI

Omani banks and other financial institutions (FIs) have experienced the first two filings with the Oman Tax Authority (OTA) for the Common Reporting Standard (CRS). The second year of filing, for which the extended due date was 10 June 2021, had an increased scope of review for the CRS filing. Furthermore, the Oman income tax law has been amended to equip the Tax Authority to seek information from FIs as per the procedures prescribed therein, apart from providing penalty provisions for non-compliance.

These developments confirm the importance that the Sultanate is giving to the creation of a tax transparent environment in collaboration with other jurisdictions. It is therefore prudent for FIs in Oman to evaluate their existing governance framework, due diligence procedures, training modules for staff, and reporting methodologies including technology, to maintain the robustness of the compliance process for CRS legislation.

Recent experiences from income tax assessments

The last couple of audit cycles have seen enhanced scrutiny from the OTA for all taxpayers. Certain Omani banks had issued Tier 1 securities and claimed the interest paid thereon as a tax deduction. The Tier 1 securities are classified within equity in their financial statements. The OTA has challenged this position and Omani banks are continuing to engage with the OTA on this matter. Other key areas of focus for the OTA relate to assessing reasonability of expenses, allowability of loan loss provisions with reference to those recommended by the Central Bank, and testing the arm's length nature of related party transactions such as recharges.

From a structural reform perspective within the OTA, all tax matters (i.e. corporate tax, VAT, withholding tax, exemptions, etc.) of a particular taxpayer are now handled by a single tax inspector. We believe this will help the OTA better understand the business of the taxpayer and concurrently require the taxpayer to maintain consistency in filings across different tax obligations. The OTA is also preparing for enhanced use of technology and data analytics to undertake risk-based assessment.

International tax reforms

Oman, as a member of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) by the OECD, had committed to implementing the four minimum standards. Consequently, it introduced Country by Country Reporting (CbCR) rules late in 2020, which are applicable to banks with cross border operations. CbCR provides a snapshot of revenues, profit/loss, employees and other key matters across jurisdictions. The information shared in CbCR is coupled with the international agreement on exchange of information between tax authorities.

CbC rules required all covered tax resident entities of multinational enterprises (MNE) to file annual CbC notifications. With the first notification compliance for the year 2020 done, the CbC notification for year 2021 is due for submission by 31 December 2021. With regard to the second compliance of filing a CbC Report, the OTA recently suspended this obligation for MNE groups which have their ultimate parent entity outside Oman. However, the requirement for the Omani headquartered banks to submit the first CbC Report by 31 December 2021 remains intact.

Likewise, Oman has also decreed the international Multi-Lateral Instrument (MLI) agreement. The purpose of the MLI is primarily to address tax treaty abuse. Banks with cross border transactions will need to review their withholding tax positions, as well as financing structures which would have been adopted because of favorable tax treaty provisions.

In July 2021, 130 country members of the OECD Inclusive Framework approved a significant framework for reform of the international tax rules. It is commonly referred to as BEPS 2.0 and comprises a two-pillar approach. Pillar One focuses on the allocation of taxing rights to market jurisdictions based on a formulatory approach, and Pillar Two secures an unprecedented agreement on a global minimum level of taxation amongst jurisdictions. While Oman already has an income tax regime in place, it may be required to set the local tax rules to align with these anticipated global changes. Multinational banks with operations in the Middle East and other jurisdictions with limited tax regimes will need to adjust to the expected change in the global and regional tax rules.

The need for tax policies and governance to be future ready

Tax rules continue to evolve and widen to keep pace with international developments, as governing bodies strive to address the deficit in state finances and increase scrutiny of the tax affairs of large taxpayers and multinational organizations. Tax compliance today is not solely reliant on traditional data from management accounting, but impacts different aspects of business. Congruence in different tax filings, e.g. income tax and VAT, will be critical as we expect tax authorities to seek reconciliations and challenge organizations where gaps are observed.

Banks should prepare themselves to make use of enhanced technology initiatives, as they work on developing a broader tax risk governance framework while meeting their obligations. With the enhanced focus on transparency today, tax is expected to remain a priority on the agenda for stakeholders in the banking industry.

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The role of stringent regulatory compliance

A failure to develop and factor in regulatory expectations is a significant threat to an organization's ability to meet strategic objectives. Maryam Zaman explains why unforeseen changes to laws and regulations may derail otherwise well thought out plans.

Regulatory risk has been a major concern for financial institutions over the past few years. The global and local regulatory environment continues to become more complex, and a closer look at the results of the KPMG 2020 Global CEO Outlook survey in the banking sector indicate why regulatory risk will remain a top concern for some time to come.

The banking sector's appetite for growth remains strong, with 99 percent of survey respondents stating they intend to grow their banks geographically over the next three years. Respondents also recognized that the complexity of regulatory risk increases as banks grow and become exposed to multiple regulatory environments. As a result, they also identified regulatory risk as a threat to their organizational growth plans. A further complication is the increasing pace of change within each regulatory environment. An understanding of the current regulatory landscape is no longer enough. Instead, banks must form expectations on the regulatory trajectory and factor these expectations into expansion plans.

In Oman and the Middle East, the regulatory landscape is rapidly evolving. Over the last two years alone, local authorities have issued or revised many regulations to strengthen the banking sector, ensure financial stability, and reinforce a new round of economic growth. The CBO is in the process of drafting a new banking law and has issued various circulars and guidelines related to Islamic finance, fraud risk management, anti money laundering and combating the financing of terrorism, Omanisation, digital onboarding of customers, FinTech, measures related to Covid-19, and several other topics. On 25 February 2021, the CMA issued a decision approving the regulation for public joint stock companies based on the provisions of Commercial Companies Law of 2019.

Building robust compliance frameworks

To succeed in an environment characterized by continual change, banks must adopt compliance frameworks that are mature and flexible. Existing frameworks can be a good starting point. A well-established example is Compliance Management Systems (ISO 19600:2014).

Banks may even opt to develop their own frameworks; however, they should ensure that key elements, such as compliance risk assessments, policies and procedures, training and communications, whistleblowing and investigation, monitoring, testing, and reporting are included in their framework. In all cases, the selected compliance framework should be tailored to the bank's circumstances, strategic objectives, and growth plans. If this framework alignment is sufficiently detailed, compliance costs need not rise as the bank grows and regulations change.

Emerging market regulators, such as those in the Oman, are playing catch-up to their developed market counterparts or industry-leading practices as they seek to facilitate greater integration with the global financial system and attract foreign investment. This catch-up pattern allows banks to proactively anticipate regulatory changes by benchmarking current local regulations against those in developed markets.

Important insights into upcoming regulatory developments may be gained in this manner, particularly in areas relating to environmental protection, cybersecurity, data-privacy, and risk-based compensation. Of course, local economic and market conditions must be considered while performing such benchmarking analysis.

The compliance function itself has not escaped the attention of regulators. Several new banking regulations have introduced minimum standards aimed at ensuring the effectiveness of compliance functions.

CBO Circular BM 932 on Corporate Governance of Banking And Financial Institutions requires banks to establish an independent compliance function that that will develop necessary systems and controls, assess the impact of new laws and regulations on licensed institutions' operations and procedures and conduct periodic compliance reviews.

The CMA's 2009 Executive Regulations of the Capital Market Law require the board of directors of companies operating in securities to appoint a compliance officer to act independently from management.

The compliance officer shall report to the board of directors and the audit committee and provide advice to management on financial risks, market risks and credit and operational risks.

Formulating an action plan

Because new regulations often necessitate changes to multiple business processes, when a new regulation is issued, banks should follow the following steps:

- Update the bank's regulatory repository
- Communicate changes to the relevant stakeholders (e.g. process owners, senior management, the board, board compliance committee)
- Conduct an impact assessment of the new regulations
- Review policies and procedures across the bank impacted by the new regulation and assess whether any updates are required therein
- Identify, document and implement controls to ensure compliance with the new regulations
- Design appropriate compliance testing techniques and adjust compliance monitoring plans
- Conduct employee trainings on the new regulations, the revised bank's processes and their roles and responsibilities to ensure compliance.

Technology to the forefront

IT tools should be carefully considered when designing a compliance framework. They can help compliance functions implement complicated tasks more efficiently by supporting the maintenance and functioning of regulatory repositories, compliance checklists, and compliance monitoring plans. They can be leveraged for the automation of compliance self-assessments, provision of real-time compliance calendars, and implementation of bank-wide dashboards diagnosing the overall compliance health of the organization.

Given the pace of change and global development, coupled with Oman's drive to develop its legislative and legal framework to ensure compliance with international standards, we can expect further regulatory developments. It is vital for compliance professionals to keep themselves up to date with ever-changing legislation and regulatory guidance. The deluge of new and expanded regulations is also a signal to banks in Oman to start the process of re-designing compliance frameworks and re-thinking the way the compliance function operates, and its place within the organization. Failure to do so may lead to an exponential increase in compliance costs that can potentially reduce opportunities for growth.

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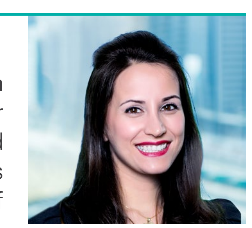

Unlocking the value of external audit

Some commentators have recently been asking what the value of an audit is. Ravikanth Petluri outlines the areas where it can add considerable value to the interests of all stakeholders, and the action that can be taken to facilitate this.

Too often, the audit is seen as a "tick-box exercise" rather than as a critical pillar in a bank's governance structure. Nowhere is a strong and effective corporate governance framework more important than in the banking sector. In the Middle East and in Oman, significant steps have been taken already, with regulations recently introduced on enhancing the corporate governance framework within banks to move towards international leading practice.

However, less widely covered is the auditors' role in the overall corporate governance framework, and particularly the role external auditors play in supporting the aims of the Audit Committee (AC).

Encouraging robust dialogue

After the global financial crisis, the Institute of Chartered Accountants in England and Wales (ICAEW) presented several recommendations on how the audit process might evolve to promote confidence in the banking system. A key finding was that the relationship between auditors and ACs plays a critical role in good governance.

In the follow-up report, Enhancing the Dialogue between Bank Auditors and Audit Committees, a working group of audit firms and banks made a number of observations on how to make the relationships work well.

The report stressed the need to strike the appropriate balance between cooperation and challenge. Whilst there is not always the need for extensive debate on judgments, engagement on these critical areas are sometimes lacking in ACs.

One of the topics most discussed with the external auditor in the AC is what is considered to be the range of provisioning judgements. It is vital the AC understands where management has positioned itself on the auditors' views of the range of acceptable and possible outcomes. There are, however, several areas of judgement that can also be debated throughout the audit cycle, rather than at the end of the year. The ICAEW suggests "if those discussions result in a changed approach, there is time to implement the change in an orderly manner".

Attendance at audit and risk committee meetings

The discussion of the audit should not be considered as merely an 'agenda item' for the AC at quarter and year ends, but as an opportunity for the external auditor to provide independent insight on matters discussed in the AC meeting. In addition, audit teams typically have significant experience across a large number of different banks; extracting and taking full advantage of that experience can provide independent insight, contributing to an enhanced audit experience.

Good practice, as recommended by the ICAEW report, is that the audit partner attends the full meetings of the audit and risk committees. Our experience indicates it is clearly advantageous to ensure timely involvement of the auditors in understanding the background of critical matters, rather than reviewing minutes months later.

The ICAEW report recommends that where there are separate audit and risk committees, the auditor also attend the risk committee where "sharing risk assessments could assist both the auditor and risk committee in performing their roles".

Increasing auditor engagement

In recent years there has been commendable progress in the areas of direct engagement throughout the audit cycle and reviews of the audit files by the CBO and Capital Market Authority (CMA) in Oman and the other regulators in the Middle East.

We would encourage more frequent bilateral, i.e. between regulator and auditor, and trilateral meetings, including the bank, to collectively create a better understanding of the audit approach taken and the work done.

Unleashing the power of data

Increasing use of Data & Analytics (D&A) is often the key to unlocking the rich information stores that businesses hold. For audits, this means D&A is providing better insight into an organization's controls and risks and enables the auditor to further challenge assumptions and conclusions.

As banks in Oman are planning to invest significantly in technology, the quality and depth of 'data pools' will be enhanced. The value of data analytics and forecasting can be vast, but only if this data is made available timely, without significant undue effort, to the auditors who have also heavily invested in resources with data analytical capabilities.

Examples of where technology has been used effectively include revaluing 100% of derivatives portfolios using special platforms, and using analytics and machine-learning technology to identify unusual trends and outliers in 100% of journal entries and loan portfolios. By obtaining this deeper understanding of data populations and focusing on higher risk transactions, audit quality can be enhanced.

The audit profession is continually improving, evolving and reacting to audit regulator challenges. However, in order to unlock the value of external audit for stakeholders, there should be collective responsibility to ensure auditors work jointly with the audit committee and regulators. The ultimate objective is the same: to contribute to the quality of financial statements that provide a 'true and fair view'.

It is an exciting phase in the development of audit — the potential for auditors to add greater and deeper value, to clients and wider stakeholders in the capital markets, is significant.

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