



APPLICATION OF VALUE ADDED TAX TO PROVISION OF COLLATERAL (LIENS (AND MORTGAGES

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TAX CIRCULAR

Subject Matter of This Circular

Upon entering into a loan agreement, a borrower will commonly provide a lien or a mortgage -a temporary transfer of a right or interest in the borrower's property- to the lender as a form of security or collateral against repayment of the loan. The property may be real estate or moveable property.

Whilst interpretations of a lien and a mortgage under individual agreements and practices may vary, these can broadly be described as follows:

- A lien is a security interest that the borrower grants to the lender for a specified term, usually until the time at which the debt is satisfied.
- A mortgage is itself a form of lien under which the borrower conveys a security interest in immovable property to the lender as security for the payment of a loan.
- A temporary transfer of title by the lender to the borrower in immovable or certain movable property as collateral for a loan is a form of security similar to a lien or mortgage.

The distinction between the different types of security interests should not affect the VAT treatment in this subject matter. This Circular refers collectively to mortgages and liens and other forms of security interests as **collateral**. This Circular discusses the application of VAT to these transactions and provides its interpretation on the Value Added Tax Act and its Implementing Regulations.

1. Collateral in the Borrower's Property

The grant of collateral in the borrower's (moveable or immovable) property does not constitute a supply of Goods and is not subject to VAT.

In many cases, the security rights transferred to the lender would not give the lender possession or the right to dispose of property (unless the borrower

defaulted on its obligations under the loan agreement). Therefore, the grant of security interests as collateral would not constitute a supply of Goods as defined under the basic principles of the GCC VAT system. For completeness, the provisions of the VAT Implementing Regulations confirm that any temporary transfer of property in these circumstances is not considered a supply of Goods in Saudi Arabia.

This interpretation also applies in cases where the formal notarized title in the property is transferred to the lender; provided the loan agreement intends this to be temporary and does not give the right of ownership or disposal to the lender.

2. Release of Collateral

Upon full repayment and at the conclusion of the loan, the lender's security interests in the property under the lien or mortgage typically are terminated.

Depending on the agreements between borrower & lender, the reversion might take place by the lender's rights expiring, or a transfer of the formal notarized title from the lender back to the borrower. In either case, the lender does not make a supply of the property for VAT purposes.

The release of collateral creates no VAT obligations for lender or borrower.

3. Transfer of Full Ownership Upon Default

In certain cases where the borrower defaults on its obligations under the loan agreement (a "default event"), loan agreements generally allow the lender to take possession to the property, or to sell the property to use as proceeds against the unpaid loan amount.

The transfer of the right of disposal in the borrower's property to the lender upon the default event means that the transfer of collateral ceases to be temporary. The

borrower therefore makes a supply of Goods for VAT purposes as a result of the default event. The application of VAT to the supply depends on the circumstances.

- **3.1. The lender takes possession of the property for its own use, or holds it as an asset for later sale**

In this case, there is a Supply of Goods (the mortgaged property) from the borrower to the lender. If the borrower is not a Taxable Person and the property was held in the borrower's private/non-economic capacityⁱ, no VAT arises on the borrower's supply.

If the borrower is a Taxable Person (or becomes a Taxable Person as a result of the saleⁱⁱ), the supply is subject to VAT.

The property forms part of the assets of the lender, and the lender will be liable to account for VAT on any subsequent supply it makes of the property in its own name.

- **3.2. The lender arranges for the sale of the property to a third party, without holding the property as its own asset**

In this case, GAZT considers that the lender arranges a Supply of Goods (the mortgaged property) directly from the borrower to the third party. If the borrower is not a Taxable Person and the property was held in the borrower's private / non-economic capacity, no VAT arises on the borrower's supply. It is not relevant in this case that the sale is arranged by a lender who is a Taxable Person.

i Refer to GAZT published guideline on Economic Activity. If the mortgaged property is real estate, please also refer to Article v)9), Registration provisions applying to specific circumstances, VAT Implementing Regulations and GAZT published guidance on Real Estate.

ii If moveable or immovable property of high value is transferred, it may cause the borrower to exceed the Mandatory Registration Threshold for VAT and be required to register

If the borrower is a Taxable Person (or becomes a Taxable Person as a result of the sale), the supply of the property is subject to VAT. The value of that supply is the total monetary and non-monetary consideration received in respect of the sale of collateral. Any deductions taken by the lender to meet unpaid loan amounts or defray costs of sale do not affect the value of the defaulting borrower's supply.

The borrower is obligated to issue a Tax Invoice for the supply and report the VAT due. If the lender is arranging the sale following default, it might also assist with compliance with the defaulting borrower's VAT obligations.

This Circular is issued by the General Authority of Zakat and Tax (“GAZT”) to provide its interpretation of the tax laws in force at the time of issuance and their application in specific circumstances. The opinions and interpretations provided in this circular are consistent with opinions provided by GAZT through tax rulings and legal clarifications. This Circular is issued for information purposes only. It should not be construed to constitute an amendment to the tax laws in force in the Kingdom. The content of this Circular does not include, or purport to include, all the relevant legal provisions relating to the subject matter. The Circular is not binding on the Authority, nor any taxpayer, in respect of any transaction carried on and it cannot be relied upon in any way.

