

## ***COMPLIANCE COST REVIEW***

### **Shari'a Compliant Financial Products**

#### **1. Introduction**

##### **1.1 Background**

In line with Government commitments to reduce the compliance burdens that are placed on businesses, HM Revenue & Customs (HMRC) assesses the likely change in compliance costs whenever a policy is introduced or changed. The results of that analysis are published in a final Regulatory Impact Assessment (RIA) when the associated legislation is laid before Parliament. Where a consultation document is published during the analysis period, it is accompanied by a partial RIA.

This document summarises the outcome of a post-implementation review of the final RIA that was published in March 2005 for the above-mentioned measure by the Inland Revenue (IR). A copy of the published final RIA can be found in the annex to this review.

This review re-assesses the compliance cost analysis published in the original RIA and addresses two main questions:

- whether the estimates of compliance costs used in the RIA were correct, with hindsight; and
- whether the processes used to estimate compliance costs were appropriate and reasonable, given the circumstances at the time.

HMRC intend to use this review to improve the RIA process, and also to assist in future policy development and evaluation work in general. As such, the emphasis is on identifying learning points for future assessment of compliance costs. The review does not revisit the original policy decision.

## **2. The published RIA**

### **2.1 Description of the policy change**

The objective of this policy change was to ensure that Shari'a compliant financial products are taxed in an equitable way to other products in order that product providers don't face commercial disadvantages. Whilst ensuring fair tax treatment for consumers of these types of products.

### **2.2 Anticipated compliance costs or savings**

In terms of costs, there should have been a saving for financial institutions (both Islamic banks and high street banks offering such products) offering Shari'a compliant products because of these changes to tax rules. However, it was almost impossible to quantify these savings (hence no figures in the RIA). The reason given for this being that for the most part these products would simply not be offered (especially in the case of high street banks) if tax treatment were not clarified. The point of this measure was to tax-enable these products, and it was thought that only time would tell how successfully banks had become at marketing these products.

With regard to other businesses (including small businesses) there should have been no new costs or savings. As it was thought that the vast majority of Shari'a compliant products marketed in the UK at that time were retail products.

## **3. Conduct of the review**

Each compliance cost review is conducted individually, and the review process is adapted to suit the particular circumstances applying in each case. The emphasis is on making sure that the review itself - and any burden of consultation - are sufficient to meet the objectives of the review, but proportionate to the likely benefits.

In this case, the review was led by an HMRC project team supported by consultants. The staff in the review team were completely independent of those involved with the original policy change.

An essential element of the review was consultation with those actually affected, and consultants were commissioned to carry out a small number of targeted in-depth interviews with some of those businesses affected by this policy change. The research was not intended to deliver any degree of statistical robustness (to do so would have been costly and impractical) but instead to provide indicative findings. Coupled with the consultants' own knowledge and expertise, this has allowed the research to identify the major issues and any associated learning points.

The external research was complemented by an internal review of HMRC paperwork and electronic files.

#### 4. Were the original estimates of compliance costs accurate?

This section addresses two main aspects – the nature of the change in compliance costs (i.e. what did people have to do differently) and the monetary impact of that change (what did it cost or save them).

Question	Comments
Were the specific types of cost and benefit identified in the RIA (e.g. reading legislation, filling in forms, updating IT systems, saving time etc.) incurred?	<p>The RIA referred to economic, social and environmental costs generally. On compliance costs it stated “It is not expected that there will be a compliance burden on business”. It also stated, however, that “There may be a cost during the transition period”.</p> <p>Generally, respondents agreed that the impact on compliance costs had been negligible, as anticipated. Transitional costs were incurred however these were thought to have been minor.</p>
Were costs/savings incurred at the expected time?	<p>The minor one-off costs of familiarisation were incurred at the expected time.</p> <p>One respondent identified that these changes have clarified the tax treatment of Shari’a financial products. This respondent felt that this resulted in a significant ongoing saving in their compliance costs as they no longer needed to seek the counsel of tax advisors about these products.</p>
Were costs/savings incurred by the expected people?	<p>To the extent that there were any costs these seem to have been incurred as expected, i.e. by financial institutions offering Shari’a compliant financial products. However as mentioned above only one respondent suggested that savings were made.</p>
Were any other costs/savings, not identified in the RIA, incurred?	<p>See previous comments.</p>
If the type of costs/savings varied from the original estimates, why was that?	<p>Costs did not quantifiably vary from the original estimates.</p>
Could such variances have been	<p>Not applicable.</p>

foreseen at the time?	
What is the assessment now of the total value of costs and savings?	Respondents believed that there was a negligible compliance cost associated with this policy change.
If different from the original RIA, what has caused the discrepancies?	There were no material variances between actual costs and those estimated in the RIA, i.e. "negligible".
With hindsight, were the compliance cost estimates accurate?	Based on the respondents' experience, the estimates appear to have been correct, i.e. negligible.  The lack of detailed analysis in the RIA also appears to have been reasonable on the basis that respondents confirmed the impact on business had been very limited.

#### 5. Was the process used to estimate compliance costs reasonable?

Irrespective of whether the analysis turned out to be correct, the review has considered whether the original analysis was completed in a reasonable way.

Question	Comments
Who worked on the original RIA?	This RIA was completed by tax policy experts, analysts and Better Regulation advisors. No problems have been identified.
Was an adequate audit trail maintained?	There is a good audit trail. Information on compliance costs specifically was limited, but that is to be expected given the negligible impact of this policy change.
Was Cabinet Office and/or internal HMRC guidance on RIAs followed correctly?	Yes. There is evidence that the policy experts were instructed on the correct RIA procedures to use by the Better Regulation advisors.
How much effort was devoted to compliance cost estimation, and was that effort proportionate in the context of the policy measure?	The amount of effort devoted to determine the compliance cost estimate for this impact assessment certainly appears to have been proportionate in the context of this policy change.

	The RIA made it clear that these costs would be small but not quantifiable. As these products would generally not be available without this policy change.
Were the right people (both internal and external) consulted, and were their views reflected appropriately?	Yes. Externally, interested parties from the accounting, legal and banking professions as well as from the Muslim community were informally consulted about these changes. Their views being taken onboard in the final version of the RIA. Internally a wide range of analysts, policy owners and Better Regulations advisors were also consulted about this RIA.
Did those who were consulted when the RIA was written express views on the reasonableness of the process?	Those who responded to the consultation welcomed this change in legislation but did not comment on the reasonableness of the process.
Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the process?	Respondents agreed that the RIA process was reasonable in this particular case.
Were compliance costs estimated for all options mentioned in the RIA?	The effects of each of the three options. Do nothing, extra statutory concession or legislation was discussed in detail in the RIA. However, no actual estimates of compliance costs appeared in the final RIA.
Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?	As the changes mainly impacted one discrete group, i.e. financial institutions, it was unnecessary to consider different groups separately. As the market develops future Impact Assessments may need to look into any emerging definable groups.
Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?	Departmental economists were consulted appropriately throughout.
Was there sufficient time to produce a robust assessment of compliance costs?	Yes but the costs for this were not quantifiable.

Were any assumptions reasonable, given the circumstances at the time?	There were few assumptions made in the RIA and none of the respondents made specific comments about these when questioned.
Were any estimates of compliance costs caveated appropriately?	The RIA included caveats such as “not anticipated” and “unlikely” in referring to potential savings/costs. Respondents generally considered these caveats to be appropriate in the circumstances.
Were any risks correctly identified, addressed and explained?	Respondents believed that the issues had been correctly identified and assessed in the RIA and did not query any RIA comments on risk.
Were any disagreements identified and reflected appropriately (e.g. if the figures were disputed by businesses, or if more than one set of figures was available)?	There is no record of any obvious disagreements. However, the views of interested parties were taken on board in the final version of this RIA.
Would HMRC do anything differently if the exercise were repeated, and hence could the RIA process have been improved?	No evidence was identified to suggest that a change in process was required. Respondents considered the consultation process as crucial to the accuracy of the RIA, especially as this area has seen and will continue to see rapid growth.

## **6. Learning points arising from the review**

### **6.1 Learning points for future work in this policy area**

- Consultation is critical to any future work in this area.
- As this is a new and developing market respondents felt that these changes should be regarded as part of an ongoing process.
- Respondents hoped that monitoring would continue and that there would be further proposed legislative changes with a positive impact on the market.

## **6.2 Learning points for the RIA and compliance cost process in general**

- Consultation was seen as key element of any future Impact Assessments
- The respondents commented that the impact of the legislative changes should be considered at the appropriate time, i.e. soon after the changes have been made. They believe that there should be consultation before and at the time of implementation. This would allow HMRC to understand and analyse the compliance costs before and after implementation as part of one exercise.
- Respondents also thought consultancy through the introduction of a measure could avoid unnecessary compliance costs as the requirements (with HMRC's input) would be understood immediately.
- An attempt to quantify the extent of the change in compliance costs associated with each of the possible policy changes should be made. If it is not possible to quantify these costs then the impact assessment should contain detail of likely areas that would be impacted upon by each of these possible policy changes.
- More detail of what consulted stakeholders views were should appear in the final version of any published impact assessment.
- Generally there is a need for better background documentation to support the opinions/analysis used in the final version of all impact assessments.

## **7. The way forward**

Comments are invited on any aspect of this report or the wider compliance cost review programme.

The learning points are being fed into the policy development process directly if particular to one RIA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to create an action plan for HMRC to take forward to improve the RIA process and development.

## **8. Contact points for further information**

For issues relating to Corporation tax and Value added tax specifically:

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For issues relating to the compliance cost review programme generally:

Richard Bowyer  
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For issues relating to your own corporate tax affairs, please contact our Employer helpline:

Telephone: 0845-714-3143 (Mon-Fri 8am-8pm, Sat-Sun 8am-5pm).

## **ANNEX: THE PUBLISHED REGULATORY IMPACT ASSESSMENT**

### **Shari'a Compliant Financial Products**

#### **Introduction**

**4.1** This final regulatory impact assessment considers the costs and benefits of options for addressing the tax treatment of Shari'a compliant financial products. It accompanies the announcement of legislation in Budget 2005 to amend certain rules for income tax, corporation tax, capital gains tax and stamp duty land tax (SDLT). The legislation was developed in consultation with a wide range of interested parties.

#### **Purpose and Intended Effects of the Measure The Policy Objectives**

**4.2** The objective is to ensure that Shari'a compliant financial products are taxed in a way that is neither more nor less advantageous than equivalent banking products. The intended effect of the proposals is to allow providers to offer Shari'a compliant products without facing commercial disadvantage, and to enable customers to take up these products without encountering uncertainty or disadvantage over tax treatment.

**4.3** There are around 1.8 to 2 million Muslims permanently resident in the UK. Shari'a compliant finance is an important part of life for this faith group and the UK is committed to removing discrimination and unfair impediments. Shari'a compliant financial products are available to both Muslims and non-Muslims, so all consumers should have the opportunity to take up these products without facing undue tax barriers. The tax proposals for Shari'a compliant products apply equally regardless of the faith of provider or customer.

#### **Background**

**4.4** Shari'a law prohibits transactions that involve interest, gambling, speculation or unethical investment. The most pronounced difference between Islamic financing and existing equivalent products is the prohibition on interest. This is based on the view that it is unacceptable in and of itself for money to increase in value merely by being lent to another person.

**4.5** For customers who want to adhere to Shari'a law, this rules out financial products that result in either payment or receipt of interest, such as conventional deposit accounts and loans. However, Shari'a law does not prohibit the making of a return on capital if the provider of the capital is willing to share in the risks of a productive enterprise. Thus profit and loss sharing arrangements are considered acceptable, provided there is risk sharing.

**4.6** Islamic financial transactions are structured using contracts, or combinations of contracts that satisfy the requirements of Shari'a law. Some of the most common are as follows:

- Mudaraba financing, a partnership structure, consisting of one or more partners that contribute capital and a managing partner who contributes knowledge and expertise. The managing partner receives a fee for services provided. The manner in which profits are to be distributed must be predetermined.
- Murabaha sometimes referred to as mark-up or cost plus financing. The financial institution purchases the goods for the customer and re-sells them to the customer on a deferred basis, adding an agreed profit margin. The customer then pays the

sale price for the goods either in instalments or one lump sum at the end of the period.

- Ijara, the Islamic equivalent of a conventional lease. There are several variations on this structure.

**4.7** Financial institutions in the UK are now offering Shari'a compliant products that are economically equivalent to conventional banking products but do not involve interest or speculative returns. The first Shari'a compliant mortgage product in the UK was offered in 1997. Before legislation in 2003 to remove the double payment of stamp duty land tax on such products, however, the size of the market was limited and there were no other providers.

**4.8** In recent years there have been a number of prominent developments in the UK Islamic finance market, and there is now considerable interest in developing and marketing a wide range of products. Shari'a compliant current accounts, savings accounts, and house purchase facilities are now available. All deposit takers must be authorised and regulated by the Financial Services Authority (FSA).

**4.9** The tax treatment of Shari'a compliant financial products is in some areas uncertain and in others produces anomalous results. These anomalies can put providers of Shari'a compliant products at a commercial disadvantage. Customers may also suffer a disadvantage if financial institutions have to charge proportionately more for Shari'a compliant products.

**4.10** In 2003, reforms to modernise SDLT included two reliefs for Alternative Property Finance. These reliefs are used by providers and users of Shari'a compliant financial products who wish to structure property finance so as to avoid the payment or receipt of interest. To achieve this end, Shari'a compliant property finance products had been developed, but they involve a series of chargeable land transactions that are not necessary under conventional mortgage structures. It was these additional land transactions that the Government sought to relieve from SDLT.

**4.11** This legislation removed the possible double imposition of SDLT on a house purchased using two Shari'a compliant financial products. Legislation was not tied to the Qu'ran or the Islamic faith, but used intrinsic features of the underlying contracts under UK law to define the transactions to which the rules apply. Reaction from the Muslim community to the reliefs has been positive and the legislation is being reviewed in light of further developments and growth in the Shari'a compliant finance market.

### **The Risks Being Addressed**

**4.12** A number of issues have emerged concerning income tax and corporation tax. For example, where a Shari'a compliant savings account operates under a Mudaraba contract, the return to the customer is initially based on a pre-determined division of profits. As such, under current UK tax law the return is treated in the same way as a dividend from a UK company and needs to be included in the customer's income tax return as such.

**4.13** The financial institution would be unable to treat the payment as a deduction for corporation tax purposes. Since the tax treatment of the bank in some cases depends on the tax position of the customer, it can be difficult for the bank to comply with its tax reporting obligations.

**4.14** The customer's tax position can also be quite different to that of a customer with a savings account in a conventional bank. For example, there would be no tax deducted at source that non-taxpayers and taxpayers due to pay tax at the lower rate (10 per cent) could reclaim (tax is deducted at source from savings income at 20 per cent). Customers could also have problems in filling in their tax return.

**4.15** Tax problems also occur in the finance of business asset purchases. Under a Murabaha contract, the financial institution purchases the asset for the customer and re-sells to the customer, adding an agreed profit margin. As the institution adds a profit margin rather than charging interest on a loan, the customer may be unable to get full tax relief for the cost of buying the asset.

**4.16** With regard to stamp duty land tax, there are currently two reliefs that relate to Shari'a compliant products, which were introduced in 2003. The first relief relates to Ijara products. The relief allows financial institutions to buy property and then lease it to the individual who pays rent and simultaneously makes capital repayments. The property passes to the individual at the end of the agreement. Without relief this product would incur stamp duty land tax twice and potentially lease duty. There is also a relief for Murabaha products. This allows financial institutions to buy property and then sell it on immediately to an individual at a higher price. The financial institution then accepts deferred payments of the purchase price.

**4.17** Since 2003, there has been significant growth and development in the Islamic finance market with the result that some problems not envisaged at this time have since emerged. In particular the relief for Ijara products is currently difficult to use in Scotland. In Scotland residential leases are limited to a maximum of 20 years, but standard securities (the equivalent of mortgages) are generally 25 years or more. For Ijara products it is necessary for there to be a lease for the entire period of the arrangement, which needs to be 25 years to make it equivalent to a standard mortgage.

**4.18** In Scotland there are 43,000 Muslims of whom approximately 65 per cent are homeowners. This group has hitherto not had access to Shari'a compliant mortgages. Offering Shari'a compliant mortgages, which incur the same level of stamp duty land tax, will offer Muslims and others in Scotland a greater degree of choice and flexibility.

**4.19** A further problem exists with a product known as Diminishing Musharaka, a subset of Ijara. With a Diminishing Musharaka product, beneficial ownership is explicitly transferred to the individual during the term of the lease. This means it falls outside the scope of the existing relief, which required the financial institution to hold the 'interest' in the property until it finally reverts to the individual.

**4.20** Extending the relief to this product will further enhance the capability of providers of Shari'a compliant financial products to offer a wider range of choice to consumers. Consumers in turn will be better placed to find a product that meets their needs.

**4.21** Regulation of financial services is important in providing consumer protection and an orderly market. Clarification of tax treatment and the removal of tax disadvantages should encourage product development within the UK regulated sector.

## **Options**

### **Do Nothing**

**4.22** This would not address the potential unfairness and uncertainty outlined above, and would not encourage the provision of Shari'a compliant financial products by the regulated market. There is a risk that if no action is taken, such products might develop in an unregulated market.

### **Extra Statutory Concession**

**4.23** An Extra Statutory Concession (ESC) could potentially address the problem in the short-term by alleviating the clearest anomalies whilst permanent solutions are developed in legislation. This allows more time to develop long-term solutions in what is still a fast developing area. However, this would provide only a temporary solution and could not address areas where current tax treatment might have conferred an advantage for one party on Shari'a products. It would not offer a structural solution capable of giving a clear framework for the future development of new products.

### **Legislative Solutions**

**4.24** After internal analysis and consultation, the preferred way forward is to recommend a legislative solution. However, the precise form of the legislation requires careful consideration to fit with existing tax law for financial products and the UK's responsibilities under its network of taxation treaties. In consultation it emerged that it would not be possible to address all tax issues affecting the development of Shari'a compliant products with a single piece of legislation. Therefore it was agreed to establish a forum to evaluate progress achieved and continue to work towards solutions on outstanding issues after Finance Bill 2005.

## **Business Sectors Affected**

### **Financial Institutions**

**4.25** The pace of market developments in the UK since the legislation on SDLT in 2003 suggests that a large number of financial institutions will be interested in developing a range of Shari'a compliant products once greater clarity is brought to the question of tax treatment, and will benefit from enhanced flexibility in development and marketing.

### **Small Businesses**

**4.26** Initially, most of the Shari'a compliant products currently in development will be geared towards retail customers. However, Shari'a compliant business products are already being developed, and banks have shown interest in expanding into this area. Over time a significant proportion of the customer base for providers of Shari'a compliant financial products is likely to be Muslim run small businesses who wish to comply as far as possible with the provisions of Shari'a law. At present, they may face difficulties in reconciling this obligation with securing necessary financial access.

### **Issues of Equity and Fairness**

**4.27** The proposal seeks to address an existing inequality in the tax treatment of Shari'a compliant financial products, and to promote fairness by contributing to the Government's financial exclusion and asset saving objectives.

**4.28** The Government is committed to working together with financial services providers to achieve a reduction in the one in twelve households in the UK who lack access to a bank account of any kind. Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and loans.

**4.29** The Government is also seeking, through measures such as the Saving Gateway and Child Trust Fund, to provide targeted support and incentives for saving. Evidence suggests that on average British Muslims have less access to and uptake of financial services than the majority of the population. Part of the reason for this may be the lack of provision of Shari'a compliant products.

**4.30** Applying the tax law as it currently stands would leave in place a real inequality since the tax treatment would not always reflect the economic purpose of the transactions. For example, Islamic banks may be at a commercial disadvantage to conventional banks in that they cannot always deduct the cost to them of obtaining funds against the profit that they make from providing funds to their customers.

**4.31** Customers could suffer if providers have to charge proportionately more for their products than conventional banks, although some may be better off overall if in some circumstances they would pay less tax on the equivalent product from a conventional bank.

**4.32** There are close links between providers of Shari'a compliant financial products and the ethical investment market. Many of the concerns of this customer base are mirrored in the concerns of banks' Shari'a supervisory committees, for example the prohibition of investment in alcohol, tobacco, gambling, or financial institutions dealing in interest. Investment markets benefit from growth in liquidity and transparency.

**4.33** Moves towards removing possibly disadvantageous tax treatment for Shari'a compliant products will extend product flexibility and consumer choice. They may also have the effect of encouraging investment in banks advertising themselves as ethical.

## **Benefits**

### **Economic**

#### **Do Nothing**

**4.34** No real economic benefits could be expected from applying existing tax law to new Shari'a compliant products. There could be a real risk of customers turning to products developed outside the UK, or to products developed outside the regulated sector, and continued tax uncertainty would be likely to hinder further product development and innovation.

#### **Extra-Statutory Concession**

**4.35** This would have offered a short-term benefit by allowing current businesses to go ahead on an agreed basis, but does not offer a long-term stable platform for development.

#### **Legislative Solution**

**4.36** The clarification of tax rules has the potential to encourage development of Shari'a compliant financial products within the UK. This should in turn generate investment, jobs and tax revenues in the UK economy. The emergence of a thriving and competitive market in Islamic finance products could substantially benefit London as a global financial centre.

**4.37** Some customers for these products may at present be in an uncertain position over their tax position, and others may find themselves in an untaxed environment. Legislative changes would put everyone on an equal footing.

**4.38** The primary policy objective is to remove an existing inequality that derives from the inapplicability of existing legislation to the taxation of Shari'a compliant financial products, and to offer genuine choice to consumers wishing to take up these products. The Exchequer effect in the short term is expected to be minimal, but potentially positive in the long-term if more institutions offer such products, if the existing product range is expanded, and if the customer base continues to expand.

## **Social**

### **Do Nothing**

**4.39** It is unlikely there would be any social benefits from this course of action.

### **Extra Statutory Concession**

**4.40** An ESC could provide a limited social benefit by allowing one bank to offer Shari'a compliant products in the short-term without tax disadvantage, thus potentially widening financial access for the bank's customer base. However, since the measure would have been very limited, it is unlikely that it would contribute significantly towards longer term social issues.

## **Legislation**

**4.41** Continued difficulties with the development of Shari'a compliant products has the potential to cause difficulty and frustration for the UK Muslim community. There are clear social benefits in the wide availability of well-defined, well-regulated financial products in all sections of the community.

## **Environmental**

**4.43** None of the options are expected to have any significant environmental impact.

## **Costs**

### **Economic**

#### **Do Nothing**

**4.44** There would be continued economic cost from this option. Financial institutions offering Shari'a compliant products would have to operate at a commercial disadvantage with the result that profits may be affected. Without the removal of existing uncertainties over the tax treatment of Shari'a compliant financial products, it is unlikely that there would be a great deal of incentive in offering them amongst high street financial institutions.

## **Extra Statutory Concession**

**4.45** An ESC might allow institutions offering Shari'a compliant financial products to operate profitably in the short-term but would not remove uncertainty in the longer term.

**4.46** As a concession, it could apply only to the party to the transaction who was disadvantaged by it. An ESC cannot impose a tax charge on a party who was better off. This could have opened up scope for avoidance by parties setting up deals to take advantage of this mismatch.

## **Legislation**

**4.47** It is unlikely that legislation will have a significant negative Exchequer impact.

**4.48** For example, with regard to the changes to SDLT, Muslim homeowners in Scotland have been paying SDLT normally on house purchases. Offering Shari'a compliant mortgages which do not give rise to a different level of SDLT will not result in any significant change in revenue. Similarly, the cost of extending the relief to the Diminishing Musharaka product should be nil for the same reasons.

**4.49** Legislation will not be tied to the Qu'ran or the Islamic faith, but rather use intrinsic features of the underlying contracts under UK law to define transactions to which the rules will apply. As always, the possibility of abuse has to be considered. The legislation will therefore contain safeguards to prevent it being used for avoidance.

**4.50** There is some operational impact on the Inland Revenue, who will have to ensure that systems for monitoring, reporting and auditing the deduction of tax at source are able to cope with these financial products. Tailor-made guidance, forms and letters will also be needed. However, it is not anticipated that the impact and cost will be substantial.

## **Social**

### **Do Nothing**

**4.51** Failure to act would unfairly inhibit the activities of providers of Shari'a compliant financial products. It is unlikely that these products will be widely offered if the existing tax uncertainties are not addressed, with the result that any possible contribution towards financial inclusion and savings and asset objectives would be very limited. Informal provision of finance may continue on a similar scale as before.

## **Extra Statutory Concession**

**4.52** This option would demonstrate the Government's serious consideration of the issues, but since longer-term uncertainties would remain, the social benefits in terms of greater inclusion and/or asset ownership are likely to be limited.

## **Legislation**

**4.53** The social costs of legislating to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products are minimal. The main risk is that the legislation will not address 100 per cent of the tax issues for 100 per cent of the products offered, so that some uncertainties (and the need for ongoing legislation in the future) remain.

## **Environmental**

**4.54** None of the options are expected to result in significant environmental costs.

## **Small Business Impacts**

**4.55** The current focus of existing Shari'a compliant financial products is the retail market (retail mortgages, personal loans, current and savings accounts etc.). However, research suggests there are a very large number of Muslim small businesses in the UK with a potential demand for Shari'a compliant business products. Successful trials of these products, together with the Government's commitment to legislate to remove inequality and uncertainty, could well lead to the development of a range of products geared towards small businesses. Such products would allow them to reconcile faith commitments with more secure access to finance.

## **Competition**

**4.56** A competition assessment has been undertaken and the competition filter indicated that legislation to address current uncertainty and inequality in the tax treatment of Shari'a compliant financial products should not have any significant adverse effects on the competitive processes in the financial services market.

**4.57** The major affected market will be the banking sector – both those institutions offering solely Shari'a compliant financial products and high street banks with an interest in offering such products alongside (albeit ring-fenced from conventional investments) conventional banking products. A number of other providers offer or are planning to offer alternative property finance products. There are also private membership organisations, which offer interest-free loans (financed by membership fees) and housing finance.

**4.58** In terms of competition, do nothing would have had no obvious positive consequences. Given the uncertainties and commercial disadvantages that would remain for providers of Shari'a compliant financial products, this option could have negative competitive consequences by restricting the profitability of offering such products, perhaps enabling only those banks willing to fund Shari'a compliant operations from other areas to compete in the marketplace.

**4.59** Extra statutory concession would have some competition enhancing effects by allowing providers of Shari'a compliant products to offer them without tax disadvantage. But given that long-term uncertainty would not be removed, it is unlikely that there would be much interest amongst other potential providers to offer these products. The effect of this option might therefore have been to restrict competition.

**4.60** Legislation could have significant positive consequences for competition. If legislation to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products is successfully introduced, it is likely that there will be considerable interest amongst other financial institutions, both mainstream and those offering solely Shari'a compliant products. Customers (not necessarily Muslims alone) will be offered a greater degree of choice since they should not have to pay disproportionately more for Shari'a compliant than for conventional banking products.

**4.61** The overall effect should therefore be to encourage an expansion of both the range of financial products available and the number of institutions willing to offer them.

## **Securing Compliance**

### **Do Nothing**

**4.62** There could be continuing compliance difficulties as the banks may have difficulties in meeting their reporting requirements because of the uncertain tax position of their customers.

### **Extra Statutory Concession**

**4.63** An ESC could only enable the tax position of the disadvantaged party to be addressed. Some transactions might result in one party being advantaged, leaving scope to avoid potential asymmetries.

### **Legislation**

**4.64** Legislation should provide a clear framework for providers to meet their reporting requirements and should therefore have a beneficial impact on compliance. The legislation will apply the reporting obligations and compliance provisions that apply to the tax deduction scheme for bank and building society interest.

### **Review, Monitoring and Evaluation**

**4.65** Finance Bill 2005 legislation on Shari'a compliant financial products will build on the measures taken in Finance Bill 2003 on stamp duty land tax and is expected to make a significant contribution to the facilitation of product development and the extension of consumer choice. Given the complexity of some of the issues involved, and the dynamic nature of the market in Shari'a products, it is proposed to establish a longer term review mechanism to analyse the effectiveness of this legislation and monitor market developments.

**4.66** Measures announced in this Budget address potential problems in the tax treatment of Shari'a compliant products relating to the rules for income tax, corporation tax, and stamp duty land tax. Complications with other taxes, for example VAT, may arise in the future. This could lead to problems in financing purchase of products such as cars and/or business properties (on which VAT is chargeable). Because VAT is a European tax, a solution is likely to take longer and may have to be found at the EU level.

**4.67** There are currently two broad types of Shari'a compliant home purchase arrangements available in the UK: Murabaha and Ijara. On 31 October 2004, the Financial Services Authority (FSA) assumed responsibility for the regulation of mortgages, including mortgage backed equity release products and Murabaha. However, neither home reversion plans nor Ijara products fall within the framework of financial services set out by the Financial Services and Markets Act 2000 (FSMA) and are therefore not within the scope of FSA regulation.

**4.68** The Government recently consulted on whether Ijara products should be included in the legislation to bring home reversion products into FSA regulation and the majority of respondents agreed that they should. Legislation to bring Home Reversion schemes into the scope of FSA regulation will be brought forward as soon as Parliamentary time allows.

**4.69** The market in Shari'a compliant financial products is extremely dynamic, with the result that, providing the Financial Services Authority (FSA) gives approval, a range of new products are likely to be offered in the UK marketplace over the next few years. Given that legislation can only apply to the underlying contract in each transaction, some products (if

they involve new forms of contract) will require legislation to remove inequality or uncertainty in tax treatment.

**4.70** A review mechanism has been established to identify: the extent to which legislation has or has not succeeded in its objectives; the uptake of Shari'a compliant financial products by UK Muslims and other interested parties; remaining discrepancies in the tax treatment of these products; and the development of new Shari'a compliant financial products. Contact details will be made available for interested parties to express their views and request information.

## **Consultation**

**4.71** A process of informal consultation with providers and users of Shari'a compliant financial products and a wide range of interested parties, including representatives of the accounting, legal and banking professions, as well as a number of UK Muslim organisations, is ongoing.

**4.72** A consultation seminar to discuss Shari'a compliant products in relation to tax issues was held at HM Treasury in January. This was well attended and provided a useful platform for further contact with interested parties. Following the outcome of this meeting, a number of technical expert groups have been formed. These will continue to meet to monitor progress and outstanding issues.

## **Contact Point**

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