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ALTERNATIVE FINANCE PRODUCTS

INTRODUCTION

4.1 This final regulatory impact assessment considers the costs and benefits of options for addressing the tax treatment of sukuk. It is also concerned with a minor clarification to the alternative finance arrangement legislation in Finance Act 2006. It accompanies the announcement of legislation in Budget 2007 to amend certain rules for Income Tax, Corporation Tax, Capital Gains Tax, and Stamp Duty Land Tax (“SDLT”).

PURPOSE AND INTENDED EFFECTS OF THE MEASURE

4.2 Alternative methods of finance, structured in a way that does not involve interest, were not conceived of when most tax law was drafted. As a result the tax treatment of some alternative finance products is inconsistent or uncertain when compared with conventional finance products.

4.3 Since 2003 legislation has been introduced to ensure that the tax treatment of alternative methods of finance is made certain and is, as far as possible, neither more nor less advantageous than that of equivalent financial products. This gives those people and entities wishing to utilise alternative finance products the ability to do so without being disadvantaged because of tax.

4.4 There is currently legislation enabling the provision of alternative methods for an individual or business to finance a property purchase, bank deposits and borrow money from a financial institution. The focus has moved to the issue of sukuk.

Background

4.5 The demand for alternative finance products comes mainly from Muslims, although they may be used by any consumer. Islamic (or Shari’a) law prohibits transactions that involve interest, gambling, speculation or unethical investment.

4.6 The most pronounced difference between Islamic financing and existing equivalent products is the prohibition on interest. For customers wishing 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 shared risk.

4.7 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.

- 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.
- Musharaka financing, a partnership agreement. A common form is diminishing musharaka where the partners jointly acquire an asset. The financier's share of the asset decreases through periodic payment containing elements of capital repayment and rent from the other partner, who eventually becomes the sole owner.
- Ijara, the Islamic equivalent of a conventional lease. There are several variations on this structure, one important form being ijara wa'iqina. Ijara wa'iqina is similar to a hire purchase agreement; the financial institution buys goods, rents them to the customer and transfers the goods to the customer in exchange for a defined terminal payment.
- Wakala, a form of agency agreement. The financial institution promises a return to the investor. The financial institution keeps any return over and above that which has been promised to the investor as their agency fee.
- Sukuk, which is at its simplest a certificate (sakh) that evidences a share in the beneficial ownership of particular assets. The holder of the certificate is paid a return that is their share of the income generated by the assets. The issue of the sukuk obtains funding and can 'securitise' assets.

4.8 Financial institutions in the UK are now offering Shari'a compliant alternative finance products that are economically equivalent to conventional banking products but do not involve interest or speculative returns.

4.9 In 2003, reforms to modernise SDLT included two reliefs for Alternative Property Finance.

4.10 The first concerned a series of chargeable land transactions that are not necessary under conventional mortgage structures, and the reform relieved those transactions from SDLT.

4.11 The second removed the possible double imposition of SDLT on a house purchased using two Shari'a compliant financial products.

4.12 Further reforms in 2005 and 2006 concerned:

- savings products (including mudaraba and wakala);
- asset finance (murabaha and musharaka products);
- SDLT (lease based mortgages); and
- Child Trust Funds.

4.13 A Regulatory Impact Assessment for the 2006 changes was published in March 2006 <http://www.hmrc.gov.uk/ria/ria-alt-finance.pdf>

Rationale for Government Intervention

4.14 The tax treatment of the issue of a sukuk based upon 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. Whereas conventional mortgages can be securitised and the tax treatment certain. A securitisation of a conventional mortgage book enables the financial institution to expand its lending capacity whilst complying with the current Regulatory regime for lenders. Tax uncertainty is one factor that prevents providers of alternative finance products from issuing sukuk based on their portfolio of alternative finance products. This restricts the market for alternative finance products by preventing the financial institution from expanding its lending capacity.

4.15 A number of issues have emerged from further consultation with representatives from the community, professional advisors and financial institutions since the changes made in Finance Act 2006. Taking these forward it is proposed to make the following changes in Finance Bill 2007.

- Ensure that the current uncertainty on the tax treatment of sukuk resolved.
- Clarify the tax treatment of wakala based products to ensure that the income arising from such products is taxed on the correct person.

CONSULTATION

Within Government

4.16 The risks to be addressed are issues of taxation; consultation has therefore taken place within HM Treasury and HMRC as the two departments involved with tax policy.

Externally

4.17 HM Treasury and HMRC have continued the process of consulting informally with consumers and providers of alternative finance products. A technical working party involving banking, legal and accounting professionals has been formed to look at the direct tax treatment of alternative finance returns. This group has been informally consulted regularly throughout the last year, the last meeting of the working party being on 4 October 2006, although informal discussions have taken place since then.

OPTIONS

Do Nothing

4.18 This option will leave the risks and uncertainties set out above in place, disadvantaging those financial institutions who wish to offer alternative finance but are unable to securitise current financial assets. Islamic banking is a worldwide growth area – tax barriers will restrict the competitiveness of UK institutions (or UK branches of overseas banks) that wish to offer Shari'a compliant products.

Legal Opinion

4.19 Seeking a legal opinion of the tax treatment of each product seen and publishing it with guidance. This would remove any uncertainty over how much tax the parties were liable for and enable commercial decisions to be made about whether or not to proceed. However, this is only a temporary solution as products will need to be considered on an ad hoc basis and does not address the issues arising when an anomalous tax treatment is found.

4.20 As legal opinion can only be sought on existing products, this solution cannot address the need to provide a clear framework for developing new products for the UK market.

Legislation

4.21 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. We shall therefore be continuing the consultation process through to Budget 2008.

COSTS AND BENEFITS

Sectors and Groups affected

4.22 These issues affect two main groups:

- Financial institutions; and
- Muslim consumers and businesses wishing to invest in Shari'a compliant products.

4.23 Financial institutions offering Shari'a compliant products currently within the alternative finance regime will be disadvantaged because of the uncertainty over the tax treatment of any sukuk issued on the basis of such products, whereas the securitisation of conventional financial assets, such as a mortgage book will have certainty of tax treatment. If financial institutions are unable to securitise their Shari'a compliant financial assets this may restrict the ability of the financial institutions to offer such products.

4.24 Initially, Shari'a compliant products were geared primarily towards individuals this has now been extended to businesses. If tax uncertainty restricts the ability of financial institutions to issue sukuk based on Shari'a compliant financial assets within the alternative finance regime then this will similarly restrict the funding available to Muslim consumers and businesses for property purchases.

4.25 The issue of a sukuk provides an opportunity for Muslim individuals and businesses to invest in a Shari'a compliant product. Resolution of the tax uncertainty surrounding a sukuk issue will encourage Muslim investors to purchase sukuk certificates.

Benefits

Do nothing

4.26 There are no appreciable benefits of this option. This option will do nothing to address the underlying tax problems set out above and will therefore be of no benefit to the financial institutions who offer alternative financial products nor to customers and businesses that require them.

Legal Opinion

4.27 Providing legal opinions on individual products would offer limited benefits. It would offer some certainty over the tax treatment, but it is not a judgment so has no legal force. The issue of a sukuk also involves complex non-tax issues, such as trust law. In addition other sukuk issues with the same economic effect often have quite different legal structures and wordings. It is possible that products whose economic effect if the same could therefore have quite different tax treatments.

Legislation

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

4.29 The primary policy objective is to remove existing inequalities that derive from the inapplicability of existing legislation to the taxation of alternative 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, are able to securitise those products in a sukuk and so enabling the financial institution to provide further funding for their customer base.

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

4.31 It is reasonable to expect that the development of a regulated Islamic financial sector in the UK would bring into the regulated environment financial transactions that may currently be taking place without any significant regulation or consumer protection.

Costs

Do nothing

4.32 Failure to act would not remove the uncertainties that inhibit the securitisation of Shari'a compliant products. It is likely that the market for sukuk will be constrained partly because of the tax issues involved with the result that any possible contribution towards financial inclusion and savings and asset objectives would be very limited.

4.33 There would be continued economic cost from this option. This could prevent financial institutions offering Shari'a compliant products or, for the major banks, locating their Islamic banking operations outside of the UK. In addition uncertainty over the tax treatment of sukuk issues would prevent the UK becoming a global player in the sukuk market.

Legal Opinion

4.34 Legal opinions might allow institutions offering sukuk issues to operate with certainty in the short-term with regard to specified issues but would not remove uncertainty in the longer term as products will need to be considered on an ad hoc basis. This option also cannot address the issues arising when an anomalous tax treatment is found.

4.35 This option would demonstrate the Government's serious consideration of the issues, but as legal opinion can only be sought on existing products, this solution cannot address the need to provide a clear framework for developing sukuk issues in the UK market.

Legislation

4.36 The social costs of legislating to remove inequality and uncertainty in the tax treatment of sukuk issues are minimal. This is however an evolving market. We already aware that sukuk issues are being considered and developed, that may well need further legislation. The main risk is that, by raising customer expectations, HMT and HMRC will face continuing demands for further legislation as financial institutions develop more sophisticated Shari'a-compliant products that are not covered by existing provisions.

4.37 It is unlikely that legislation will have a significant Exchequer impact. For example, with regard to the changes to SDLT, the issues surrounding the tax treatment are discouraging sukuk issues based on Shari'a compliant property finance. Offering sukuk issues which do not give rise to a different level of SDLT will not result in any significant change in revenue.

4.38 Legislation will not be tied to the Qu'ran or the Islamic faith, but rather uses 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.

4.39 It is not expected that there will be a compliance burden on business. There may be a cost during the transition period as advisors and financial institutions adjust to the new regime. However as the regime will only apply to financial institutions and investors issuing or holding sukuk any transitional costs will be limited.

4.40 There is some operational impact on HMRC. Amended guidance will be needed and advice may be requested by financial institutions on the tax treatment of a sukuk issue in a similar way advice may be requested on a securitisation. However, it is not anticipated that the impact and cost will be substantial.

SMALL FIRMS IMPACT TEST

4.41 Initially most of the alternative finance products developed were geared towards individuals however over time a significant proportion of the customer base for providers of alternative finance products is likely to be Muslim proprietors of small businesses who wish to comply with the provisions of Shari'a law.

4.42 These measures, although not aimed directly at small businesses will enable financial institutions to continue to offer and potentially expand finance to customers requiring Shari'a compliant financing.

ENFORCEMENT, SANCTIONS AND MONITORING

4.43 These are positive measures for affected parties which allow consistent tax treatment. Avoidance disclosures will be monitored to identify, and where necessary act on, any attempt to use alternative finance arrangements for avoidance purposes.

4.44 The success, or otherwise, will be monitored on an ongoing basis through discussions with financial institutions and their advisors at the existing technical group meetings; any issues which arise will be addressed in a proportionate manner.

IMPLEMENTATION AND DELIVERY PLAN

4.45 The policy will be implemented by legislation to be included in the Finance Bill 2007 and by guidance to be published by HMRC.

ADMINISTRATIVE BURDEN

4.46 The cost is negligible. The aim of the policy is to provide an agreed tax structure and understanding within which sukuk can be taxed within the UK. There will be a small administrative burden placed on financial institutions and companies wishing to utilise the new legislation, as they will need to adjust to and understand the new regime, just as the securitisation regime. This will be more than balanced out by the benefits that the legislation brings through enabling financial institutions to securitise their Shari'a compliant products and providing certainty to investors wishing to purchase sukuk.

POST-IMPLEMENTATION REVIEW

4.47 There are plans to conduct a survey of financial institutions and alternative finance consumer groups (e.g. Muslim Council of Britain) at an appropriate juncture to check the awareness of alternative finance products in the market and whether there are any further taxation issues which hinder the adoption of alternative finance products.

4.48 Ongoing informal review, through the existing technical group meetings, of the legislation allowing early consideration of any problems will continue.

SUMMARY AND RECOMMENDATION

Table 4.1 Summary costs and benefits table

Option	Total benefit per annum: economic, environmental, social	Total cost per annum: - economic, environmental, social - policy and administrative
1	None	Unfairly restricts the business of Shari'a compliant financial services.
2	A Legal opinion will allow institutions to offer products with certainty over how HMRC will treat them for tax It will allow wider access to finance from the regulated sector.	This option will carry a small administrative burden to HMRC. There is a risk that a court may disagree with any legal opinion. There are likely to be future costs of finding a long term solution
3	Enables a level playing field for tax purposes. Indirectly promotes financial inclusion. Promotes competition in the financial sector. Provides a framework and precedent for future work in this area.	Small administrative burden to HMRC. Legislation will need to be updated to reflect further innovations.

4.49 The market for alternative finance products has the potential to be very large, but current providers of alternative finance products are rendered uncompetitive with other financial institutions due to the tax treatment of sukuk products.

4.50 The market has welcomed the legislation already enacted to remove unequal tax treatment from certain alternative finance products. Informal consultation has highlighted further areas containing unequal treatment. A long-term approach is required to enable the UK to maintain its position as a global financial centre.

4.51 Legislation is therefore recommended to provide a long-term, stable, solution to the unequal treatment presently received by alternative finance structures identified.

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REGULATORY IMPACT ASSESSMENT

Alternative Finance Products

Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs

Signed by the responsible Minister:

Ed Balls
Economic Secretary to the Treasury

Dated: 13 March 2007