

Summary: Intervention & Options

Department /Agency: HMRC	Title: Impact Assessment of Sukuk (Islamic Bonds) Legislation	
Stage: Consultation	Version: 1	Date: 26 June 2008
Related Publications: The full consultation document is available at http://www.hmrc.gov.uk/consultations/index.htm		

Available to view or download at:

<http://www.hmrc.gov.uk/better-regulation/ia.htm>

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What is the problem under consideration? Why is government intervention necessary?

The Government is keen to promote the growth of the alternative finance market in the UK. In order to achieve this it is necessary to deal with certain tax barriers preventing the development of the industry. The tax treatment of the issue of a sukuk based upon Sharia'a compliant financial products is in some areas uncertain and in others produces anomalous results. These anomalies can put providers of Sharia'a compliant products at a commercial disadvantage. This particular measure addresses Stamp Duty Land Tax (SDLT) barriers to issuing sukuk.

What are the policy objectives and the intended effects?

There are two policy objectives for Islamic finance. For business we wish to establish London as a gateway for international Islamic finance. For individuals, we wish to ensure that everybody, irrespective of their beliefs, has access to competitively priced financial products and that there is equal taxation of these products. Sukuk issuance (Islamic bonds) can help achieve both of these objectives.

What policy options have been considered? Please justify any preferred option.

Two options considered: 1- Do nothing 2. Provide framework to enable a sukuk market to develop in the UK. Choosing the first would mean missing opportunities to develop Islamic finance in the UK, including addressing SDLT barriers to business and would allow tax inequality of alternative finance products to continue. The second option is preferred. The clarification of tax rules will encourage the development of the alternative finance industry. A competitive market in these products could substantially benefit London as a global financial centre, generating further investment.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

HMRC will conduct a post-implementation review within 1-3 years of introduction.

Ministerial Sign-off For Consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

Kitty UssherDate: 25 June 2008

Summary: Analysis & Evidence

Policy Option: Preferred	Description: Provide a legislative framework for Sukuk (Islamic Bonds)
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' This measure does not impose costs on business. It helps to enable businesses to offer commercial sukuk backed by property if they so choose. There is no cost to the Exchequer			
	One-off (Transition) Yrs				
	£ Not applicable		n/a		
	Average Annual Cost (excluding one-off)				
	£ Not applicable		n/a	Total Cost (PV)	£ Not applicable
Other key non-monetised costs by 'main affected groups' There are no non-monetised costs for affected groups - the only costs are transaction costs (legal services etc) for those companies who choose to offer commercial sukuk, and these costs are not imposed by this measure.					

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' This measure will enable companies to offer sukuk which will further increase the market in the UK, leading in turn to increased tax revenue. The global sukuk market has more than doubled in 2007 to exceed USD\$60bn, having grown from USD\$500m in 2001. This measure will assist with enabling the UK to attract a significant proportion of this growing market.			
	One-off Yrs				
	£ To be quantified				
	Average Annual Benefit (excluding one-off)				
	£ To be quantified		£ To be quantified	Total Benefit (PV)	£ To be quantified
Other key non-monetised benefits by 'main affected groups' The availability of commercial sukuk will help further develop the UK market in Islamic finance products, which will help develop the UK as a centre for Islamic finance, with knock on effects for the UK's comparative advantage in financial services and economic growth.					

Key Assumptions/Sensitivities/Risks

The total costs depend on the cost of sukuk issuance and the likely number of issuances. Issuance of sukuk is voluntary so the benefits will necessarily outweigh the costs. Exchequer costs likely to be minimal, subject to precise details of implementation

Price Base Year 2008	Time Period Years tbc	Net Benefit Range (NPV) £ To be quantified	NET BENEFIT (NPV Best estimate) £ To be quantified
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What is the geographic coverage of the policy/option?	UK				
On what date will the policy be implemented?	Royal Assent, FB09				
Which organisation(s) will enforce the policy?	HMRC				
What is the total annual cost of enforcement for these organisations?	£ Minimal				
Does enforcement comply with Hampton principles?	Yes				
Will implementation go beyond minimum EU requirements?	N/A				
What is the value of the proposed offsetting measure per year?	£ Not applicable				
What is the value of changes in greenhouse gas emissions?	£ Not applicable				
Will the proposal have a significant impact on competition?	No				
Annual cost (£-£) per organisation (excluding one-off)	<table style="width: 100%; border: none;"> <tr> <td style="width: 25%; text-align: center;">Micro 0</td> <td style="width: 25%; text-align: center;">Small 0</td> <td style="width: 25%; text-align: center;">Medium 0</td> <td style="width: 25%; text-align: center;">Large 0</td> </tr> </table>	Micro 0	Small 0	Medium 0	Large 0
Micro 0	Small 0	Medium 0	Large 0		
Are any of these organisations exempt?	<table style="width: 100%; border: none;"> <tr> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> </tr> </table>	No	No	No	No
No	No	No	No		

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ Negligible	Decrease of £ Negligible	Net Impact £ Negligible

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

Background

This Impact Assessment covers many of the same issues that were previously addressed in the Regulatory Impact Assessment for Alternative Finance Products issued at Budget 2007.

Whilst the previous assessment only looked at the issuance of a Government sukuk, this document incorporates the issues previously raised and considers them in conjunction with the impact of a commercial sukuk issuance in the UK.

The Issue /Situation

Islamic Finance has to be compliant with Sharia'a law. In Sharia'a law certain transactions are prohibited, principally, those involving riba (interest).

Existing UK tax legislation does not provide for alternative methods of finance, structured in a way that does not involve interest. As a result the tax treatment of some alternative finance products is inconsistent or uncertain when compared to conventional finance products.

Since 2003 legislation has been introduced to ensure that the tax treatment of alternative methods of finance is made certain and, as far as possible, creates an equal playing field for equivalent financial products. This gives those people and entities wishing to utilise alternative finance products the opportunity to do so without being disadvantaged because of tax.

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 now moved to the issue of sukuk.

Sukuk may often be backed by interests in land or property as the underlying asset. In a normal securitisation the investor does not have a direct ownership share in the underlying asset but merely an interest bearing certificate, whereas in a sukuk there is the issue that the investors own part of the underlying asset.

At present a stamp duty land tax (SDLT) charge on sukuk places an additional barrier to issuance compared with a conventional equivalent. This extra charge therefore puts this structure at a considerable disadvantage relative to conventional securitisations.

Policy objectives and intended affects

No SDLT should be charged when land is sold to the issuer of a sukuk, and no SDLT charged on the leaseback of the building to the vendor. In addition the position of sukuk bondholders should be clarified to ensure that SDLT does not arise on the acquisition of a sukuk certificate.

This will enable the UK Government to achieve its aim to boost London's position as an international financial hub and encourage greater social inclusion among its two million Muslims

The Options

Do Nothing

This option will disadvantage those financial institutions that 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 Sharia'a compliant products.

Financial institutions offering Sharia'a compliant products 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 Sharia'a compliant financial assets this may restrict the ability of the financial institutions to offer such products.

There would be continued economic cost from this option. This could prevent financial institutions offering Sharia'a compliant products or the major banks locating their Islamic banking operations outside of the UK. This in turn would reduce choice to customers and therefore deny options to individuals who wished to use alternative finance products. In addition uncertainty over the tax treatment of sukuk issues would prevent the UK becoming a global player in the sukuk market.

There are no appreciable benefits to this option. This option will do nothing to address the underlying tax problems and will therefore be of no benefit to the financial institution that offer alternative financial products to customers and business that require them.

Introducing the necessary legislative framework

Stamp duty land tax (SDLT) is a charge on the acquisition of a chargeable interest whether or not evidenced in writing. Issuing a conventional bond secured on a building does not cause any SDLT to arise. However in a sukuk structure the originator (Financial institution) in order to be Sharia'a compliant must transfer an asset to a special purpose vehicle (SPV) so that the investors can own part of the underlying asset. SDLT will therefore be charged if a chargeable interest such as a building is transferred to an SPV that issues a sukuk, and is charged again when the originator buys back the building when the sukuk is wound up.

Assuming there is no change in current legislation then any sukuk issuance will be subject to SDLT charges at the following points.

SDLT charge 1 – SPV purchasing asset from originator. At this point the purchaser (the SPV) will be liable for a chargeable consideration for the transaction at a rate of four per cent (assuming asset is valued at more than £500,000).

SDLT charge 2 – Originator purchasing asset from SPV. On the winding up of the sukuk, the originator will purchase the asset back from the SPV, at the point the purchaser (this time the originator) will be liable for a chargeable consideration for the transaction at a rate of four per cent (assuming asset is valued at more than £500,000).

This extra charge therefore puts this structure at a considerable disadvantage relative to conventional securitisations.

SDLT charge 3 – There is also some uncertainty as to whether sukuk certificate holders would be liable to SDLT, as the certificate will evidence their interest in an underlying chargeable asset.

Therefore in the case of SDLT, it is desirable that no SDLT should be charged when land is sold to the issuer of a sukuk, no SDLT charged on the leaseback of the building to the vendor and that no SDLT arises on the issue of the sukuk certificate.

There are significant tax avoidance risks associated with addressing these issues. The main issues revolve around how HMRC could deal with complex structures developed to avoid SDLT that fall within the alternative finance investment bonds legislation but may in fact not be genuine alternative finance investment bonds, merely a means for avoiding SDLT. As these structures are likely to involve large commercial transactions, the potential loss to SDLT would be significant, and once the property had been passed into a SPV future payments of SDLT arising from the property in the SPV when sold could also be avoided by merely selling the shares in the SPV rather than the property itself.

This risk will be countered by ensuring that any relief has sufficient safeguards within it to ensure that such avoidance is not possible. HMRC will also retain the power to enquire into any such transactions to ensure that the relief is not abused.

Cost and Benefits

There are no costs imposed on business by this measure – companies are free to choose whether to offer commercial sukuk based on a commercial decision weighing up transaction costs (legal fees etc) and likely returns.

In terms of benefits, the clarification of tax rules has the potential to encourage development of Sharia'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.

By removing existing inequalities the UK Government will enable the alternative finance industry 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 as more institutions offer such products, and are able to securitise those products in a sukuk, so enabling the financial institution to provide further funding for their customer base.

As Government is seeking views from main affected groups on costs and benefits of this measure, it expects to quantify these more fully on completion of the consultation.

Continued difficulties with the development of Sharia'a compliant products gives 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 for all sections of the community.

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.

HM Revenue & Customs faces no additional costs from removing the SDLT charges from the structuring of sukuk bonds.

Economic Impact Tests

Competition Assessments

The Office of Fair Trading outlines four criteria for a Competition Assessment, asking whether the measure would:

1. Directly limit the number or range of suppliers?
2. Indirectly limit the number or range of suppliers?
3. Limit the ability of suppliers to compete?
4. Reduce suppliers' incentives to compete vigorously?

The answer to all four questions is no for this measure, which instead is likely to enhance competition within the UK by assisting in the development of the alternative finance market and ensuring that alternative finance products are not disadvantaged by UK taxation requirements. This will increase both the number and range of suppliers.

Small Firms Impact Test

This policy will have no negative impact on small firms because issuance of sukuk is voluntary and the option won't be taken up for small firms where the benefits do not outweigh the costs. Leveling the playing field for sukuk may also have some positive impacts in terms of increasing some small firms' access to finance if they are able to find investors via sukuk bonds that may not have invested in conventional bonds.

Legal Aid Impact Test

There will be no need for a new criminal sanction or civil penalty.

Race Equality Impact Test

Policies specifically designed to tackle evidence of racial disadvantage or potential discrimination, as revealed through monitoring, should not need to be screened or assessed for their relevance to the race equality duty. This measure falls into this category.

Environmental/ Social/ Sustainable Development Impact Tests

HMRC has considered all the remaining impact tests, but concluded that none of them is likely to be affected by this reform. This assessment will be kept under review and updated in the light of consultation if appropriate.

Post –Implementation Review

HMRC will conduct a post-implementation review with reference to the operational impacts of this new process within a controlled timescale. It is currently anticipated that this will be between one and three years from the date of implementation. The review will cover development of the alternative finance industry and the anticipated positive impact on the UK economy. It will also endeavor to see what impact it has upon tax avoidance.

HMRC continues to work with all the key stakeholders of Stamp Duty Land Tax. Within these groups, stakeholders continually assess the performance of the SDLT regime, suggest ideas for improvements and evaluate changes that have already been made. This is a vital tool for gauging the effectiveness of any changes in the stamp duty system and will provide a useful forum for ensuring that the relief works as it was intended to.

Enforcement, Sanction and monitoring

These are positive measures for affected parties that allow consistent tax treatment. Avoidance disclosures will be monitored to identify, and where necessary HMRC will act on any attempt to use alternative finance arrangements for avoidance purposes through the SDLT enquiry regime.

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

Summary

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. Hence there is to date no UK market in commercial sukuk.

The alternative finance industry has welcomed the legislation already enacted to remove unequal tax treatment from certain alternative finance products and has highlighted further areas containing unequal treatment.

A long- term approach is therefore required to enable the UK to maintain its position as a global financial center. Legislation is therefore recommended to provide a long-term, stable solution to the unequal treatment presently received by alternative finance structures identified.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Annexes