



Chartered
Institute of
Taxation

Excellence in Taxation

Aligning the tax treatment of Islamic finance and conventional finance Submission by the Chartered Institute of Taxation

1 Introduction

- 1.1 Successive governments have supported and legislated for a level playing field between conventional finance and Islamic finance, such that Islamic finance transactions are taxed no more heavily (and no more lightly) than conventional finance transactions. However, there is not yet a completely level playing field between the taxation of conventional finance and Islamic finance.
- 1.2 Assuming that government policy¹ remains to achieve parity of tax treatment, this submission discusses one of the areas where unequal tax treatment persists, and proposes a way of achieving equal treatment which draws upon precedent in existing tax law.
- 1.3 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 1.4 Our stated objectives for the tax system include a legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences. It is with this particular objective in mind that we make this submission.

2 The economic transaction and conventional financing

- 2.1 It is commonplace for an owner of commercial real estate on which there are no borrowings to use that real estate as security for new borrowing. The real estate in question may have a market value that is no higher than the owner's original

¹ The Prime Minister's speech to the Gulf Co-operation Council in December 2016 refers to continuing the work that the UK has been leading over the past three years to make London one of the great capitals of Islamic finance anywhere in the world. <https://www.gov.uk/government/speeches/prime-ministers-speech-to-the-gulf-co-operation-council-2016>

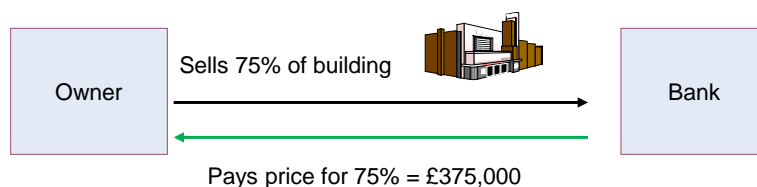
purchase price, or quite often it may have appreciated in value during the owner's period of ownership.

- 2.2 The transaction is straightforward. The owner of the building approaches a potential lender, which will advance a loan to him taking security on the building. For example, if the building is worth £500,000, and if the lender is willing to lend 75% of the value of the building, the owner can borrow £375,000 from the lender.
- 2.3 Assuming that the loan is to be secured on the property, which is normally the case, land registry documents will be executed to ensure that the lender has a properly secured first charge on the property, taking priority over unsecured creditors.
- 2.4 There are no tax implications from the refinancing, regardless of whether the market value of the building is the same as the owner's base cost, or is much higher. The refinancing does not give rise to SDLT; nor does it entail a disposal of the real estate for capital gains tax (CGT) purposes, or for the purposes of corporation tax on chargeable gains.

3 How refinancing is carried out using Islamic finance

- 3.1 The Islamic finance structure normally used for such a refinancing is diminishing shared ownership (DSO). It is illustrated below.

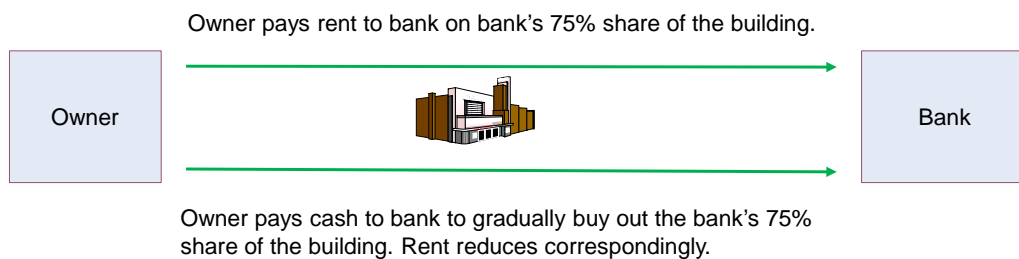
DSO transaction to create 75% leverage



- 3.2 The DSO transaction begins with the owner selling 75% of the building to the bank for £375,000.
- 3.3 After the sale, although the owner will only own 25% of the building, it will have the right to occupy, or to sublet, 100% of the building. Accordingly, the owner will pay rent to the bank on the 75% of the building owned by the bank. Industry practice is for this rent to equate to a market rate of interest on the £375,000 that the bank has provided. The rent paid to the bank does not reflect open market rents for buildings; it is computed solely by reference to the price of money, ie market interest rates plus a lending margin.

- 3.4 If the investor wishes to reduce the £375,000 finance provided by the bank, it does so by re-purchasing slices of the property from the bank. The re-purchase price is in practice always at the bank's original cost so that the transaction can qualify as a DSO transaction as defined for tax purposes by CTA 2009 section 504. For example, if the investor wanted to reduce by £5,000 the £375,000 that is the bank's stake in the property, the investor would purchase an extra 1% of the property from the bank, for a price of £5,000, increasing the investor's stake to 26%. In future, the investor would pay rent (computed by reference to market interest rates applied to £370,000) on only 74% of the property.
- 3.5 These cash flows are illustrated below.

Future cash flows in DSO transaction



4 The tax implications of refinancing using Islamic finance

- 4.1 For SDLT purposes, even though 75% of the property is sold by the owner to the bank, and then repurchased in slices over some future period, these sales do not give rise to any SDLT. This is because FA 2003 section 71A applies where the bank is a 'financial institution' as defined. FA 2003 section 71A (2) exempts from SDLT the sale by the owner to the bank, while section 71A (3) exempts the subsequent sales of parts of the building by bank back to original owner.
- 4.2 For CGT purposes, the sale of 75% of the building by the owner is a part disposal for capital gains tax purposes. If the building is worth more than the owner's original base cost, a tax liability will arise.

For example, if the current value of the building is £500,000, and the original base cost is £100,000, with the 25% retained being worth £125,000 (which should be the case, as owner is entitled to buy back the bank's share for £375,000) then a capital gain will arise as follows:

Proceeds of sale of 75%	£375,000
Applicable base cost: $\frac{\text{£100,000} \times \text{£375,000}}{\text{£375,000} + \text{£125,000}}$	£75,000
Chargeable gain	£300,000

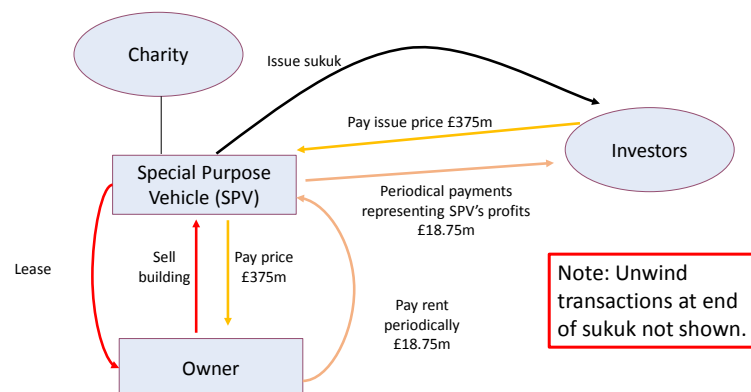
- 4.3 There are no relieving provisions to prevent this chargeable gain arising and being taxed. Accordingly, the Islamic finance transaction is taxed considerably more heavily than the economically equivalent conventional finance transaction.

5 Proposed legislative amendment to produce parity of treatment

- 5.1 This part of the submission explains how the approach that UK tax law takes for a different, but similar, transaction, is potentially capable of adaptation to the above scenario to establish a level playing field. It first explains the different transaction and the special provisions UK tax law has already introduced for it, before suggesting how to adapt UK tax law for Shariah compliant refinancing of appreciated real estate.
- 5.2 For a conventional finance transaction instead of borrowing from a bank, (if the amounts involved were larger than in the example) the original owner could have chosen to borrow from the capital markets by issuing debt instruments listed on a stock exchange, which could either be secured on the building, or could be unsecured. The issue of listed debt instruments, whether secured on the building or unsecured, has no SDLT consequences and does not result in a disposal of the building for CGT purposes.
- 5.3 The Islamic finance transaction that is the economic equivalent of borrowing using listed debt instruments is the issue of sukuk.

It is illustrated below:

Issue of sukuk to use a building to raise finance at 5% finance cost



Note: As listed debt instruments would not be used for amounts as small as £375,000, here the figures have been scaled up to £375 million. The cost of finance assumed is 5%.

- 5.4 The structure entails the creation of a special purpose vehicle (SPV), owned by a charity. The role of the charity² in this structure is identical to the standard role of a

² The charitable purpose of the charity is normally to give money to other charities; it earns a small amount from the SPV as dividends or other payments

charity in a conventional asset backed securitisation. It is to allow the asset being sold to enable securitisation to be held in a vehicle owned by the charity so that is not part of the original owner's group, and is not exposed to the owner's bankruptcy risks. The SPV buys the property from the owner for £375m (even though the market value may be £500m) and rents it back to owner. The SPV pays for the property by issuing sukuk to investors for an issue price of £375m. These sukuk are participation certificates, which entitle their owners to all of the economic returns from the building achieved by the SPV.

- 5.5 The SPV uses the £375m it raises from investors to purchase the building from the owner. Afterwards, it rents the building back to the owner for an annual rent of £18.75m (computed as 5% of £375m).
- 5.6 After five years, the owner will be required to repurchase the property from the SPV for a fixed price of £375m, which SPV will pass on to the sukuk investors, thereby bringing the sukuk arrangements to an end.

6 UK tax treatment of the sukuk transaction

- 6.1 In the absence of relief, the sukuk transactions would potentially give rise to tax consequences including:
- A disposal for CGT purposes when the owner sold the building to the SPV.
 - SDLT on the sale from the owner to the SPV.
 - A disposal for CGT purposes when the SPV sold the building back to the original owner at the end of the sukuk arrangements.
 - SDLT on the sale from the SPV back to the original owner.
- 6.2 However, CTA 2009 section 507 contains a definition of 'Investment Bond Arrangements' which is intended to cover sukuk transactions. FA 2009 Schedule 61 builds upon CTA 2009 section 507 by adding some further conditions which a transaction must satisfy, before then giving the tax treatment outlined below.

These additional conditions are contained in FA 2009 Schedule 61 para 5. In brief, they require (using the terminology of the transaction above)

- Owner to transfer land to the SPV and the SPV to agree that when the SPV ceases to hold the land, it will be transferred back to the original owner.
- SPV to issue sukuk which relate to the land.
- SPV to lease the land back to owner to generate income for the purposes of the sukuk.
- Within 120 days, the creation of a first legal charge on the land in favour of HMRC to provide security for the SDLT that would otherwise be payable on the sale of the land from owner to SPV.
- The SPV to issue sukuk to investors which raise for the SPV cash of not less than 60% of the value of the building at the time it was sold by owner to SPV.
- SPV continues to hold the land as an asset for the purposes of the sukuk until the sukuk are terminated.
- Within 30 days of the sukuk terminating, the land is transferred back to the owner.
- The sale from SPV back to owner does not take place more than 10 years after the initial sale from the owner to the SPV.

6.3 Provided these conditions are satisfied, the tax consequences are as follows:

- No SDLT is charged on the sale by owner to SPV, or on the subsequent sale back by SPV to the owner.
- Each of the sale of the building by the owner to SPV, the lease from SPV to the owner, and the sale of the building by SPV back to the owner are not treated as disposals for CGT purposes.
- For capital allowances purposes, the owner is treated as continuing to be entitled to any capital allowances due on the building, and SPV receives no capital allowances.

6.4 The overall effect of the provisions is that the use of the building by owner to raise finance by the issue of sukuk receives the same tax treatment as would have arisen if owner had issued conventional listed debt instruments, whether unsecured or secured on the building.

7 Proposal to amend UK tax legislation to achieve parity for Shariah compliant refinancing of appreciated real estate

7.1 This section first outlines the conditions that we suggest should apply before any relief is given, and then outlines the proposed relief.

7.2 The suggested conditions are as follows:

- The owner transfers land to a qualifying financial institution for the purposes of a diminishing shared ownership (DSO) transaction between the financial institution and the owner. The requirement for a qualifying financial institution harmonises with the existing requirement that DSO transactions are not possible without one of the parties being a financial institution as defined in the alternative finance arrangements provisions.
- The land should be located in the UK. This is a practical provision intended to ensure that a legal charge of the type proposed below in favour of HMRC can indeed be created. (It may in future be possible to extend the law to other jurisdictions that enable legal charges of appropriate strength to be created in favour of HMRC.)
- The DSO transaction mentioned above is entered into.
- The owner and financial institution, as appropriate, deliver to HMRC within a specified period a first legal charge over the land equal to the CGT that the owner would have paid if the owner had sold the building in a taxable disposal for a consideration equal to the price paid by the financial institution to the owner.
- The owner must claim relief via the self-assessment return.
- Within a period of N years, by virtue of the DSO contract, the entire ownership of the land is re-acquired by the owner from the financial institution. While the sukuk provisions mentioned above use N=10, real estate mortgage loans are often for longer periods. HMRC would need to consider what is normal market practice, and N=20 or 25 may be a more appropriate provision.

7.3 There would be no requirement to legislate further for relief from SDLT. The SDLT provisions already in place for Islamic finance should mean that no SDLT is paid on

the sale by owner to financial institution, or on the subsequent sale by the financial institution to the owner.

- 7.4 However, the following provisions, mirroring those in the sukuk provisions, would appear appropriate to achieve parity of treatment:
- The sale of the land by owner to the financial Institution, the DSO rental arrangements, and the subsequent sale by financial institution back to owner, whether in stages or in a single event, should not be treated as disposals for CGT purposes. Accordingly, for CGT purposes the owner would be treated as owning the building throughout.
 - The owner would be treated as the continuing owner of the building for capital allowances purposes.

8 Acknowledgement of submission

- 8.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

9 The Chartered Institute of Taxation

- 9.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
28 March 2018