HM Treasury Consultation:

Tax Simplification for Alternative Finance

RESPONSE FROM:

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Tax Simplification for Alternative Finance

To: HM Treasury

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A. About the respondent

1. Mohammed Amin (known as "Amin") is a Fellow of the Institute of Chartered Accountants in England and Wales, a Fellow of the Chartered Institute of Taxation ("CIOT"), and an Associate Member of the Association of Corporate Treasurers.

2. From 1990 until retirement at the end of 2009 Amin was a tax partner in Price Waterhouse / PricewaterhouseCoopers. His specialities included the taxation of financial instruments and the tax treatment of Islamic finance. From mid-2007 he led PwC's Islamic finance practice in the UK and was a member of PwC's four-person Global Islamic Finance Leadership Team.

3. Amin was the principal author of the CIOT's submission *"Aligning the tax treatment of Islamic finance and conventional finance"*[1] which was sent to HM Revenue & Customs ("HMRC") on 28 March 2018. This explained the Shariah compliant refinancing problem which is the subject of the current consultation.

4. Amin also took part in the subsequent conference call about the submission between the CIOT and HMRC. It was deeply disappointing that HMRC concluded that the problem was insufficiently important to merit resolving at that time.

5. Many of Amin's writings and presentations on Islamic finance are available on his website.[2]

[1] Available at https://www.mohammedamin.com/Downloads/CIOT-to-HMRC-March-2018-Shariah-compliant-refinancing.pdf

[2] See https://www.mohammedamin.com/Islamic_finance.html

B. Preliminary comments

6. This consultation is extremely welcome, but is long overdue.

7. Our country's tax law arose in an environment where all finance was conventional finance. Accordingly, Shariah compliant financial transactions often give rise to additional tax costs (compared with equivalent conventional finance transactions) unless tax law is amended to ensure that Islamic finance and conventional finance are on a "level playing field." For over 20 years governments, whether Labour, Coalition, or Conservative have agreed that equality of treatment is a desirable goal.

8. The writer recognises that the adaptation of tax law is inevitably a slow process given the complexity of tax law, pressure on space in the finance bill, and the importance of not creating tax avoidance opportunities.

9. Nevertheless, the Government has been particularly slow in recognising the need to address the problem of refinancing real estate in a Shariah compliant way, where the real estate is not a principal private residence and therefore potentially gives rise to a taxable capital gain on disposal.

10. HMRC has failed to give clear guidance to taxpayers about the scope for a capital gains tax charge in such circumstances.

11. Worse still, it has treated taxpayers unequally, since in at least one case, [3] having full knowledge of the facts, HMRC concluded that no tax charge arose, while other taxpayers carrying out the same transactions have been pursued for capital gains tax.

12. A solution has been available since at least 2009.

13. After the basic legislation to facilitate sukuk issuance was introduced in Finance Act 2007 section 53 ("Alternative finance investment bond") no issuance took place. In the writer's opinion this was due to the triggering of a capital gain if appreciated real estate was sold to the special purpose vehicle ("SPV") which was to issue the alternative finance investment bonds.

14. Accordingly, Finance Act 2009 Schedule 61 was enacted. Provided the qualifying conditions set out in the earlier paragraphs of the schedule are met, paragraphs 10 and 12 of Schedule 61 ensure that there is no capital gains tax

[3] See the ante-penultimate paragraph on the page https://www.mohammedamin.com/Islamic_finance/Shariah-compliant-refinancing-treated-unfairly.html

disposal when the original owner sells the real estate to the SPV, or when the SPV sells it back.

15. Such provisions could have been easily adapted for Shariah compliant refinancing using diminishing shared ownership.

16. Finally, please note the quality control failure on page 8 of your consultation document. The Financial Secretary to the Treasury does not have a letter “e” at the end of his surname.

C. The need for retrospection

17. The consultation document says nothing about existing cases.

18. As mentioned above, there are many cases where taxpayers are facing unexpected liabilities because HMRC has failed to issue guidance making it clear that HMRC considers that selling appreciated real estate to an (Islamic) bank in order to refinance it using diminishing shared ownership triggers a taxable capital gain.

19. Worse still, as mentioned above in paragraph 11, HMRC has failed to apply its view consistently.

20. Accordingly, the writer considers that for capital gains tax purposes either:

    20.1. The new legislation should be made retrospective to the date the diminishing shared ownership rules were first introduced, or

    20.2. An extra-statutory concession should be introduced so that HMRC ceases to pursue all open cases and refunds taxpayers who have settled with HMRC.

21. The writer does not propose retrospection for the capital allowances changes for two reasons:

    21.1. Firstly, the capital allowances problem mentioned in the consultation document appears to be far less widespread than the capital gains tax problem.

    21.2. Secondly and more importantly, making the capital allowances changes retrospective would have the effect of removing capital allowances from one set of taxpayers (the financial institutions that have provided the refinancing) to give them to another set of taxpayers (the persons who have obtained the refinancing.) It would be unreasonable to deprive some taxpayers of capital allowances retrospectively.

D. Answers to your numbered questions

1. Are there any other implications which may arise for CGT on entering into alternative refinancing arrangements which are not considered in Chapter 4?

22. The writer considers your summary of the CGT problem in your paragraph 4.7 to be complete, and is not aware of any other CGT implications.

2. Do you agree with the conditions described in Chapter 5 and do you think they could cause any unforeseen issues that could undermine our intent?

23. The writer agrees with the conditions set out in your paragraph 5.3 subject to the comments below in response to your question 3.

3. Should alternative refinancing arrangements be completed in a set period of time? If so, what would be the appropriate period be?

24. The set period of time for the arrangement needs to be long enough to cater for the durations actually used in either Shariah compliant or conventional refinancing.

25. 25 years appears to be adequate. However, HM Treasury should check with some conventional lenders (and with the four Islamic banks) whether they occasionally engage in refinancing transactions extending over more than 25 years.

4. Do you think the proposed rules should be limited to arrangements where the finance provider is a financial institution or extended to home purchase plans providers?

26. The proposed rules should be extended to home purchase plan providers.

27. The requirement for a financial institution (using the term as extended by the alternative finance provisions) is the most significant differentiator between conventional finance and Islamic finance causing “the playing field” to not be level. The writer acknowledges the Government’s desire to proceed cautiously when legislating for Islamic finance, and the requirement for an entity subject to financial services legislation helps to guard against abuse.

28. However, this points towards using the widest existing category of permitted entity for the party providing the refinancing.

29. Please note that question 4 near the top of your page 19 has not been carried forward to Chapter 8.

30. In response to that question 4 on page 19, the conditions should be restricted to property alone for the following reasons:

    30.1. In the overwhelming majority of cases, Shariah compliant refinancing takes place using real estate. Apart from securities (mentioned in paragraph 30.3 below), there are relatively few other assets that would appear both suitable for refinancing transactions (taking into account the commercial requirements of finance providers) and within the capital gains tax rules.

    30.2. Including other forms of property would make the legislation much more complex to draft.

    30.3. There is existing legislation in TCGA 1992 section 263A ("Agreements for sale and repurchase of securities: capital gains tax") which covers repo transactions involving securities.

5. Under what circumstances would a financial institution dispose of their interest in the property to a third party? Do you have any view on what tax implication this should have on P?

31. The most likely occasions when a financial institution is likely to dispose of its interest in the property to a third party are:

    31.1. When the financial institution transfers its rights to an SPV as part of a sukuk issue to securitise part of its financing book, just as conventional banks securitise their loan books.

    31.2. When the financial institution sells part of its financing book outright to a third-party financial institution, just as conventional banks often sell part of their loan books.

    31.3. If the party financed ("P") has defaulted on their obligations and the financial institution is seeking to recover what it can from its interest in the property.

32. In the first two cases 31.1 and 31.2, provided P continues to be subject to the same obligations regarding payments and repurchasing of the real estate, the legislation needs to ensure that there are no tax consequences for P.

33. In such transactions, all that has changed is the identity of the entity which is P's counterparty – P's obligations continue unchanged. There are no grounds for subjecting P to a capital gains tax charge in such circumstances.

6. Do you have any views on the requirement for P to bring a disposal value into account on transfer of the property by the finance provider to a third party, and how would this work in practice?

34. As explained above, if the finance provider transfers the property to a third party in circumstances where P continues to be subject to P's obligations, and continues to comply with them, then there should be no occasion of charge. All that would have changed is the identity of P's counterparty.

35. The other occasion when the financial institution is likely to transfer the property to a third party is when P is in default, and the financial institution is seeking to recover what money it can. In that situation, the transactions between P and the financial institution should be retrospectively disqualified from the benefits of the new legislation so that:

    35.1. The initial refinancing is treated as a sale transaction, of either the whole or part of the property depending on the percentage sold to the financial institution.

    35.2. Any subsequent partial re-acquisitions by P while the contract was being performed should be treated as such.

36. The legislation should permit the assessing of such gains, even if many years have passed since the original transactions, and P should be charged interest on the CGT thereby paid late.

37. This seems more appropriate than assessing P by reference to the market value of the property on the date the transaction goes into default as proposed in your paragraph 5.8 which risks being unfair to either P or to the financial institution or both. Both parties should be taxed by reference to what they have done, and the payments that have taken place between them.

7. Do you have any views on how the proposed rules will deal with default events or agreements that otherwise fail to complete?

38. See the response above to your question 6.

39. The final bullet of your paragraph 5.7 reads *"the financial institution abandons its option to require P to repurchase the interest."*

40. It is highly unlikely that a financial institution would abandon such an option while P was continuing to perform P's obligations under the contract. Such abandonment would be irrational. However, provided P is to continuing to perform P's contractual obligations, the law should not impose any adverse

consequences on P from an action undertaken solely by the financial institution. That would be unfair.

41. If a default by P has occurred, then the writer's view on the appropriate consequences are set out in the earlier response to question 6.

8. What avoidance circumstances do you think are likely to arise in respect of the proposed solution and what further safeguards against avoidance would you propose?

42. Your paragraph 5.9 states that the rules will address a number of other cases.

43. The first bullet of your paragraph 5.9 raises the issue *"P and the financial institution are connected."* As tax law already denies many tax treatments to connected persons, the writer considers it reasonable to exclude the application of the proposed new legislation where P and the financial institution are connected.

44. With regard to the second bullet of your paragraph 5.9, *"the financial institution assigns its interest in the property to another party that is not a financial institution or where the other party is a financial institution but the transaction effectively resulted in the termination of the financing arrangement"*, unilateral actions of the financial institutions in circumstances where P is continuing to perform all of P's obligations under the contract should not result in any adverse tax consequences for P. It is unlikely that the financial institution would derive a tax benefit from such an assignment, but if the government is concerned that this might constitute tax avoidance, then any action taken should be directed at the financial institution and not impact upon P, provided P is continuing to perform all of P's obligations under the contract.

45. Obviously if P has collaborated with the financial institution in undesirable revisions to the arrangements, then retrospective cancellation of the tax treatment as outlined in paragraph 35 above would be reasonable.

46. It would appear reasonable for the new legislation to require all contracts qualifying under it to stipulate that the financial institution:

    46.1. may not assign its interest in the property to another party that is not a financial institution.

    46.2. may not assign its interest in the property to another financial institution if such assignment effectively resulted in the termination of the financing arrangement.

47. The third bullet your paragraph 5.9 considers the case where *"the land will be transferred back to P at a price lower than that paid by the financial institution."*

48. If P and the financial institution are dealing at arm's length, this logically requires that the rent paid by P be greater than an arm's-length rent. (Otherwise, P would be making a gain at the expense of the financial institution.) It appears appropriate to require that if a transaction is to qualify under the proposed rules, the price for the transfer back to P should be no lower than P's sale price to the financial institution.

49. In your Example 4, the writer considers it wrong for P to suffer any tax penalty if P is continuing to perform P's obligations under the contract, and P and the financial institution are not connected. (Taking account of the comment in paragraph 43 above, P and the financial institution would not be connected, since the new legislation would be excluded in the case of connected persons.)

50. Considering tax avoidance more generally, provided P and the financial institution are unconnected parties dealing at arms length, their opposite commercial motivations should ensure that no tax avoidance takes place. Accordingly, the legislation should only apply if P and the financial institution are unconnected at the commencement of the transaction.

51. Furthermore, if P and the financial institution become connected part way through the life of the transaction, the application of the new rules should be withdrawn retrospectively as outlined in paragraph 35 above.

9. Do the capital allowances implications described in Chapter 6 arise in practice and cause issues for those seeking to refinance using alternative finance arrangements? If so, how often are arrangements entered into such that those implications arise?

52. The writer has no practical experience with transactions where capital allowances have been an issue.

10. Do the capital allowances implications described in Chapter 6 prevent those seeking to refinance using alternative finance from doing so?

53. No response.

11. Are there any other implications which may arise for capital allowances on entering into alternative finance arrangements which are not considered in Chapter 6?

54. No response.

12. If the government makes the changes proposed, how many refinancing arrangements using alternative finance products each year would be entered into?

55. While the writer is an expert on the relevant tax law, he is not involved with organising such transactions and accordingly is unable to respond.

13. Do you have views, and can you provide evidence, on the extent to which DSO arrangements are used by businesses?

56. From the number of times the tax issues have been raised with the writer, he considers that DSO arrangements are used relatively widely by Muslims who invest in commercial real estate, and in residential real estate for letting purposes. However he has no quantitative data.

14. Do you have any comments on the administrative burdens required to comply with the proposed rule?

57. The administrative requirements appear straight forward. It would help if the legislation contained a clear list of requirements that needed to be fulfilled both at the inception of the contract, and throughout its life, if the contract was to qualify for the new rules.

58. Such requirements would then be built by legal practitioners into their standard contracts.

15. Do you envisage any equalities impacts from the proposals that the government should take account of?

59. Current tax law treats Muslims who engage in Shariah compliant refinancing of real estate that is not a principal private residence less favourably than non-Muslims who engage in conventional refinancing of similar real estate.

60. Accordingly, the enactment of the new rules should increase equality in our society, by removing a feature that treats some Muslims worse than non-Muslims.