

4

REGULATORY IMPACT ASSESSMENT FOR ALTERNATIVE FINANCE PRODUCTS

Introduction

4.1 This final regulatory impact assessment considers the costs and benefits of options for addressing the tax treatment of alternative methods of finance (including Shari'a compliant finance). It accompanies the announcement of legislation in Budget 2006 to amend certain rules for Income Tax, Corporation Tax, Capital Gains Tax and Stamp Duty Land Tax ("SDLT").

Purpose and Intended Effect

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 The objectives of the legislation are 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 will give those people and entities wishing to utilise alternative finance products the ability to do so without being disadvantaged because of tax.

4.4 Government has been tackling the taxation of alternative finance products since 2003. There is currently legislation enabling the provision of alternative methods for an individual to finance a residential property purchase, bank deposits and personal loans.

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:

- 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'iqatna. Ijara wa'iqatna 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.

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:

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

4.10 Further reforms in 2005 concerned:

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

4.11 A Regulatory Impact Assessment for the 2005 changes was published in March 2005 (<http://www.hmrc.gov.uk/ria/sharia.pdf>)

Rationale for Government Intervention

4.12 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.

4.13 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 2005. Taking these forward it is proposed to make the following changes in Finance Bill 2006.

- Enable the use of diminishing musharaka based products by business for asset and real property finance.
- Make certain the tax treatment of wakala transactions, there is currently uncertainty over beneficial ownership.
- Extend the current reliefs from SDLT to all entities, including companies, clubs and LLPs.
- Ensure that alternative finance loans at a non-commercial rate between employer and employee are treated as benefits in kind.

Consultation

Within Government

4.14 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

4.15 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 being on 7 February 2006.

Options

1. Do Nothing

4.16 This option will leave the risks and uncertainties set out above in place, disadvantaging those who wish to utilise alternative finance. 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.

2. Legal Opinion

4.17 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.

4.18 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.

3. Legislation

4.19 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 2007.

Costs and Benefits

Sectors and Groups Affected

4.20 These issues affect three main groups:

- Muslim consumers;
- Small businesses; and
- Financial institutions.

4.21 Muslim consumers are the main market for alternative finance products due to the prohibition on interest contained within Shari'a law. The current uncertainty over tax treatment of some alternative finance products, combined with the continuing double SDLT for persons who are not individuals has limited the growth of the regulated market.

4.22 Initially, Shari'a compliant products were geared primarily towards individuals. Financial institutions are now extending Shari'a products to businesses. Muslim businesses are expected to be major beneficiaries of this legislation as it will enable them to make their capital structure Shari'a compliant.

4.23 Since initial legislation in 2003 opened up the market for alternative finance mortgages a wide number of financial intuitions have participated in the market. These institutions have expressed an interest in developing a full range of alternative finance products for the retail, commercial and private clients. Over time a significant proportion of the customer base for providers of alternative financial products is likely to be the proprietors of Muslim run small businesses who wish to comply with the provisions of Shari'a law. At present, they may face difficulties in reconciling this obligation with securing necessary financial access.

4.24 There is likely to be some shift from conventional finance products to alternative finance products as people adopt the method of finance most suited to their needs. Financial institutions who offer only conventional products may therefore see a reduction in trade, but within the context of fair and open competition.

Benefits

1. Do Nothing

4.25 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 customers and businesses who require alternative financial products nor to the financial institutions who offer them.

2. Legal Opinion

4.26 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. In addition alternative finance products with the same economic effect often have quite different legal structures and wordings. It is possible that products structured in the same way could therefore have quite different tax treatments.

3. Legislation

4.27 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.

4.28 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, if the existing product range is expanded, and if the customer base continues to expand.

4.29 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 and equality benefits in the wide availability of well-defined, well-regulated financial products in all sections of the community.

4.30 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

1. Do Nothing

4.31 Failure to act would not remove the uncertainties that inhibit the provision 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.

4.32 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. Without the removal of existing uncertainties over the tax treatment of Shari'a compliant financial products, it is unlikely that there would be an appetite to offer them amongst high street financial institutions.

2. Legal Opinion

4.33 Legal opinions might allow institutions offering Shari'a compliant financial products to operate with certainty in the short-term with regard to specified products 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.

4.34 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 new products for the UK market.

3. Legislation

4.35 The social costs of legislating to remove inequality and uncertainty in the tax treatment of Shari'a compliant financial products are minimal. This is however an evolving market. We already aware that products are being 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.

4.36 It is unlikely that legislation will have a significant Exchequer impact. For example, with regard to the changes to SDLT, Muslim businesses have been utilising conventional finance products and paying SDLT in the usual manner. 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.

4.37 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.

4.38 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 tax payers adjust to the new regime.

4.39 There is some operational impact on HMRC, 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. Amended guidance and minor changes to forms will also be needed. However, it is not anticipated that the impact and cost will be substantial.

Small Firms Impact Test

4.40 Initially, most of the alternative finance products developed were geared towards individuals. However, banks are interested in extending their Shari'a compliant business products to businesses. 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. At present, they may face difficulties in reconciling this obligation with securing necessary financial access.

4.41 These measures will enable small businesses to choose whether they would like to finance their investments via alternative finance products.

Competition Assessment

4.42 A competition assessment has been undertaken and the competition filter indicated that legislation to address current uncertainty and inequality in the tax

treatment of alternative finance products should not have any significant adverse effects on the competitive processes in the financial services market.

4.43 The main market affected 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 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.

4.44 In terms of competition, the do nothing option 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.

4.45 The legal opinion option would have some competition enhancing effects by allowing providers of Shari’a compliant products to offer them with certainty of tax treatment. 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.

4.46 The legislation option 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.

4.47 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. 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.

4.48 Islamic financial arrangements are now widely used in many parts of the world to finance major developments, such as airport construction, and in merger and takeover activity. Removal of tax obstacles will enable UK institutions to compete more effectively in this global market.

Enforcement, Sanctions and Monitoring

4.49 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.

4.50 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 being addressed in a proportionate manner.

Implementation and Delivery Plan

4.51 The policy will be implemented by legislation to be included in the Finance Bill 2006 and by guidance to be published by HM Revenue and Customs.

4.52 There will be a small administrative burden placed on businesses wishing to utilise the new legislation, as they will need to adjust to and understand the new regime. This will be more than balanced out by the benefits that the legislation brings through enabling business to choose the method of finance most suited to their needs.

Post-implementation Review

4.53 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.

4.54 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

Option	Total benefit per annum: Economic, Environmental, and Social	Total cost per annum: Economic, Environmental, Social, Policy and Administrative
1	None	Parts of society excluded from regulated financing methods. Unfairly restricts the business of Shari'a compliant financial services.
2	A Legal opinions will allow institutions to offer products with certainty over how HM Revenue and Customs 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 HM Revenue and Customs. 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. Promotes financial inclusion. Promotes competition in the financial sector. Provides a framework and precedent for future work in this area.	Small administrative burden to HM Revenue and Customs. Legislation will need to be updated to reflect further products/innovations

4.55 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 alternative finance structures.

4.56 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 solution is required to enable the UK to maintain its position as a world leading centre of financial excellence.

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

Contact Point

Richard Stirling
HM Treasury
Corporate Taxation Team
2/E2
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 6105

E-mail: Richard.Stirling@hm-treasury.gsi.gov.uk

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:

Ivan Lewis
Economic Secretary to the Treasury

Dated: 16 March 2006