HM Treasury

Tax Simplification for Alternative Finance

January 2024

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This publication is available at: www.gov.uk/official-documents.

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ISBN: 978-1-916693-48-7 PU: 3362

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Chapter 1
Foreword

Financial services is one of the UK's most innovative and important industries. They are a priority for the government and are one of the Chancellor's growth industries. As Financial Secretary, I am focused on three principles for our tax system: making it fairer, making it simpler, and ensuring that it supports growth. The Islamic finance industry forms part of a globally competitive financial services regime. The government is committed to ensuring the tax system supports the growth of this industry and is fair for everyone; no one should be denied the services they require on account of their faith.

The UK is the leading western hub for Islamic finance. Institutions in London and around the UK have been providing Islamic finance and related professional services for nearly 40 years, and there are more institutions offering Islamic financial services in the UK than anywhere in Europe or North America. Islamic finance retail customers in the UK are served by our four fully licenced Sharia-compliant banks and 20 international banks which offer Islamic financial products – everything from Sharia-compliant mortgages to savings products, including fixed-rate bonds, easy access, and notice accounts.

A thriving Islamic finance sector is crucial to securing financial inclusion and growth in the UK for our Muslim community of nearly four million people. Everyone has the right to expect access to services that are compatible with their faith, without tax consequences that would not arise under equivalent conventional finance. The alternative finance tax rules were created with this is mind, and it is right that they be kept under regular review to ensure fairness, simplicity and equal treatment with the tax rules for conventional finance.

The government is aware of a difference in tax treatment when a commercial or residential property is refinanced using alternative rather than conventional finance methods. In these situations, a capital gains liability may arise, and capital allowances could be lost for those using alternative financing, when this would not have been the case for those using conventional financing.

This consultation seeks views on reforms that would address the capital gains issue and asks for information on the extent of the capital allowances issue. HM Treasury wishes to ensure that any changes to the alternative finance tax rules are effective and proportionate for the financial institutions administering these products and customers they serve. At the same time, it is important that this is carefully balanced with the government's commitment to maintaining a robust tax system with the necessary anti-avoidance mechanisms in place.

I hope that a wide range of individuals and organisations respond to this open process of review and help put the tax treatment of the UK Islamic finance industry on a level playing field with conventional finance.

NIGEL HUDDLESTONE MP

Chapter 2
Introduction

2.1 Capital Gains Tax (CGT) is charged on the gain made when an asset is disposed of. Gains made on the disposal of certain assets, such as residential properties that have been used as a main home, are exempt from CGT. Gains made on the disposal of residential properties that have not been used as main homes, such as second homes and rental properties, are chargeable to CGT. The rates of CGT are 18% and 28% for gains made on the disposal of residential property (and carried interest) and 10% and 20% for all other assets.

2.2 Capital allowances let taxpayers write off the cost of certain capital assets against taxable income. They take the place of depreciation charged in commercial accounts, which is not normally deductible for tax purposes.

2.3 'Alternative finance' is a method of raising finance that characteristically involves the sale, purchase and renting of assets in circumstances where 'conventional' financing would involve lending at interest.

2.4 Although there are some significant differences between how alternative finance and conventional finance are structured, the tax rules aim to provide a level playing field for tax purposes across both. These rules are based on Islamic financing but can be used by both followers and non-followers of the Islamic faith.

2.5 However, under the current rules, entering into certain types of alternative finance arrangements can result in CGT and capital allowances consequences that those using conventional financing would not face. This is currently the case for refinancing arrangements, where an existing property is used as collateral to obtain finance. For example, where a landlord uses alternative refinancing arrangements, they may be subject to a CGT charge where a landlord using conventional refinancing arrangements would not be. The refinancing of main homes would be unaffected in both situations as Private Residence Relief (PRR) applies.

2.6 The government is therefore consulting on potential changes to the alternative finance rules to level the playing field. However, the government is keen to ensure that any change in rules does not create avoidance opportunities or significant administrative burdens.

2.7 This consultation includes nine chapters. Chapter 3 provides some background to alternative financing arrangements and Chapter 4 explains the issue regarding unequal CGT outcomes. Chapter 5 focuses on the CGT issue and outlines the proposed changes. Chapter 6 focuses on capital allowances and seeks views about whether change is required for capital allowances. Chapter 7 asks about impacts, and Chapter 8 provides a summary of questions. Chapter 9 contains the privacy notice.

2.8 The consultation will run until 11.59pm Tuesday 9 April 2024, after which the government will carefully consider the response received. A summary of responses will be published in due course together with details of the next steps. Respondents may get in touch if they would like to discuss any aspects of the consultation document or have any questions at: TaxSimplificationAlternativeFinance@hmtreasury.gov.uk

Chapter 3

Background: Buying a property using alternative finance

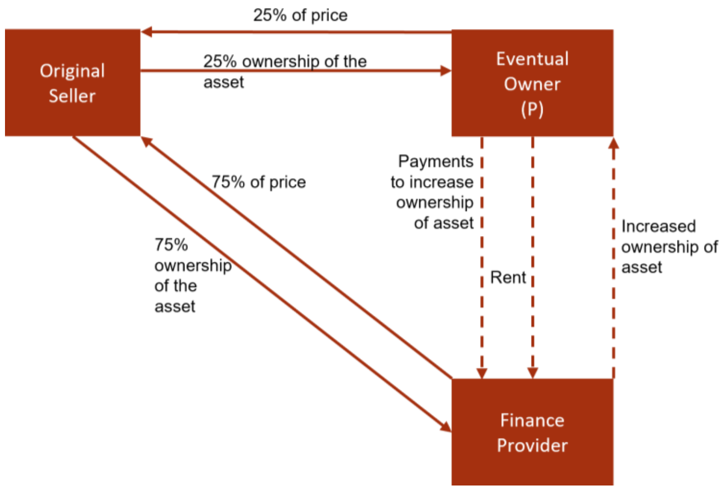
3.1 Under 'conventional' financing arrangements, a person who wishes to acquire a property can approach a financial institution to loan them the required capital, using the property as security. Where the loan is approved, the person would purchase the property and the financial institution would register its interest in the property should it have to be repossessed and sold in the event of a loan default. The person would then repay the loan to the financial institution over a period of time along with an element of interest.

3.2 Alternative finance arrangements are structured differently. Primarily they do not involve the payment or receipt or interest, which is prohibited by Islamic law.

3.3 One common method of alternative finance is for the parties to enter into a diminishing shared ownership (DSO) agreement. These agreements typically require the person (P) seeking finance and the financial institution providing it to each acquire a beneficial interest in the property being purchased. P will then have sole right of occupation, or use of the property. They will also typically be entitled to the whole of any income, profit, or gain relating to the property, including any increase in its value.

3.4 P would then over a period of time:

- purchase the beneficial interest in the property that they do not already own (from the financial institution) and eventually become the sole owner; and
- make other payments (or pay rent) to the financial institution for use of the property in respect of the share of the beneficial interest that they do not own
- As an alternative, instead of buying the beneficial interest in the property over a period of time, P may choose to buy it at the end of the arrangement. This falls within the existing DSO tax rules.



3.5 Besides DSO, other relevant types of alternative finance include:

- **Purchase and resale arrangements:** These involve assets being purchased by a financial institution and then sold to P, with the payment by P being on deferred terms and typically with a markup.

- **Investment bond arrangements:** These typically involve the party wishing to raise finance, either directly or through a special purpose vehicle, issuing bonds over assets that they identified and acquired for the purpose of generating income or gains. The bond issuer makes payments to the bond holder that are economically equivalent to a commercial return on a loan of capital. Upon maturity of the bond, the bond issuer would dispose of the asset and make a repayment of capital to the bond holder.

The tax consequences of purchasing a property using alternative financing arrangements

3.6 The existing alternative finance rules ensure that those who use it to purchase property have similar tax outcomes to those using conventional finance.

- **Income tax and corporation tax:** Where certain conditions are met, amounts paid or received under alternative finance arrangements that do not involve interest are treated as if they were interest for income tax purposes, or as loan relationship debits and credits for corporation tax purposes.

- **Capital Gains Tax (CGT):** For the purposes of CGT, alternative finance is excluded from the consideration for the sale and purchase of an asset. (Similar rules apply to companies who corporation tax on capital gains. Throughout this consultation, ‘CGT’ is used to refer to the taxation of capital gains for both individuals and companies.)

- **Stamp Duty Land Tax (SDLT):** For alternative finance arrangements, transactions which take place between the financial institution and the customer are exempt from SDLT. This includes the sale by the customer to the financial institution and the sale back from the financial institution to the customer. Under these rules, SDLT is charged on the initial property purchase, which is made by a financial institution such as a bank. The customer will then acquire the property by paying to the bank the cost of the property (including SDLT) and financing costs. Under these arrangements, SDLT is only charged once – on the bank's purchase. Property transfers made in the course of refinancing are also exempt from charge, in the same way the remortgaging does not result in an SDLT charge. This treatment aims to ensure the customer pays broadly the same amount of tax that they would have paid had they taken out a conventional mortgage.

- **Capital allowances:** Capital allowances let taxpayers write off the cost of certain capital assets against taxable income. An amount of expenditure treated in the same way as interest under the alternative finance rules is not normally part of the qualifying expenditure for which capital allowances can be claimed.

Chapter 4

Issue: Refinancing property using alternative finance arrangements

4.1 Where a person who already owns a property wishes to raise finance using that property as collateral – 'refinancing' – an issue may arise in some circumstances when they wish to use alternative finance arrangements.

4.2 This chapter starts by describing conventional refinancing arrangements and their CGT tax treatment. It then does the same for alternative refinancing arrangements, and in doing so explains the issue we wish to address. Capital allowances treatment is addressed in Chapter 5.

Conventional refinancing arrangements

4.3 Under a conventional refinancing arrangement, a person (P) would approach a financial institution for a loan with the property being used as security. The loan would then be repaid over a period of time with interest.

Example 1: the refinancing process through the conventional financing method

- P approaches a financial institution for a loan (refinancing) for a property they already own. The financial institution agrees to advance the loan taking security on the building.
- For example, if the building is worth £500,000, and if the financial institution is willing to lend 75% of the value of the building, P can borrow up to £375,000 from the lender.
- 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 financial institution has a properly secured first charge on the property, taking priority over unsecured creditors.

- However, the beneficial interest of the building would remain in possession of P unless they default on their loan payments and enforcement actions are taken to claim the security.

Tax implications of using conventional arrangements to refinance

- **Income tax and corporation tax:** There would be no tax implications for the borrowing person where they act as a private individual, only when a person is for example, a landlord or corporate landlord.
- **Stamp Duty Land Tax (SDLT):** There are no SDLT implications because the interest that the financial institution acquires over the property – in the form of the charge – is an exempt interest for SDLT purposes.
- **Capital Gains Tax (CGT):** There are no CGT implications because ownership in the property has not changed.
- **Capital allowances:** There are no implications for capital allowances because there is not a disposal event.

Alternative financing arrangements

4.4 Where an individual wishes to raise finance using diminished shared ownership (DSO) arrangements, P would sell an interest in a property they already own to a financial institution, who would then advance the finance required. Over the period of the arrangement the person would pay the financial institution rent for use of the property that is now owned (or part-owned) by the financial institution.

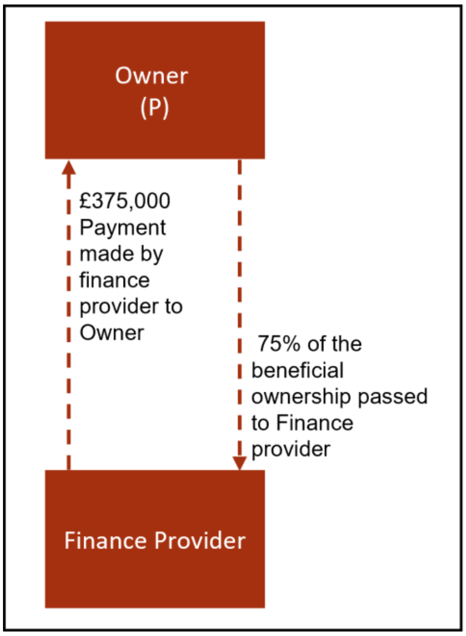
4.5 P may choose to either repurchase slices of property back from the financial institution over the duration of the arrangement, or alternatively, at the end of the arrangement the person would buy back the property. This method of finance can lead to tax implications for P.

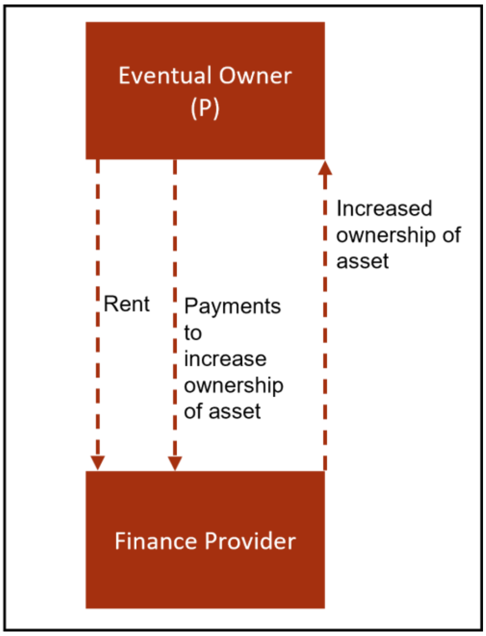
Example 2: the refinancing process through the alternative financing method

- a person (P) who owns a residential property that is used for letting purposes approaches a financial institution providing alternative finance.
- They use a common method of alternative finance known as DSO (see Chapter 2). In this example, P sells a 75% beneficial interest in the building to the financial institution for £375,000 for 10 years.
- As part of the arrangement, P enters into an agreement with the finance provider to allow them exclusive rights to occupy and use of the building. This means that although P will now only own 25% of the building, they will still have the right to occupy, or to sublet, 100% of the building. In exchange, P will pay rent to the financial

institution on the 75% of the building owned by the financial institution.

- P may then choose to either:
    - repurchase from the financial institution the 75% interest in the building at the end of the 10 years; or
    - reduce the £375,000 finance provide by the financial institution by re-purchasing slices of the property from the financial institution.





Tax implications of using alternative finance to refinance – the issue

4.6 The SDLT, income tax, and corporation tax rules broadly accommodate alternative refinancing arrangements. However, there are particular problems for CGT, as under the current rules transferring an interest in the property to the financial institution creates a disposal event.

4.7 The problem can be illustrated as follows.

Example 3: the CGT implications of refinancing using alternative finance

- using the same scenario as example 2, the sale of 75% of the beneficial interest in the residential property building by the owner to the financial institution will be treated as a part disposal for tax purposes.
- The purchase cost of the residential property was £100,000 and, at the time of refinancing, the market value is £500,000. Therefore, the 25% retained by the person requesting finance is worth £125,000 and

the 75% share that the financial institution now owns is worth £375,000.

- the CGT charge would be as follows (assuming they are a higher rate taxpayer and ignoring the annual exempt amount):
    - proceeds of sale of 75% is £375,000
    - base cost of purchase according to the proportion of new ownership is £75,000 (£100,000 x £375,000 / (£375,000 + £125,000))
    - chargeable gain is £375,000 - £75,000 = £300,000
    - CGT rate for residential property is 28% for a higher rate taxpayer = £84,000.
    - If there are no relieving provisions to exempt it, such as PRR, this CGT charge would be due within 60 days of the disposal completing.

4.8 This outcome could deter some people from using alternative finance arrangements when they wish to refinance. Chapter 5 sets outs a possible solution based on comments made by stakeholders.

4.9 **Capital allowances:** As these transactions do not fall within the existing alternative finance rules, a disposal event could arise where plant and machinery allowances or structures and buildings allowances are available and have been claimed. Chapter 6 considers the potential capital allowances implications further.

Questions

4.10 Are there any other implications which may arise for CGT on entering into alternative refinancing arrangements which are not considered above?

Chapter 5
Capital Gains Tax proposal for alternative finance

Proposal for legislative change

5.1 This chapter sets out a proposed solution to the issue set out in Chapter 4. The overall purpose of these changes is to ensure that, where certain conditions are met, the person obtaining the finance (P) is treated as having owned the interest in property throughout the period of the arrangements, and neither P nor the financial institution are treated as having made any disposal or acquisition.

5.2 The legislation will need to set out what happens in the case of default and how agreements should be monitored in the event of default. There will also need to be robust avoidance rules.

5.3 The general proposal is that the qualifying refinancing arrangement must meet the following conditions in order to be exempt from a CGT charge:

- a transfer of an interest in land from P to the financial institution;
- a lease back of the interest from the financial institution to P;
- a set period of time for the arrangement, for example 25 years;
- an agreement that, at or before the end of the lease, the whole of the interest in land is returned to P by the financial institution, either in tranches over the life of the arrangement or following one final payment

5.4 These conditions propose that the financial institution and P must have an agreed date on which the entire interest in the asset must return to P. This is to stop arrangements where there is no genuine intention to return the interest, effectively resulting in ownership changing, from being exempt from capital gains.

Questions

1. Do you agree with the conditions described above and do you think they could cause any unforeseen issues that could undermine the intent?

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

3. 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?

4. Although this consultation focuses on refinancing property, it is possible that other assets could be used for refinancing purposes. The government would welcome views on whether these conditions should be restricted to property only.

Default and avoidance

5.5 It is possible that some refinancing arrangements may fail or that parties may enter into these arrangements for avoidance purposes. The government must be confident that the legislation and HMRC can effectively deal with such outcomes and robustly prevent avoidance before making the proposed changes.

5.6 To deter avoidance or in case of a default, the government proposes that the original base cost of the land before the arrangement was entered into will be used to calculate any gain or loss that may accrue as a result of the default or avoidance. This mirrors the approach taken when a property is sold by a financial institution where there is a default on a typical loan.

5.7 There may be a number of situations where the arrangements do not proceed as agreed, this may be because:

- it becomes clear the interest in land cannot or will not be returned to the person requesting finance, or
- the lease expires or is terminated, or
- P assigns their rights under the leaseback when the interest in land has not been returned to them, or
- the financial institution abandons its option to require P to repurchase the interest

5.8 In all such cases, P will be deemed to have disposed of the interest in land to the financial institution immediately before the event in question, for a consideration equal to its market value at that time (not for the consideration given by financial institution as part of the first transaction). A chargeable gain or loss will then accrue to P at that time.

5.9 Rules will also address cases where:

- P and the financial institution are connected
- 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

- the land will be transferred back to P at a price lower than that paid by the financial institution
- the arrangement has no genuine commercial purpose or has a main purpose of avoiding tax

Example 4: Financial institution assigning interest in property

- P owns a building valued at £500,000 and receives financing of £375,000 from a financial institution for 75% of the building
- after 5 years the financial institution assigns its remaining interest of 40% of the property (P having acquired 35%), to Z who is not a financial institution for £250,000.
- the proportion of the original base cost of the land relating to the 40% interest is £200,000.
- in that case, P is deemed to have disposed of 40% of the property for £250,000, a gain of £50,000

Questions

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

Chapter 6

Capital allowances implications regarding alternative finance

Capital allowances implications

6.1 Capital allowances let taxpayers write off the cost of certain capital assets against taxable income. They take the place of depreciation charged in commercial accounts, which is not normally deductible for tax purposes.

6.2 Plant and machinery allowances are not available for expenditure on plant or machinery for use in a dwelling-house where the person is carrying on a property business. Similarly, structures and buildings allowances are only available for structures and buildings for non-residential use.

6.3 However, if a person refinances using an alternative finance arrangement in circumstances where plant and machinery allowances or structures and buildings allowances are available and have been claimed, there may be capital allowances consequences for the person that would not arise for a person using conventional finance.

6.4 These consequences could include:

- a disposal event for the purposes of plant and machinery allowances, which would require the person to bring a disposal value into account; and
- a disposal of the relevant interest in the structure or building, which means the person:
    - would lose the ongoing entitlement to claim structures and building allowances; and
    - may have to add back any structures and building allowances which have been claimed up to that point by that person when computing the capital gain

6.5 We welcome views and evidence on whether the implications described in respect of DSO arrangements arise outside property businesses involving the rental of dwelling-houses and/or residential structures and buildings to determine whether changes are also required in relation to capital allowances.

Questions

9. Do the capital allowances implications described above 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?

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

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

6.6 If changes are required for capital allowances purposes, subject to assessing the evidence requested in the preceding paragraphs, the proposal would be to adopt a capital allowances solution for alternative refinancing arrangements that is similar to the proposal described above for Capital Gains Tax.

Chapter 7
Impacts

Impact Assessment

7.1 The government conducts impact assessments for all policy changes. To conduct an impact assessment, the government requires an understanding of the number of people, and businesses, who will be impacted by the changes.

7.2 While the government understands that there are currently few refinancing arrangements that use alternative finance products each year, more detail is required as part of the impacting of this change. The government welcomes information and insight from external stakeholders on the number of arrangements that are taken out each year.

Questions

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

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

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

Equalities assessment

7.3 The government is committed to considering the impact of the measures set out in this consultation document, including on individuals with particular protected characteristics.

7.4 In accordance with our duties under the Equality Act 2010, and as a matter of policy, we consider the impact of these measures on individuals sharing protected characteristics. With this in mind, we welcome responses from consultees on these proposals with regard to the potential impacts, by addressing the question below.

Question

15. Do you envisage any equalities impacts from the proposals that the government should take account of? If so, please explain who, which groups, including those with protected characteristics, or which businesses may be impacted and how.

Chapter 8
Summary of questions

Capital Gains: practical implications

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

Capital Gains: proposals for legislative change

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?

Capital Gains: scope and eligibility

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

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?

Capital Gains: disposals and avoidance

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?

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?

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

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?

Capital allowances: practical implications

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?

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

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?

Impact assessment

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

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

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

Equalities assessment

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

Chapter 9
Privacy Notice

Processing of personal data

9.1 This section sets out how we will use your personal data and explains your relevant rights under the UK General Data Protection Regulation (UK GDPR). For the purposes of the UK GDPR, HM Treasury is the data controller for any personal data you provide in response to this consultation.

Data subjects

9.2 The personal data we will collect relates to individuals responding to this consultation. These responses will come from a wide group of stakeholders with knowledge of a particular issue.

The personal data we collect

9.3 The personal data will be collected through email submissions and are likely to include respondents' names, email addresses, their job titles, and employers as well as their opinions.

How we will use the personal data

9.4 This personal data will only be processed for the purpose of obtaining opinions about government policies, proposals, or an issue of public interest.

9.5 Processing of this personal data is necessary to help us understand who has responded to this consultation and, in some cases, contact certain respondents to discuss their response.

9.6 HM Treasury will not include any personal data when publishing its response to this consultation.

Lawful basis for processing the personal data

9.7 The lawful basis we are relying on to process the personal data is Article 6(1)(e) of the UK GDPR; the processing is necessary for the performance of a task we are carrying out in the public interest. This task is consulting on the development of departmental policies or proposals to help us to develop good effective policies.

Who will have access to the personal data

9.8 The personal data will only be made available to those with a legitimate need to see it as part of consultation process.

9.9 As the personal data is stored on our IT infrastructure, it will be accessible to our IT service providers. They will only process this personal data for our purposes and in fulfilment with the contractual obligations they have with us. We will not be sharing any of the personal data externally.

How long we hold the personal data for

9.10 We will retain the personal data until the consultation process has been completed and the policy is implemented. After this, we will only retain personal data if it is embedded in a response, but we will not use it for any unrelated purposes.

Your data protection rights

9.11 You have the right to:

- request information about how we process your personal data and request a copy of it
- object to the processing of your personal data
- request that any inaccuracies in your personal data are rectified without delay
- request that your personal data are erased if there is no longer a justification for them to be processed
- complain to the Information Commissioner's Office if you are unhappy with the way in which we have processed your personal data

How to submit a data subject access request (DSAR)

9.12 To request access to your personal data that HM Treasury holds, contact:

The Information Rights Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

dsar@hmtreasury.gov.uk

Complaints

9.13 If you have concerns about our use of your personal data, please contact the Treasury's Data Protection Officer (DPO) in the first instance at privacy@hmtreasury.gov.uk

9.14 If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner at casework@ico.org.uk or via this website: https://ico.org.uk/make-a-complaint.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk