HM Treasury

Tax Simplification for Alternative Finance

Summary of Responses

October 2024

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Chapter 1
Introduction

1.1 Capital Gains Tax (CGT) is charged on the gains made when an asset is disposed of. Gains made on the disposal of residential properties are exempt from CGT for the period that the property has been occupied as the only or main home of its owners. CGT therefore tends to be chargeable on the gains made on the disposal of second homes and rental properties. As of 30 October 2024, the rates of CGT are 18% and 24%.

1.2 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.

1.3 '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. Alternative finance products are based on Islamic financing but can be used by both followers and non-followers of the Islamic faith.

1.4 Alternative finance arrangements are structured differently to conventional financing arrangements.

1.5 Under 'conventional' financing arrangements, a person who wishes to acquire a property can approach a financial institution to lend 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. The person would then repay the loan to the financial institution over a period of time along with an element of interest.

1.6 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.

1.7 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.

1.8 On the initial purchase of a property, the rules ensure that, for CGT purposes, alternative finance arrangements are excluded from a

CGT charge on the initial sale of beneficial interest in the property by the owner to the financial institution.

1.9 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.

1.10 This is specifically an issue when entering into a **refinancing** arrangement. For example, under a conventional refinancing arrangement, a person (P) would approach a financial institution for a loan with the property being used as security. Although the financial institution will have a charge on the property, the beneficial interest of the building would remain in possession of P. The loan would then be repaid over a period of time with interest. There are no CGT implications because ownership in the property has not changed.

1.11 However, under certain types of alternative refinancing arrangements such as DSO arrangements, P would sell a beneficial interest in a property they already own to a financial institution, who would then advance the finance required. Over the period of the arrangement P would pay the financial institution rent for use of the property that is now owned (or part-owned) by the financial institution. 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 P would buy back the property.

1.12 It is the sale of the beneficial interest in the residential property by the owner to the financial institution that is treated as a part disposal for tax purposes and results in a CGT charge.

1.13 This issue mostly impacts landlords and second homeowners using alternative refinancing arrangements. The refinancing of main homes would be unaffected in both conventional and alternative refinancing situations where Private Residence Relief (PRR) applies to the gain in full.

1.14 A similar issue applies to companies who are liable to Corporation Tax (CT) on capital gains.

1.15 On 16 January 2024, a consultation on 'Tax Simplification for Alternative Finance' was published. The consultation sought views on a legislative change that would 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 arrangements, and neither P nor the financial institution are treated as having made any disposal or acquisition. The consultation closed on 9 April 2024.

1.16 The consultation received 22 responses. Respondents included alternative finance providers, stakeholder representative groups, tax professionals, legal professionals, academics, and consumers. A summary of responses is set out in Chapter 2, and next steps are outlined in Chapter 3.

Chapter 2
Summary of Responses

Part 1 – Issue: Refinancing property using alternative finance arrangements

Question 1: Are there any other implications which may arise for CGT on entering into alternative refinancing arrangements which are not considered above?

2.1 Over three-quarters of those who responded to this question agreed that the consultation captured all CGT implications of entering into alternative refinancing arrangements and that there were no other implications for CGT to be aware of.

2.2 One respondent noted an additional CGT consequence not captured in the consultation document – the person (P) entering into the diminishing shared ownership agreement can trigger a capital loss for CGT purposes, in circumstances where the property in question has fallen in value. These losses can be offset against other taxable gains.

2.3 Whilst respondents did not consider there to be any further CGT consequences of entering into alternative refinancing arrangements, a small number noted the need to ensure that CGT rules relating to alternative finance are future proof. One respondent suggested the government commission a comprehensive study on the adaptability of UK legislation to accommodate various structures of alternative finance arrangements.

2.4 Some respondents raised concerns about taxpayers who have been liable to CGT charges as a result of entering into alternative refinancing arrangements and suggested that changes to CGT rules should apply retrospectively.

2.5 One respondent raised concerns about Annual Tax on Enveloped Dwellings (ATED) liabilities that can arise as a result of using certain alternative finance arrangements, that would not occur if conventional financing arrangements were used. ATED is a tax that was introduced in 2013 to ensure that those individuals who ‘envelope’ residential properties, by owning or purchasing them through corporate structures without a commercial purpose, pay their fair share of tax. As a result of how some alternative finance arrangements are structured, the burden of an ATED charge can fall upon both the financial institution and the individual.

Part 2 – Capital Gains Tax proposals for alternative finance.

Question 2: Do you agree with the conditions described above and do you think they could cause any unforeseen issues that could undermine the intent?

2.6 Over four-fifths of respondents who answered this question broadly agreed with the proposed conditions.

2.7 Whilst there was broad agreement on the conditions as a whole, a number of respondents suggested additions to the list of conditions. For example, a small number noted that the conditions should ensure that transfers of interests in leasehold and freehold properties both qualify for the exemption.

2.8 A small number of respondents noted that the lending of interest back to a home purchase plan provider or a regulated electronic arrangement (peer to peer lender) should qualify.

2.9 Respondents also noted that the conditions should apply to both natural and legal persons.

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

2.10 Almost two-thirds of those who responded to this question agreed in principle to the requirement that alternative financing arrangements should be completed in a set period of time. Half of those agreed on the basis that the period of time should be sufficient to cater for the refinancing arrangements used in either alternative or conventional refinancing, whilst other respondents called for a range of periods from 30 to 50 years.

2.11 One-third of respondents to this question disagreed that a requirement for refinancing arrangements to be completed in a set period of time is necessary. The most common rationale for this was that conventional mortgages of any term are exempt from a CGT charge and therefore the same approach should be taken for alternative refinancing.

Question 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?

2.12 All respondents who answered this question agreed that the rules should be extended to home purchase plan providers.

2.13 Some respondents suggested expanding the rules further to bring additional providers into scope. Some respondents thought that peer-to-peer lenders, Fintech providers and crowdfunding platforms should also qualify for the proposed rules. Others suggested expanding to all diminishing shared ownership (DSO) providers, as home purchase plan providers do not necessarily offer products for buy-to-lets or commercial properties.

Question 5: 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.

2.14 Almost half of respondents who answered this question suggested expanding the scope to allow for other assets which are used for refinancing purposes to qualify for a CGT exemption. Some noted this would pave the way for innovations and would provide flexibility and adaptability within the tax rules whereas others agreed in principle, but were cautious of adding further complexity to legislation.

2.15 Half of respondents felt that expanding CGT rules to consider other asset classes was not necessary, noting that alternative financing tends to be used for property and bringing other asset classes into scope could add further complexity to the legislation.

Question 6: 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?

2.16 Almost all respondents identified securitisation as a circumstance in which a financial institution would dispose of their interest in the property to a third party. This is a method of raising debt finance which typically involves transferring assets from the originator (in this case a financial institution) to a separate vehicle.

2.17 Other circumstances identified by respondents included; where a financial institution sells their financial portfolios to another financial institution, for example, where a financial institution winds down its business; and where the customer defaults on their arrangement with the financial institution – in those circumstances, the financial institution will dispose of its, and the customer's, interest in the property to a third-party purchaser.

Question 7: 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?

2.18 The majority of respondents felt that in instances where the customer had no control or influence over a property being disposed to a third party, such as when a financial institution sells their loan book for securitisation purposes, no CGT liability or charge should be due. Respondents stressed that the customer's commitments would stay the same – customers will continue to make their monthly rental and acquisition payments to whomever assumes the financing portfolios. These respondents felt that special rules were required in scenarios where disposals occur to a third party outside the customer's control.

2.19 In circumstances where a customer defaults on their loan, respondents broadly agreed that the customer should be required to bring a disposal value into account on transfer from the financial institution to a third party.

Question 8: Do you have any views on how the proposed rules will deal with default events or agreements that otherwise fail to complete?

2.20 Some respondents noted that default policies should align with the Financial Conduct Authority and Mortgage Market Review guidance.

2.21 In general respondents noted that, when a default occurs, the financial institution will put the property on the market to be sold via an agent. The financial institution will receive the full sale proceeds. The financial institution will deduct the outstanding finance amounts, plus fees and legal costs and the remaining balance will be paid to the customer.

2.22 One respondent noted that there may be instances where the financial institution may not be able to obtain a price in excess of the original purchase price agreed with the customer and in those circumstances, the customer would be liable for the shortfall.

2.23 One respondent agreed with the proposal set out in the consultation document, that the original base cost of the property before the refinancing arrangements were entered into is used to calculate any gains or loss.

Question 9: 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?

2.24 A number of respondents felt that avoidance risks were low and that the criteria to qualify for the CGT exemption goes far enough.

2.25 Where respondents did identify avoidance risks, these included, sales to connected parties, where respondents noted that sales to connected persons should not qualify for the CGT exemption in line with tax law elsewhere; and the risk whereby a customer completes a series of refinancing arrangements in order to obscure a gain.

Part 3 – Capital allowances implications regarding alternative finance

Question 10: 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?

2.26 One quarter of those who responded to this question did not think capital allowances implications arise in practice – respondents had not seen a case in practice or did not think there was a risk of capital allowances implications arising as DSO arrangements are typically used for residential properties where capital allowances cannot generally be claimed.

2.27 Three-quarters of those who responded to this question thought that capital allowances implications could arise in practice. Two-thirds of those had not seen a case in practice, however respondents felt that changes in capital allowances rules could be helpful.

2.28 One-third of respondents who raised capital allowances as a possible issue stated their main concern was that the benefits of capital allowances may be delayed under a DSO arrangement.

Question 11: Do the capital allowances implications described above prevent those seeking to refinance using alternative finance from doing so?

2.29 Almost three-quarters of respondents to this question thought that the current rules had the potential to discourage, or were preventing those seeking to refinance using alternative finance from doing so. Half of those respondents thought the capital allowances implications prevented those seeking to refinance using alternative finance from doing so and the other half thought there was potential for this to happen in practice but had no evidence or had not seen any cases in practice. The remaining respondents to this question were unaware of any current concerns.

Question 12: Are there any other implications which may arise for capital allowances on entering into alternative finance arrangements which are not considered above?

2.30 All respondents either did not answer the question or stated that there were no other implications to be aware of.

2.31 A few respondents reiterated their support for a solution in the capital allowances regime to treat alternative finance the same as conventional financing from a tax perspective.

Part 4 – Impacts

Question 13: If the government makes the changes proposed, how many refinancing arrangements using alternative finance products each year would be entered into?

2.32 All respondents who answered this question agreed that if the government makes the changes proposed, there would be a significant increase in refinancing arrangements entered into using alternative finance products each year.

2.33 One-third of those who responded to this question referenced a potential volume of 700,000 refinancing transactions annually. Respondents estimated that proposed changes were expected to benefit approximately 25% of alternative finance consumers in the UK.

2.34 One respondent estimated that the alternative finance market for Buy-to-Let refinancing per annum is around £120 million and that there would be sales of Buy-to-Let refinance worth £251 million over five years. Another respondent estimated there would be over £500 million of home finance originations per year completed.

Question 14: Do you have any views, and can you provide evidence, on the extent to which DSO arrangements are used by businesses?

2.35 All respondents who answered this question agreed that DSO arrangements are used frequently by businesses, and are the preferred structure, but have been limited under current rules. However, little evidence was given for this.

2.36 Some respondents asserted the importance of DSO arrangements to the UK Islamic finance property market.

Question 15: Do you have any comments on the administrative burdens required to comply with the proposed rules?

2.37 The majority of respondents who answered the question felt that the administrative burdens required to comply with the proposed rules would be minimal. Several respondents added the caveat that the administrative burdens would only be minimal providing there were clear guidelines outlined in legislation. However, all industry respondents believed the administrative burdens were straightforward.

2.38 One respondent noted they would not describe it as a "burden", and that it would allow for the UK property market to remain attractive to the Islamic finance sector.

Question 16: 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.

2.39 Almost all respondents who answered this question focused on the Islamic faith, noting the majority of those affected by the difference in treatment would likely be individuals from minority ethnic groups.

2.40 While several respondents who answered this question believed it was self-evident and declined to expand further on those impacted, several other respondents stated that consumers were being disadvantaged solely due to their faith.

2.41 Over half of respondents who answered this question emphasised that the proposed changes would achieve a level playing field which is in line with HM Treasury's objectives regarding Islamic finance.

2.42 Several respondents identified that if the proposed changes were made, there would be a positive equalities impact as those choosing to use alternative financing methods due to their faith would no longer incur extra costs.

2.43 Some consumers affected responded to the consultation and noted that alternative finance is more expensive to use, but that they had chosen it, to follow their faith. They noted that they have not received equal treatment to those who take out conventional mortgages.

Chapter 3
Next steps

3.1 The government is grateful for the many thorough written responses.

3.2 Having carefully considered all feedback provided via the consultation, the government will bring forward legislation in the next Finance Bill to provide a level playing field for those using alternative and conventional refinancing arrangements. Legislation will make changes to the taxation of gains for CGT and CT. It will also ensure that there is no Income Tax (IT) liability, or CT on revenue receipts, as a result of alternative refinancing arrangements.

3.3 The legislation will ensure that where qualifying alternative finance provisions are used, individuals will be treated as having owned the interest in the property throughout the period of arrangements, and neither the individual nor the financial institution will be treated as having made any disposal or acquisition for tax purposes. Changes will take effect from 30 October 2024.

3.4 This will mean that, from that date, individuals and companies using qualifying alternative finance arrangements will no longer be subject to CGT, CT or IT charges, where the same charge would not apply for those using conventional financing arrangements.

3.5 This will ensure the continued strength of the UK Islamic Finance sector, both in providing Muslims and non-Muslims with access to alternative finance where needed, and in supporting the UK as a leading global hub.

3.6 The government will also bring forward legislation at the next Finance Bill to ensure ATED charges do not arise where alternative finance is used to purchase residential properties, in circumstances where this charge would not arise under equivalent conventional finance arrangements.

3.7 The government has decided not to bring forward changes to capital allowances rules at this time given there is no clear evidence of real world impacts on taxpayers. The government keeps all tax policy under review.

Annex A
List of respondents

1. All-Party Parliamentary Group on Islamic and Ethical Finance (APPGIEF)
2. Al Rayan Bank
3. BDO LLP
4. Chartered Institute of Taxation
5. Foot Antsey LLP
6. Gatehouse Bank
7. Ihsan Islamic Finance Solutions (IIFS) Ltd
8. Independent Tax
9. Islamic Finance Advisory & Assurance Services (IFAAS)
10. Islamic Finance Hybrid Group
11. John Forbes Consulting LLP
12. OFFA Group
13. RSM UK Tax and Accounting Ltd
14. Senior Lecturer in Finance, Coventry University
15. StrideUp
16. Trowers & Hamlins LLP
17. A number of individuals also responded to this consultation. Their names have not been included here.

HM Treasury contacts

This document can be downloaded from www.gov.uk

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