



**HM Revenue
& Customs**

Mortgage Regulation and Tax Treatment

IREF - 2007

6 November 2007

Mortgage Regulation

- Financial Services Agency (FSA) regulates mortgage market in the UK.
- FSA subject to the Financial Services and Markets Act 2000.
- ‘No obstacles and no special favours’.
- October 2006 published PS06/12 Regulation of Home reversion and Islamic Law Compliant Home Purchase Plans – implemented 6/4/2007

Mortgage Taxation

- Follow the economic substance
- Level playing field with equivalent financial products
- Apply ordinary tax rules where possible
- Provide certainty where the tax treatment would otherwise be unclear

The taxes and duties involved in a mortgage

- Stamp Duty
- VAT
- Company Tax
- Personal Tax

Tax legislation for Islamic mortgages - alternative finance arrangements

- FA 2003 – changes to Stamp Duty
- FA 2005/FA2006 – income tax and corporation tax treatment of retail lending and borrowing arrangements
- FA 2007 – income tax and corporation tax treatment of bonds

Stamp Duty

- Finance Act 2003/2005 – ‘alternative property financing arrangements’
- Removed double charge to Stamp Duty Land Tax where property is
 - transferred to purchaser at end of lease term or where paid for in instalments
 - purchased under equity sharing arrangements

VAT

- Bound by Sixth Directive (Now VAT Dir. 2006/112)
- Property transactions using murabaha can be treated in the same way as a credit sale.
- Diminishing Musharaka – Seen as a property transaction (a lease with a gradual sale of the equitable interest).

Company and personal tax – general structure

- Sections 46 to 57 FA 2005
- ‘Alternative finance arrangements’
- ‘Alternative finance return’ (AFR) and ‘profit share return’ (PSR) is taxed
 - under loan relationships rules (companies)
 - as if it were interest (individuals)
- Schedule 2 FA 2005 applies deduction of tax rules

Section 47 Finance Act 2005

- ‘Purchase and resale’ arrangements – *murabaha*
- At least one party must be a ‘financial institution’
- The AFR is the difference between sale and purchase prices
- Equates in substance to the return on an investment of money at interest
- AFR not taxable as capital gains
- Taxable as an employee beneficial loan

Section 47A Finance Act 2005 (inserted by FA 2006)

- ‘Diminishing shared ownership’ – *musharaka*
- ‘Beneficial interest’ acquired by ‘financial institution’ and another person
- The AFR is the aggregate consideration paid to the financial institution (excluding the FI’s beneficial interest)
- Not a partnership for tax purposes
- AFR not taxable as capital gains
- Taxable as an employee beneficial loan

Company Taxation Treatment

- AFA treated as a loan relationship.
- For murabaha contracts (s47 FA 05) the purchase price is treated as the amount of the loan.
- For diminishing musharaka (s47A FA 05) the amount paid by the financial institution for its share of the property is treated as the loan.
- The return to the company is treated as 'as if' it were an interest payment.

Personal Taxation treatment

- The return on the AFA is treated as if it were interest.
- The return can be treated as an expense of the business if the AFA was undertaken to finance a business property.

Both companies and individuals

- The return paid on the AFA for murabaha and diminishing musharaka contracts is excluded from tax for Capital Gains Tax purposes.
- It is similarly excluded for capital allowances purposes.

Finance Act 2007 – alternative finance investment bonds

- Alternative finance investment bond'
- Section 48A FA 05 – conditions
- Section 48B FA 05 – consequences
- Covers only 'debt-like' sukuk – subject to normal credit risk, investor is assured interest like return and repayment of capital at the end
- If investor directly exposed to business results, or risks and rewards not equivalent to a normal bond – then may be an UUT or offshore fund

Which Islamic Mortgage?

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Bank of London and The Middle East

Introduction

- Finance Act
- Developments in Islamic Mortgages
- Main Structures used in Islamic Mortgages
- Comparative Analysis
- Mortgage Backed Sukuk
- Challenges
- Questions and Answers

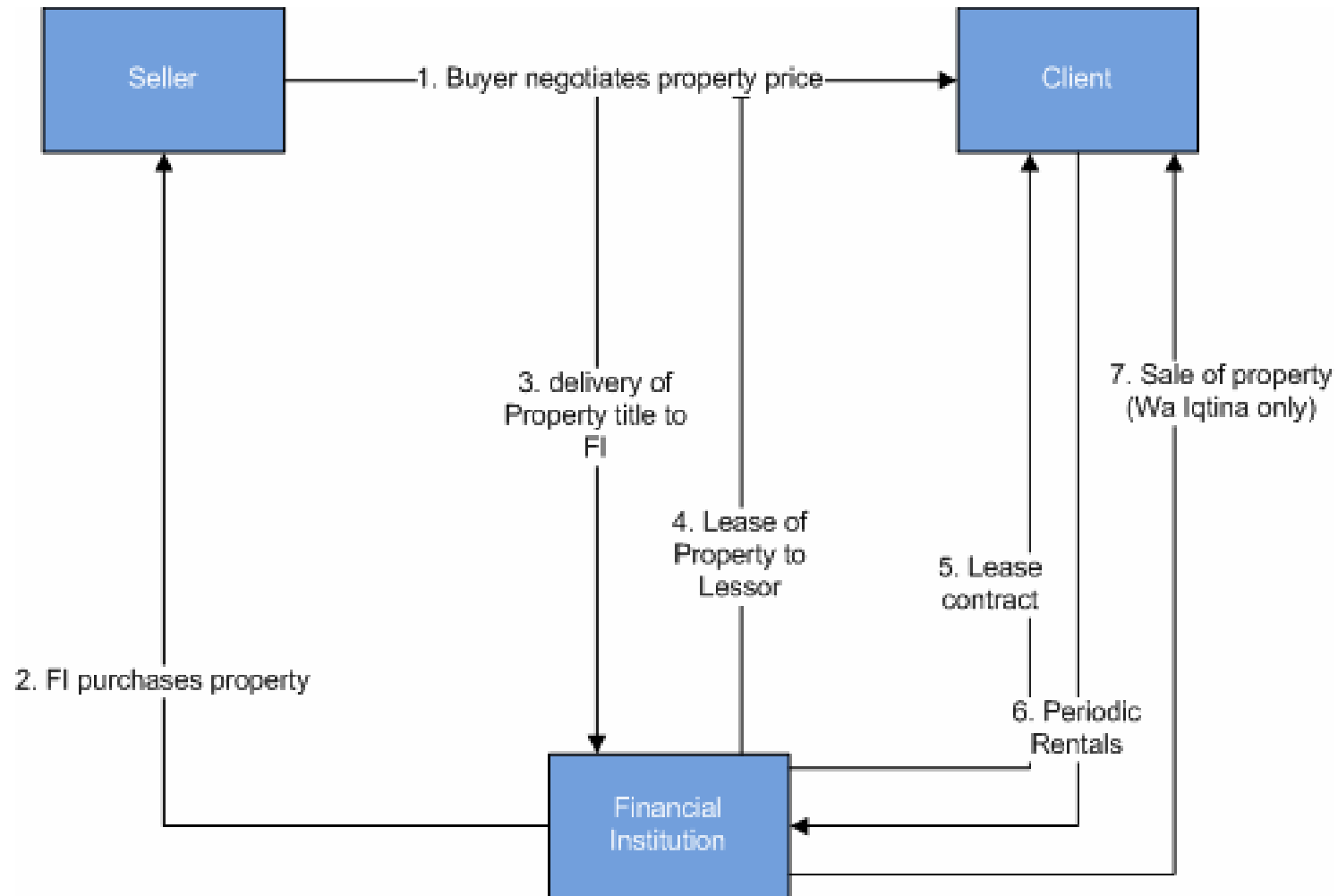
Finance Act 2005 & 2006

- 2005 and 2006 Acts are only applicable when at least one of the parties is a financial institution
- 2006 Act excluded financial institutions from enjoying any increase in the value of the asset in the diminishing Musharaka structure
- Double Stamp Duty – historically the main obstacle to offer Islamic mortgages – is addressed under the new legislation and has been abolished

Islamic Mortgages Structures

- Ijara Wa Iqtina
- Diminishing Musharaka
- Murabaha

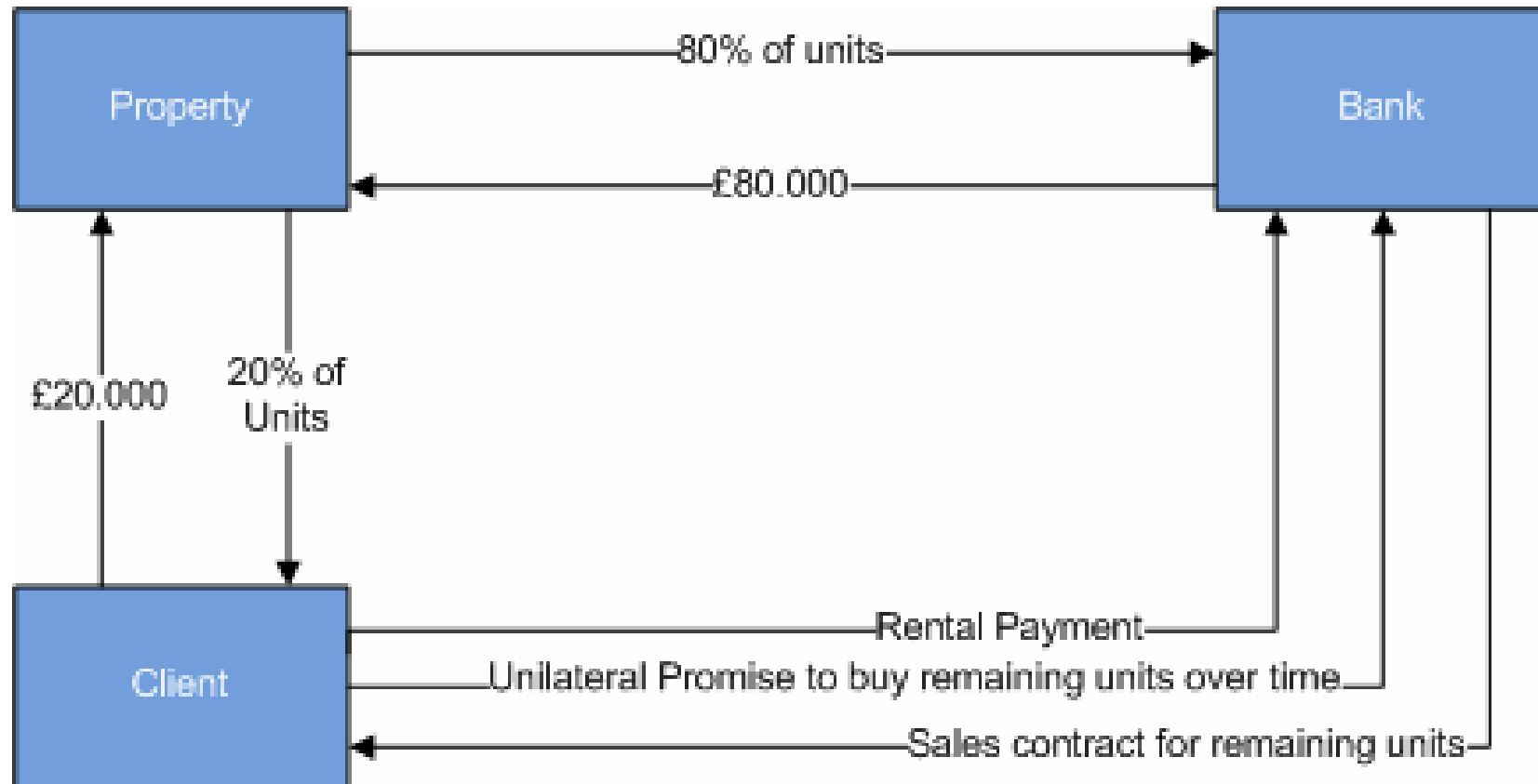
Ijara Wa Iqtina Structure



Diminishing Musharaka

- Financial institution and customer participate in the joint ownership of the property that the customer identified
- Ownership is divided into a number of units on the outset part owned by the bank and part by the customer
- Customer purchases the remaining units throughout the tenor of the mortgage

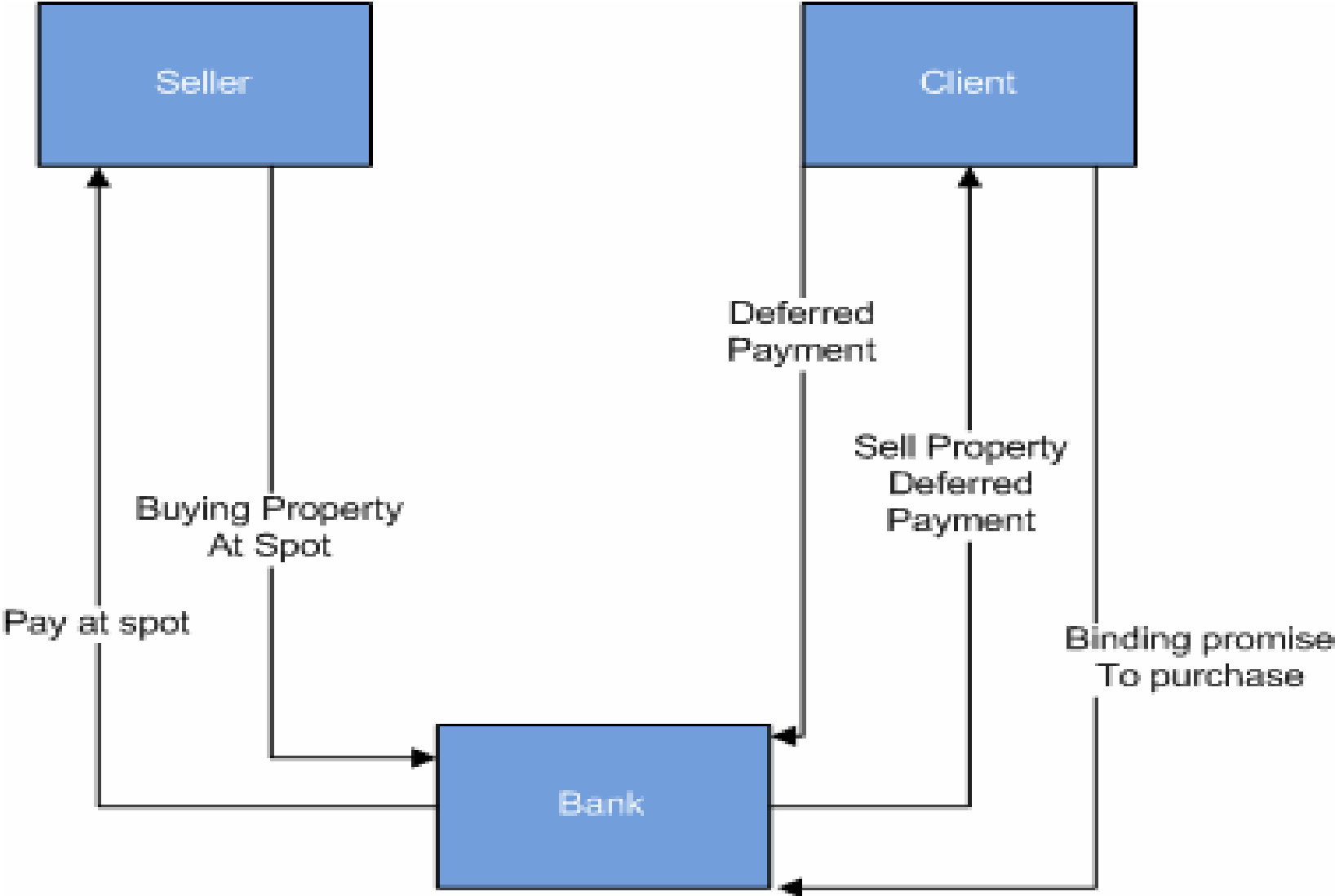
Diminishing Musharaka Structure



Murabaha Structure

- Financial institution purchase the property from the vendor based on the customer request
- Financial institution immediately sells the property with a fixed mark-up profit to the customer on a deferred payment basis

Murabaha Structure



Comparative Analysis of existing Islamic Mortgages Structures

Islamic Mortgage Structure	Murabaha Structure	Ijara Wa Iqtina Structure	Diminshing Musharaka Structure
Profit Rate	Fixed	Variable	Variable
Financial Institution Risk (based on the length of ownership by the financial institution)	Low	High	Medium
Early Repayment Option	Contractually Not Available	Available	Available
Penalty Payments	Available- Provided that it is repaid to Charity, after excluding actual losses and damages.	Available- Provided that it is repaid to Charity, after excluding actual losses and damages.	Available- Provided that it is repaid to Charity, after excluding actual losses and damages.
Securitization	Not Suitable for Securitization	Suitable for Securitization	Suitable for Securitization

Mortgage Backed Sukuk

- Potential market for mortgage backed Sukuk
- Emergence of this market may result in the abandon of the Murabaha structure
 - Murabaha is considered to be a debt
 - Debt is not suitable for Islamic securitization.

Challenges

- The main challenge facing Islamic Financial Institutions is to offer Islamic mortgages that are economically viable and can compete with conventional mortgages.
- Sell Islamic Mortgages to Muslims as well as non-Muslims
- Basel II can have negative impacts on Islamic Finance Institutions offering Islamic Mortgages.

Questions and Answers

Maulana Sheikh Shahid Raza - Partner

- The Sharia Finance Advisory Council (SFAC)