VAT Information Sheet 11/06

VAT: Guidance on the VAT treatment of certain Islamic products

12 December 2006

This Information Sheet sets out guidance on the VAT treatment of certain Islamic products currently being offered to the general public, businesses and other financial institutions by various banks in the UK.

1 Introduction

1.1 What is this Information Sheet about?

HM Revenue and Customs (HMRC), providers of Islamic products and representative trade bodies have been in discussions concerning the VAT treatment of certain Islamic products currently being offered to the general public, businesses and other financial institutions by various banks in the UK. This VAT Information Sheet sets out the findings of those discussions and the VAT treatment of those products.

This VAT Information Sheet is intended to supplement, not replace, existing HMRC guidance. It is intended that the information contained herein will be included in Notice 701/49 Finance at a later date.

1.2 Who does it affect?

This VAT Information Sheet clarifies the VAT treatment of certain Islamic products currently being offered to the general public, businesses and other financial institutions by various banks in the UK and should be read by providers of those products or by those introducing customers to those providers.

1.3 When does it come into effect?

This VAT Information Sheet provides advice to providers of certain Islamic products and the VAT treatments outlined should be applied immediately.

If you are a provider of any of the Islamic products listed in this VAT Information Sheet and realise that you have treated your services incorrectly for VAT please see paragraph 5.3.
1.4 Changes in contractual details

Please be aware that the VAT treatments of the products set out in this Information Sheet have been drawn from information, including contractual details, provided by various parties. Should the details change in any way from that described HMRC reserves the right to review the VAT treatments set out in this Information Sheet and, if necessary, to change the VAT treatment from a current or future date.

1.5 Further reading

This VAT Information Sheet should be read in conjunction with the following Notices:

- 701/9 Derivatives and Terminal Markets.
- 701/49 Finance.

You may also need to read the following Notices:

- 700/6 Rulings.
- 700/9 Transfer of business as a going concern.
- 701/21 Gold.
- 701/21A Investment gold coins.
- 700/45 How to correct VAT errors and make adjustments or claims.
- 708 Buildings and construction.
- 741 Place of supply of services.
- 742 Land and Property.
- 742A Opting to tax land and buildings.

2. Sharia’a principles

Sharia’a is a body of Islamic law and is a framework regulating aspects of private and public life.

According to Sharia’a principles the following are prohibited:

- the charging or receipt of interest (riba)
- uncertainty or deception, for example an ambiguity or lack of clarity in the terms of a contract that can give rise to speculation (gharar)
• gambling or speculation, for example any transaction undertaken for purely speculative purposes (maisir)

• unethical investments, for example dealing in activities or commodities that include pork, pornography, arms or munitions, conventional financial services, cinema, tobacco, gambling or alcohol.

This has meant that many Muslims have been unable or unwilling to obtain conventional credit finance in order to purchase goods and/or services because those products are prohibited in their faith.

In order to be able to provide Sharia’a compliant products, banks and other financial institutions in the UK, along with boards of Sharia’a scholars, have worked together to create the products listed in this Information Sheet. The basic tenants under which these products operate are via a trade or rental arrangement – which are allowed under Sharia'a.

3. Description of Islamic products and their VAT treatment

3.1 Price plus 'profit'

There are three products that use the 'price plus 'profit' principle to fund purchases - a basic product (called 'Murabaha'), one that involves commodity transactions (called 'commodity Murabaha') and a reverse of this (called 'reverse Murabaha').

3.1.1 Basic price plus 'profit' ('Murabaha')

Description

This product can be used to fund the purchase of a variety of assets, including cars, fridges, televisions and property (both residential and commercial).

Example: A customer of a financial institution (eg a bank) wishes to purchase an asset but does not have the available funds. The customer therefore enters into an agreement with the bank under which the bank will purchase the asset for the sale price (eg £10,000), taking title, whilst the customer takes possession of the asset as agent for the bank. The bank will then sell the asset to the customer for sale price plus a 'profit' (eg £15,000 (being the selling price of £10,000 and £5,000 'profit')), allowing the customer to defer payment by instalment over a set period of time or to pay the total price at a specified future date. Title to the asset will always pass from the bank to the customer at the beginning of the arrangement.

VAT treatment (goods)

Where title to the asset passes from the bank to the customer the sale is treated in the same way as a credit sale (please see paragraph 4.3 of Notice 701/49 Finance). There are two supplies being made by the bank - one of the goods and one of the facility to defer payment.
Consideration for supply of the goods will follow the normal liability rules. The 'profit' element will be treated as consideration for the facility to defer payment and will be exempt under the VAT Act 1994, Schedule 9, Group 5, item 3.

**VAT treatment (property)**

As with goods, the sale is treated in the same way as a credit sale (please see paragraph 4.3 of Notice 701/49 Finance). There are two supplies being made by the bank - one of the property and one of the facility to defer payment.

For the liability of the sale of the property you should read Notice 708 Buildings and construction, Notice 742 Land and Property and Notice 742A Opting to tax land and buildings.

The 'profit' element will be treated as consideration for the facility to defer payment and will be exempt under the VAT Act 1994, Schedule 9, Group 5, item 3.

When property is transferred as part of the purchase of a going concern the bank will not have operated the business. Where the consideration of in regard to the property the liability will follow the normal rules for property (see also paragraph 4.2 of this Information Sheet).

**3.1.2 Price plus 'profit' involving commodity transactions (‘commodity Murabaha’)**

**Description**

This product can operate in either of the following ways.

**Example 1:** A customer requires a loan of £10,000. The bank purchases commodities from a supplier for £10,000, taking title but not delivery, and then sells immediately to the customer for £10,500 (price and 'profit'), allowing the customer to defer payment, either over a set period or until a specified future date. The customer takes title to the commodities (but not delivery). The customer, using the bank as its agent, then immediately sells the commodities for £10,000 to a purchaser (the bank makes no charge to the customer for acting as agent). All of this is done on spot (ie it is done almost instantaneously to avoid the risk of either a rise or fall in the commodity price). The £10,000 cash is credited into the customer’s account for the customer to use as he/she wishes. The £500 'profit' on the sale of the commodity by the bank to the customer is what the bank makes from the deal.

**Example 2:** A customer requires a loan of £10,000. The bank, using an agent, purchases commodities from a supplier for £10,000, taking title but not delivery, and sells immediately to the customer for £10,500 (price and 'profit'), allowing the customer to defer payment, either over a set period or until a specified future date. The customer takes title to the commodities. All of this is done on spot (ie it is done almost instantaneously to avoid the risk of either a rise or fall in the commodity price). The £10,000 cash is credited into the customer’s account for the customer to use as he/she wishes. The £500 'profit' on the sale of the commodity by the bank to the customer is what the bank makes from the deal.

**VAT treatment**
The VAT treatment of commodities is set out in Notice 701/9 Derivatives and Terminal Markets. Please note that there are separate rules covering supplies of investment gold, and these can be found in Notice 701/21 Gold.

The ‘profit’ element made by the bank will be treated as consideration for the facility to defer payment and will be exempt under the VAT Act 1994, Schedule 9, Group 5, item 2.

3.1.3 Reverse of the price plus ‘profit’ involving commodity transactions (‘reverse Murabaha’)

Description

This product is the reverse to the commodity Murabaha, and is normally used to affect a loan between financial institutions. As with the commodity Murabaha described above this product can operate in either of the following ways:

Example 1: Bank A requires a loan of £100m. Bank B purchases commodities from a supplier for £100m, but does not take delivery, Bank A acting as agent for Bank B but making no charge for doing this. Bank A takes title to the commodities. Bank A then sells the commodities immediately to Bank B for £105m (price and ‘profit’), allowing Bank B to defer payment, either over a set period or at a specified future date. Bank B takes title to the commodities but not delivery. Bank B then immediately sells the commodities for £100m to an end-purchaser. All of this is done on spot (ie it is done almost instantaneously to avoid the risk of either a rise or fall in the commodity price). The £100m cash is credited into Bank A’s account.

Example 2: Bank A requires a loan of £100m. Bank B purchases commodities from a supplier for £100m, taking title but not delivery, and sells immediately to Bank A for £105m (price and ‘profit’), allowing Bank A to defer payment, either over a set period or at a specified future date. Bank A takes title to the commodities but not delivery. Bank A, with Bank B now acting as its agent, immediately sells the commodities for £100m to an end-purchaser. All of this is done on spot (ie it is done almost instantaneously to avoid the risk of either a rise or fall in the commodity price). The £100m cash is credited into Bank A’s account.

VAT treatment

See the VAT treatment set out in paragraph 3.1.2.

3.2 Lease only (‘Ijara’)

Description

This product is a basic leasing product that can be used to lease a variety of assets, including cars, fridges, televisions and property (both residential and commercial). The financial institution (eg a bank) acquires title to the asset and leases it to its customer. At no time does title to the asset pass to the customer, nor is it expected to pass. If the customer wishes to purchase the asset at a later date a separate agreement is drawn up.
VAT treatment

Consideration for supplies made under this arrangement will be treated in the same way as other forms of leasing agreements. Where the consideration is for a supply of services, other than property, it is taxable at the standard rate of VAT. Where the consideration is in regard to property, the liability will follow the normal rules for property (please see Notice 708 Buildings and construction, Notice 742 Land and Property and Notice 742A Opting to tax land and buildings).

3.3 Lease and purchase (‘Ijara-wa-Iqtina’)

Description

This product is the same as the Ijara described above except that title to the asset is expected to pass to the customer at some time, usually at the end of the contract period. It can be used to purchase both goods and property.

VAT treatment (goods)

This product will be treated in the same way as a Hire Purchase/Conditional Sale (please see paragraph 4.3 of Notice 701/49 Finance). There are two supplies being made by the bank – one of the goods and one of the facility to defer payment.

Consideration for supply of the goods will follow the normal liability rules. The additional charge above the price of the goods will be treated as consideration for a deferred payment facility and thus exempt under the VAT Act 1994, Schedule 9, Group 5, item 3.

VAT treatment (property)

Where the bank is the absolute legal and beneficial owner of the property the transaction will be treated in the same way as for goods (eg Hire Purchase/Conditional Sale), except that the normal rules for property will apply for the sale of the asset (please see Notice 708 Buildings and construction, Notice 742 Land and Property and Notice 742A Opting to tax land and buildings). The additional charge above the price of the property will be treated as consideration for a deferred payment facility and thus exempt under the VAT Act 1994, Schedule 9, Group 5, item 3.

Where the bank is unlikely to be the absolute legal and beneficial owner of the property, but takes title only by way of security, the assignment of the title by the customer to the bank operates by way of a mortgage. Any payments made by the customer to the bank will be repayments of the loan and, where the amount repaid is greater than the capital sum advanced, will be consideration for a grant of credit and be exempt under the VAT Act 1994, Schedule 9, Group 5, item 2.

When property is transferred as part of the purchase of a going concern the bank will not have operated the business. Where the consideration of in regard to the property the liability will follow the normal rules for property (see also paragraph 4.2 of this Information Sheet).
3.4 Shared ownership ('diminishing Musharaka')

Description

This product involves the use of two written contracts, being a lease agreement ('Ijara') and a diminishing ownership agreement ('Musharaka'), where two or more parties share ownership of an asset.

Example: A customer wishes to purchase a residential property for £200,000. He/she pays a deposit of £20,000 to the vendor of the property and then enters into a diminishing ownership agreement with the bank, under which the bank pays the outstanding £180,000, taking title to the property by way of a sub-sale between the vendor and the bank. The bank’s customer now has a 10% beneficial interest (or share) in the property, with the remainder being with the bank. The bank allows the customer to defer payment of the £180,000 over a period of twenty-five years. It does not (and cannot) add any interest to the £180,000 and so under this contract the customer pays back the exact amount paid out by the bank.

At the same time as the customer enters into the diminishing ownership agreement he also enters into a lease agreement, whereby the bank agrees to lease its share of the house to the customer for a variable amount of rent. This lease agreement runs concurrent with the diminishing ownership agreement.

The customer may also be expected to pay any outgoings related to the property as well as all administrative and legal costs, arrangements fees, Stamp Duty Land Tax, HM Registry fees and VAT (if applicable).

Both the amount repaid under the diminishing ownership agreement and the amount paid under the lease agreement are amalgamated and used to calculate how much of the bank’s share in the property has been purchased per month by the customer. As the bank’s share in the property decreases so does the amount paid under the lease agreement.

At the end of the twenty-five years, and if all the conditions contained within the two contracts have been met, the bank will pass title to the property to customer under the diminishing ownership agreement, normally for an additional payment.

NB - whilst some banks also require the customer to sign a third agreement under which the customer provides some form of security against payment of the amounts due under the other two contracts, other banks may also require more than three agreements to be signed.

VAT treatment

The central supplies are (i) the gradual sale of equitable interest, and (ii) lease of property. As such consideration for supplies made under this form of arrangement will follow the normal rules for property (please see Notice 708 Buildings and construction, Notice 742 Land and Property and Notice 742A Opting to tax land and buildings).
3.5 Agency (‘Wakala’)

Description

This is an investment product, which functions in the same way as Mudaraba, which is discussed at paragraph 3.7. The difference between the two is that with a Mudaraba all the profit is divided between the parties, whilst with a Wakala the investor receives only the agreed ratio against investment. Anything made above that ratio is kept by the financial institution and not given to the investor.

Example: an investor agrees to invest a sum with the bank for an agreed return (eg 5%). The bank pools the investor’s funds with the funds of other investors and its own capital and invests in Sharia’a compliant assets. At the end of a given period (eg a month) the bank returns the invested sum to the investor along with the agreed 5%. Any additional revenue that the bank makes on the customer’s money is kept by the bank (eg if the bank makes 6% then 5% is given to the customer and the additional 1% is kept by the bank). If the bank does not make the agreed percentage return then the investor gets what has been made whilst the bank gets nothing (eg if only 4% is achieved then the investor gets the full 4%).

VAT treatment

The VAT treatment depends on whether the bank or other financial institution makes the investment decisions (discretionary or 'unrestricted') or whether it follows the instructions of its clients (non-discretionary or 'restricted').

Where the bank makes the investment decisions any charges made by the bank to the investor will follow the policy set out in paragraph 2.10 of Notice 701/49 Finance. The additional profit made by the bank will be outside the scope of VAT.

Where the bank follows the instructions of its clients the additional revenue made by the bank on the investment of the capital will be taxable at the standard-rate. This is because what the bank is doing is a form of portfolio/investment management (please see paragraph 7.1 of Notice 701/49 Finance).

3.6 Islamic current accounts

Description

These operate in the same way as a conventional current account except that there is no overdraft facility and no interest added by the bank to the account for funds in credit.

VAT treatment

Any charges made by the bank will follow the policy set out in paragraph 2.10 of Notice 701/49 Finance.
3.7 Islamic savings accounts (operated under an unrestricted 'Mudaraba' contract)

Description
This product operates under Mudaraba principles whereby the bank will act as a partner and manager and applies its expertise. The bank acts in a discretionary/unrestricted capacity.

Like conventional savings accounts, the aim of the product is to give investors an agreed return on their investments. Investors normally have to keep their money in the account for a set period of time. The bank pools the investor’s money with that of other investors and the bank’s own money and then invests it in Sharia’a compliant equities.

At the end of each month the gross income is calculated and then various deductions are made (eg direct costs (including costs such as marketing), fees and other expenses incurred by the bank in investing the pooled funds). The bank’s share of the income is then calculated and the remainder is credited to the customer’s account.

VAT treatment
See the VAT treatment set out in paragraph 3.6.

4 Other VAT issues

4.1 Intermediary services
The policy for determining whether someone is acting as an intermediary for the purposes of the finance exemption is set out in section 9 of Notice 701/49 Finance.

Where you introduce customers to products that are not financial services, for example transactions in land or property, the finance exemption for intermediaries will not apply and so any fees charged will be taxable at the standard rate of VAT.

4.2 Transfers of a going concern (TOGC)
Notice 700/9 Transfers of a going concern sets out the conditions that must be met if the transfer of a business is to be treated as a going concern. If the conditions are not met then the transfer cannot be treated as a going concern and the normal VAT rules will apply to supplies of assets (note particularly paragraph 2.3.3 of the Notice on consecutive transfers of businesses).

4.3 Place of supply of services relating to land and property
If a supply consists of services that relate to land or property, the place of supply of those services is where the land itself is located, irrespective of where either the bank etc or its customer belongs. It should also be borne in mind that:
• there may be a requirement to account for the reverse charge if both the bank etc and the land are located in the UK but the supplier of those services belongs outside the UK

• if a bank etc supplies services relating to land in another member State, it might be required to register for VAT in that member State.

For further information you should read Notice 741 Place of supply of services.

4.4 Partial exemption

It is anticipated that adjustments may be needed to partial exemption methods to ensure that they achieve a fair and reasonable result. Businesses that provide Islamic products should therefore review their methods and, if necessary, contact HMRC to discuss a new fair and reasonable method going forward. Further guidance is available in VAT Notice 706 Partial exemption.

Businesses using the standard method may need to make adjustments under the standard method override, which came into effect on 18th April 2002. The override requires businesses to make an adjustment to their partial exemption calculations where the input tax deducted during the tax year differs substantially from a deduction based on use. If override adjustments are required on a regular basis then the business should certainly contact HMRC to discuss a new method going forward.

5. Frequently asked questions

5.1 What if I am about to offer, or I am already offering an Islamic product not covered by this Information Sheet?

If you are about to launch, or are already offering an Islamic product not covered by this Information Sheet, and you wish to know how the VAT treatment, please contact either your Client Relationship Manager or our National Advice Service (please see paragraph 5.5 for details on how to contact the National Advice Service). If you are asked to write to the National Advice Service you should include a full description of how the product works as well as copies of agreements and any promotional literature (see paragraphs 2.3 and 2.4 of Notice 700/6 Rulings).

5.2 What if I have a product of the same name as one described in the Information Sheet but which operates differently?

Should you provide a product under one of the titles used in this VAT Information Sheet, but which does not operate in the manner described, then the VAT treatment set out may not apply. In this case, you should seek advice from either your Client Relationship Manager or the National Advice Service (for details on how to contact the National Advice Service please see paragraph 5.5).
5.3 What if I am offering a product that operates in the same way as one of those listed, but which isn’t an Islamic product?

If you are offering a product that operates in the same way as one of those listed the corresponding VAT treatment will apply.

5.4 What if I am providing one or more of the products set out in the Information Sheet but I am applying the wrong VAT treatment?

5.4.1 Applying the correct VAT treatment

- If you have been given a ruling by HMRC but chose not to apply it you will now need to apply the correct VAT treatment as detailed in this Information Sheet from the date of this Information Sheet. You must also make a claim or adjustment for earlier periods (see paragraph 5.4.2).

- If you have been given a ruling by HMRC that is now incorrect you should apply the correct VAT treatment as detailed in this Information Sheet from the date of this Information Sheet. If you wish to make a claim or adjustment for earlier periods you should see paragraph 5.4.2.

- If you have not been given a ruling by HMRC but have been applying an incorrect VAT treatment you should apply the correct VAT treatment as detailed in this Information Sheet from the date of this Information Sheet. You must also make a claim or adjustment for earlier periods (see paragraph 5.4.2).

5.4.2 Information on making claims and adjustments

Where you need to, or wish to make a claim to HMRC, you may do so, subject to the conditions set out below, by using one of the following methods (full details are given in VAT Notice 700/45 How to correct VAT errors and make adjustments or claims):

- where the total of previous errors does not exceed £2,000 net tax, an adjustment may be made to your current VAT return

- where the total of previous errors exceeds £2,000 net tax, a separate claim should be submitted to HMRC (in these cases the errors must not be corrected through your VAT returns).

Details of where to send your claims can be obtained from Update 2 to VAT Notice 700/45 How to correct VAT errors and make adjustments or claims or the National Advice Service (see paragraph 5.5).

All adjustments or claims are limited to a three-year period (subject to Business Brief 13/06) and will be subject to the following conditions:
• all claims must take into account input tax that has been claimed/not claimed

• businesses must be able to produce evidence that they accounted for VAT, and must be able to substantiate the amount claimed.

Subject to the three-year limitation period, any claim should be for all prescribed accounting periods in which the liability error occurred.

Should a claim not take into account all errors or all affected accounting periods, then HMRC will seek to set-off amounts owed to us for these periods against amounts claimed in other periods.

HMRC may reject all or part of a claim if repayment would unjustly enrich the claimant. More details on ‘unjust enrichment’ can be found at part 14 of VAT Notice 700/45 How to correct VAT errors and make adjustments or claims.

A notification to HMRC that a business intends making a claim in the future is not a valid claim.

5.5 Who can I contact for further information?

If you have a query for which you have been unable to find the answer, either within this Information Sheet or the Notices mentioned, please contact either your Client Relationship Manager or our National Advice Service on 0845 010 9000 (+44 2920 501 261 for International Enquiries), which is available from Monday to Friday, 8.00 am to 8.00 pm (GMT).

If you have hearing difficulties, please ring the Textphone service on 0845 000 0200.