

Sukuk—investment bond arrangements and UK VAT

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This Practice Note outlines the UK VAT treatment of the issue of a sakk by an issuer to an investor (or sakk holder).

A sakk is a certificate that confers certain rights on the holder to receive payments from time to time. Its key characteristics are comparable to those of a bond (or similar financial instrument).

‘Sukuk’ is the plural of ‘sakk’.

A sukuk issuance is a form of Islamic financing. For more information on Islamic financing generally, see Practice Note: [Key principles of Islamic finance](#).

For more information on other (non-VAT) tax aspects of sukuk, see Practice Notes: [Sukuk—investment bond arrangements and their UK direct tax treatment](#), [Sukuk—investment bond arrangements and stamp duty and SDRT](#) and [Sukuk al ijara—tax reliefs for sale and leaseback arrangements](#).

This Practice Note is written on the assumption that:

- the issuer is a corporate special purpose vehicle
- both the issuer and the sakk holder belong in the UK for VAT purposes in relation to the sukuk issuance
- any trust property held by the issuer that constitutes land, or goods for VAT purposes, is situated (and remains) in the UK, and
- each transaction entered into by the issuer or the sakk holder is with a counterparty who belongs in the UK for VAT purposes in relation to that transaction

For more information on the concept of belonging for VAT purposes, see Practice Note: [Where is a supply made?—How do I know where the recipient or supplier of services belongs?](#)

Structure of sukuk issuance

A sukuk issuance is generally structured as follows:

- the issuer declares a trust in favour of the sukuk holders over the asset(s) it acquires, and
- each sakk it issues represents an undivided beneficial ownership interest in the underlying trust property

From the commercial perspective, a sukuk issuance is in economic substance the equivalent of a bond issuance, with each sakk conferring a right on the holder to:

- payments equating to what would be interest had the sakk been a conventional bond, and
- on maturity, repayment of the principal

For more information, see Practice Note: [Sukuk—investment bond arrangements and their UK direct tax treatment—What are sukuk?](#)

VAT characterisation of sukuk—form versus substance

A key question from the VAT perspective is whether the issue or transfer of a sakk should be:

- analysed in accordance with its legal structure, ie as the creation or transfer of an interest in the underlying trust property—for more information, see: [VAT analysis of sukuk as dealing in the underlying property](#) below, or
- treated in accordance with its economic substance, ie in the same way as the issue or transfer of:
 - a bond (or similar financial instrument)—for more information, see: [VAT analysis of sukuk as conventional bonds](#) below, or
 - a unit in a unit trust (or similar collective investment scheme)—for more information, see: [VAT analysis of sukuk as interests in a collective investment scheme](#) below

Neither EU nor UK VAT legislation contains provisions that deal specifically with Islamic financing products.

This is in stark contrast to the position in relation to UK direct tax, where special rules have been introduced to deal with the treatment of certain Islamic financing products, which are referred to in the relevant legislation as alternative finance arrangements.

These include alternative finance investment bond arrangements, which, provided that the relevant conditions are satisfied, would encompass sukuk.

For more information on the other (non-VAT) tax rules that are potentially applicable to sukuk, see Practice Notes: [Sukuk—investment bond arrangements and their UK direct tax treatment](#), [Sukuk—investment bond arrangements and stamp duty and SDRT](#) and [Sukuk al ijara—tax reliefs for sale and leaseback arrangements](#).

Although HMRC has issued guidance on the UK VAT treatment of certain Islamic financing products, the products discussed do not include sukuk.

References:
[VATFIN8000](#)

There is, therefore, a lack of authority and guidance on, and thus a degree of uncertainty over, the precise UK VAT treatment of a sukuk issuance.

Even the offering circular dated 30 June 2014 for the issuance by HM Treasury UK Sovereign Sukuk Plc does not mention VAT.

References:
[UK government sukuk 2014 offering circular, pp 39–41](#)

The position is further complicated by VAT being an EU tax, which means that the UK VAT treatment of a sukuk issuance must be consistent with applicable EU laws and principles. For more information, see Practice Note: [VAT—European legal principles](#).

In theory, the VAT treatment of a sukuk issuance is the same across all EU jurisdictions. However, the position in practice may be less harmonised.

VAT analysis of sukuk as dealing in the underlying property

Because a sakk represents an undivided beneficial ownership interest in the underlying trust property, where its issue is analysed as the creation of a proprietary interest in the underlying trust property, its VAT treatment would be the same as the VAT treatment of any supply the subject matter of which is the same as the underlying trust property.

The VAT treatment of any transfer or redemption of the sakk would follow the VAT treatment of its issuance.

Whether the issuance, transfer or redemption of the sakk would be standard-rated, zero-rated, exempt or otherwise for VAT purposes would depend on the precise nature of the underlying trust property (which typically comprises land or commodities such as base metals).

However, this is not the approach normally taken in the UK.

VAT analysis of sukuk as conventional bonds

In the UK, it is generally accepted that:

- no VAT should be payable in respect of the issue, transfer or redemption of a sakk, and
- a sukuk issuance should be treated for VAT purposes in the same way as a bond issuance

This analysis focuses on the sakk being an instrument that carries a right to periodic payments and the eventual return of the sakk holder's investment, ie the principal.

This approach, which looks more to the economic substance of the transaction (as opposed to its strict legal form), is not dissimilar to the approach taken in the UK in relation to receivables securitisations where the assignment of the receivables, necessary from the legal perspective to effect a 'true sale', is disregarded for UK VAT purposes (being treated as a 'pre-condition' rather than a supply).

References:

Capital One Bank (Europe) v HMRC (2005) ([VTD 19238](#))

MBNA Europe Bank v HMRC [2006] STC 2089

[VATFIN3240](#)

For more information on VAT and securitisations, see Practice Note: [Asset-backed securitisations—the UK tax treatment](#).

Where the issue of a sakk is treated for VAT purposes in the same way as the issue of a bond (or similar financial instrument):

- the issue of the sakk is not a supply for VAT purposes

References:

Kretztechnik AG v Finanzamt Linz [2005] STC 1118

[VATFIN4250](#)

[VATSC97600](#)

- the transfer of the sakk is similarly not a supply although, in certain circumstances (such as where the sakk holder is trading in sukuk or similar financial instruments), it may amount to an exempt supply, and

References:

Kretztechnik AG v Finanzamt Linz [2005] STC 1118

Value Added Tax Act 1994, Sch 9, Pt II, Group 5, item 6(a)

[VATFIN4250](#)

- the redemption of the sakk does not give rise to any supply

References:

[VATFIN4250](#)

For more information on the VAT treatment of conventional securities, such as bonds, see Practice Note: [Exemption from VAT for dealing with securities and underwriting](#).

The analysis should be revisited in any case where the commercial or economic focus of the particular transaction, or the terms of the particular sukuk, are more on the sukuk representing undivided beneficial ownership interests in the underlying trust property.

HMRC should be consulted where there is doubt over the precise UK VAT treatment of any particular sukuk issuance.

VAT analysis of sukuk as interests in a collective investment scheme

An alternative VAT analysis is to treat a sukuk issuance for VAT purposes in the same way as the issue of units in a (widely funded) unit trust.

Because a sakk represents an undivided beneficial ownership interest in the underlying trust property, a sukuk issuance could be said to be a form of pooled investment, and the arrangements could be regarded as a 'collective investment scheme' (like a unit trust).

Although legislation exists that would prevent alternative finance investment bond arrangements (which, provided that the relevant conditions are satisfied, would encompass sukuk) from being treated for the purposes of certain direct taxes as a collective investment scheme (for which, see Practice Note: [Sukuk—investment bond arrangements and their UK direct tax treatment—Collective investment schemes](#)), those provisions do not apply in relation to VAT.

References:

[CFM11130](#), [CFM44230](#)

Where the issue of a sakk is treated for VAT purposes in the same way as the issue of a unit in a (widely funded) unit trust:

References:

VATA 1994, Sch 9, Pt II, Group 5, item 6(e)

[VATFIN4250](#)

- the issue of the sakk is not a supply for VAT purposes
- the transfer of the sakk is similarly not a supply although, in certain circumstances (such as where the sakk holder is trading in sukuk or similar financial instruments), it may amount to an exempt supply, and
- the redemption of the sakk does not give rise to any supply

For more information on the VAT treatment of units in authorised unit trusts, see Practice Note: [Exemption from VAT for dealing with securities and underwriting—Dealing with securities exemption](#).

For more information on unit trusts and other fund vehicles, see Practice Note: [Authorised investment funds—defined](#).

Normal VAT principles apply to supplies of sukuk trust property

Transactions entered into by the issuer in relation to the underlying trust property (such as where the issuer sells the trust property to a third party) are subject to general VAT principles in the normal way.

For example, if the issuer enters into a murabaha, that murabaha would be treated in the same way for UK VAT purposes as if it had been entered into by any other person. In other words, no special rules apply simply because the transaction or asset in question is the subject of, or is otherwise connected with, a sukuk issuance.

Who makes supplies in relation to the trust property?

If, as a matter of legal analysis, the sukuk represent undivided beneficial ownership interests in the underlying trust property, where a supply is made for VAT purposes in relation to the underlying trust property (for example, where the issuer sells the trust property to a third party), who makes the supply?

Is it:

- the person holding the legal title to the trust property (the issuer), or
- the beneficial owners of the trust property (the sukuk holders)?

It is generally accepted that unless the underlying trust property is land (where the position may be different), the person who should be treated as making the supply for VAT purposes is the person holding the legal title to the trust property, ie the issuer, even where the trust is a bare trust (which is fiscally transparent for other tax purposes).

References:

Walter Hall Group PLC (VTD 18007)

Therefore, where the supply is taxable (such as where it is standard or zero-rated), it is the issuer that must ascertain if it is required to register for UK VAT (or apply for exemption from such registration), and not the sukuk holders.

A notable exception is where the underlying trust property is land. In such a case, special rules may apply to treat the supply as being made by the sukuk holders, although in practice, if the sukuk are widely held by many different investors, HMRC may still treat the issuer as the supplier.

Sukuk-al-ijara

A sukuk-al-ijara is a sukuk issuance backed by an ijara.

An ijara is a lease. It is sometimes coupled with an undertaking to transfer ownership at the end of the lease term (in which case the arrangement would in economic substance be the equivalent of a hire-purchase or even a sale and leaseback or sale and lease & sale-back).

By way of example, the issuer of a sukuk-al-ijara of land may:

- purchase land
- lease it back to the vendor (or the originator) on finance lease terms, and
- (assuming no breach of the lease terms) sell the land back to the originator at the end of the lease term

Sukuk where the trust property is land

There are special rules in UK VAT legislation that deal specifically with the situation where the grant of an interest in, right over, or licence to occupy, land is made by one person (eg the legal titleholder in relation to the land) but the benefit of the consideration for the grant accrues to another (eg the beneficial owner), such as where the land is held on bare trust.

References:

VATA 1994, Sch 10, Pt 3, para 40

[VATLP04250](#)

These special rules are referred to in the remainder of this Practice Note as the para 40 rules.

Where the para 40 rules apply, the legal titleholder would not be treated as the person making the supply (as would ordinarily be the case where the supply is in relation to a non-land asset). Instead the beneficial owner would be treated as the person making the supply.

The para 40 rules are relevant to a sukuk issuance where the issuer is entering into a land transaction—a sukuk-al-ijara of land, for example.

In assessing whether the para 40 rules apply in relation to any particular transaction, one should consider:

- the nature of the particular transaction, and
- whether, from the VAT perspective, the character of the arrangements is such as to give rise to:
 - land supplies

- financial supplies, or
- both land and financial supplies

Although most land and financial supplies are exempt (see Practice Note: [Exemption from VAT for land and buildings](#)), an option to tax is available in the UK to convert what would be an exempt supply of an interest in, right over, or licence to occupy, land into a standard rated supply for VAT purposes (see Practice Note: [The option to tax land](#)), whereas such an option is not available in the UK in relation to financial supplies. Whether a supply is a land supply or a financial supply, therefore, may result in a different UK VAT treatment.

References:

VATA 1994, Sch 9, Pt II, Groups 1 and 5

VATA 1994, Sch 10, Pt 1

Para 40 rules do not apply if there is no supply of land

Where the arrangement is in economic substance the equivalent of a hire-purchase (including a sale and leaseback or sale and lease & sale-back), HMRC considers that where the purchaser/lessor (the party that would have been the lender had the transaction been a conventional loan secured by a mortgage) takes title to the land only by way of security, the initial sale of the land by the originator to the 'lender' should operate by way of a mortgage only. In such a case, no supply (whether of land or otherwise) should arise from the initial sale for VAT purposes.

References:

[VATFIN8360](#)

Further, HMRC considers any payments to be made by the originator to the lender in such a scenario (ie any payments to be made pursuant to the leaseback or the sale-back) to be repayments of a loan, with any amounts greater than the principal advanced being characterised as interest, ie the consideration for an exempt financial supply.

References:

VATA 1994, Sch 9, Pt II, Group 5, item 2

[VATFIN8360](#)

The para 40 rules would not be engaged in such a case.

Para 40 rules apply if there is a supply of land

The para 40 rules would be relevant where the 'lender' (eg the issuer on a sukuk-al-ijara) is regarded as making land supplies for VAT purposes, such as where it takes absolute legal and beneficial ownership of the land. The question then would be whether, because of the para 40 rules, the sukuk holders (rather than the issuer) would be treated for VAT purposes as the persons making any supplies in relation to the land, such as those arising from the grant of the lease.

On a typical sukuk issuance, there would be a multitude of investors, the identities of whom would change from time to time. Therefore, even if the para 40 rules technically apply, it is considered that, as a matter of practice, HMRC would still regard the issuer (and not the sukuk holders) as the person making the relevant supplies for UK VAT purposes.

References:

[VATLP04250](#)

This treatment would be consistent with how HMRC deals with the UK VAT treatment of Jersey property unit trusts (JPUTs) for example, for which see Practice Note: [Property holding structures—SDLT and VAT treatment of a Jersey property unit trust \(JPUT\)—VAT treatment of JPUTs in relation to supplies of land](#).

References:

[VAT Notice 742A, para 7.2](#)

As mentioned above, a sukuk issuance could be said to be a form of pooled investment, like a unit trust (see Practice Note: [Sukuk—investment bond arrangements and their UK direct tax treatment—Collective investment schemes](#)). If this is correct, then a sukuk-al-ijara of land would be similar in nature to a property unit trust, in which case HMRC's practice in relation to the UK VAT treatment of JPUTs would be of particular relevance.

In practice, and notwithstanding the para 40 rules, HMRC treats the trustees of a JPUT (the legal titleholders to the land), and not the unitholders (the beneficial owners), as making the relevant supplies for UK VAT purposes.

Applying the same approach to a sukuk-al-ijara of land would result in the issuer (and not the sukuk holders) being treated for UK VAT purposes as making any supplies in relation to the land, such as those arising from the grant of the lease. For more information on the other UK (non-VAT) tax aspects of sukuk-al-ijara of land, see Practice Note: [Sukuk al ijara—tax reliefs for sale and leaseback arrangements](#).

For more on the UK VAT treatment of JPUTs, see Practice Note: [Property holding structures—SDLT and VAT treatment of a Jersey property unit trust \(JPUT\)](#).