

Middle East / North Africa Tax Forum
Istanbul

Taxation of Islamic finance transactions

Mohammed Amin MA, FCA, AMCT, CTA (Fellow).
20 October 2011

Disclaimer

- Taxation is a complex subject and almost all issues require specific professional advice.
- Nothing in this presentation is intended to constitute professional advice.
- The presenter accepts no responsibility to anyone who may act, or refrain from acting, as a result of anything shown or said during this presentation.

Presentation outline

- Speaker details
- An outline of some common Islamic finance transactions and some of the taxation issues that can arise

Mohammed Amin

Until 31 December 2009, Mohammed Amin was a tax partner at PricewaterhouseCoopers LLP and led their Islamic finance practice in the UK.



He is:

- a chartered accountant, a chartered tax adviser and a qualified corporate treasurer
- a Council member of the Chartered Institute of Taxation
- a member of the Policy & Technical Committee of the Association of Corporate Treasurers

Amin has spoken on Islamic finance on every continent, except Antarctica! Some of his articles and presentations on Islamic finance can be found on his website:

www.mohammedamin.com

Illustrative transaction

Conventional purchase

- Machine delivered, cost 1,000
- Pay immediately by borrowing bank loan
- Two year bank loan @ 5% simple interest payable on repayment.
- Five year machine life

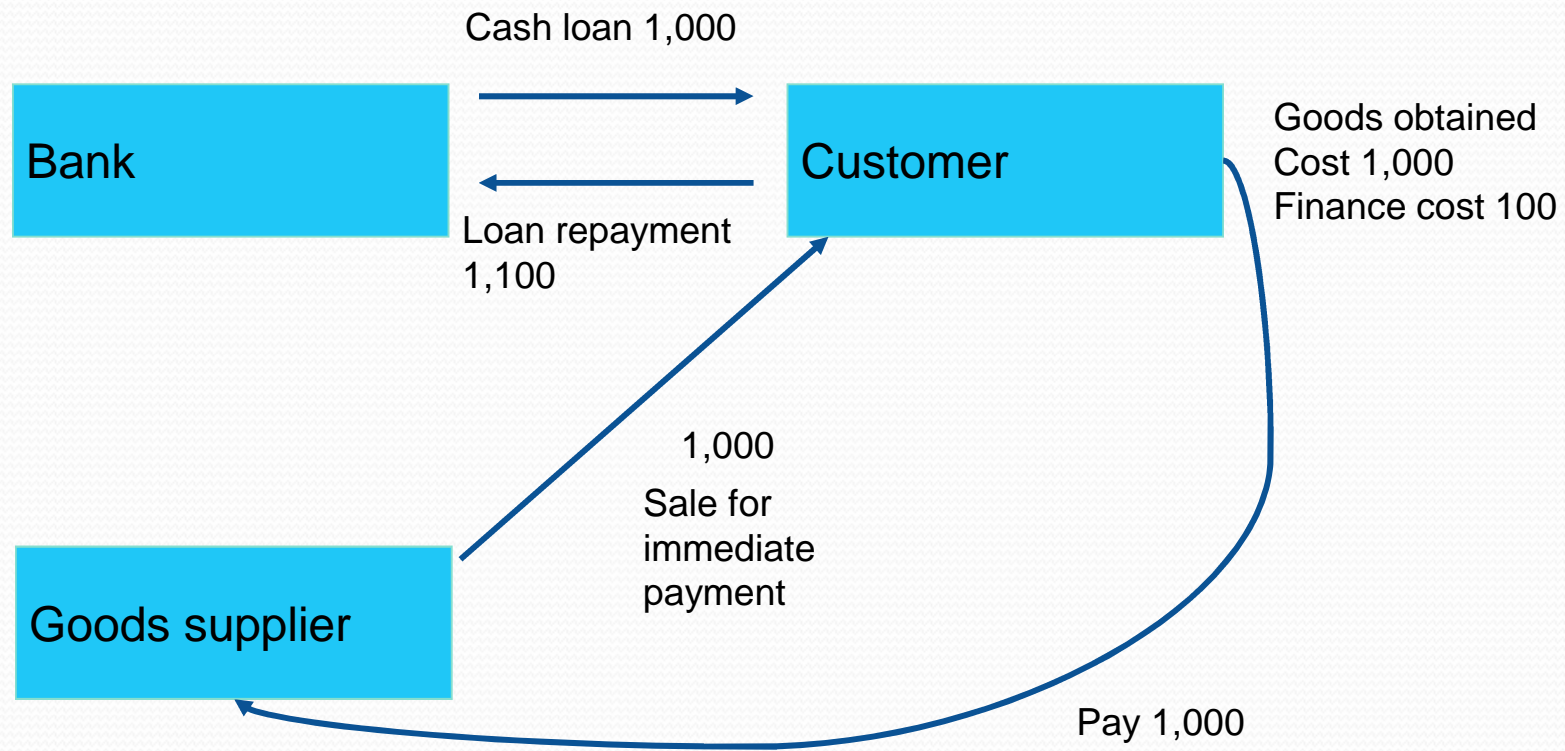
Islamic purchase

- Machine delivered now
- Payment due after two years
- Machine price 1,100
- Five year machine life

Identical cash flows

This slide introduces a simple hypothetical example. It shows that basing the tax treatment upon the legal language of the contracts used, while ignoring the economics, results in different tax treatments for conventional and Islamic finance.

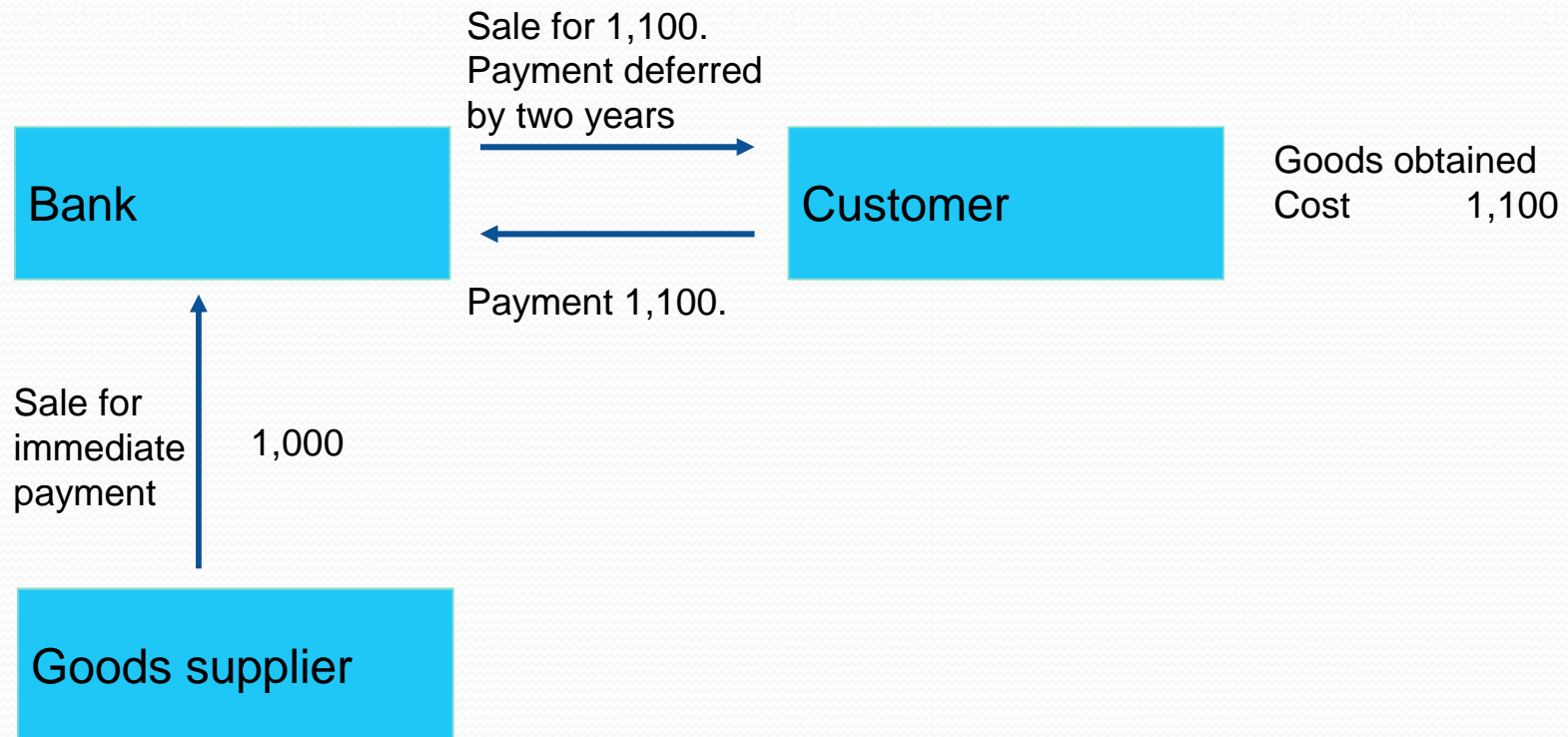
Conventional purchase



Conventional purchase tax deductions

Year	Amortisation	Interest	Total
1	200	50	250
2	200	50	250
3	200		200
4	200		200
5	200		200
Total	1,000	100	1,100

Islamic purchase



Legal evaluation of Islamic purchase

- There is no cost of finance
- The machine cost 1,100
- Machine is paid for two years after delivery
- **Assume** tax depreciation only given after machine has been paid for

Legal analysis Islamic purchase tax deductions

Year	Amortisation	Interest	Total
1	0	0	0
2	0	0	0
3	366		366
4	366		366
5	367		367
Total	1,100	0	1,100

Although the total tax deductions, namely 1,100, are the same as with the conventional purchase, they are given later. Having the deductions given later would normally be regarded as unfavourable.

Economic evaluation of Islamic finance purchase

- Machine value on delivery 1,000
- Agreed price 1,100
- Payment due after two years
- Excess 100 price must be finance cost
- 50 per year finance cost
- Machine **effectively** paid for on delivery as finance costs suffered

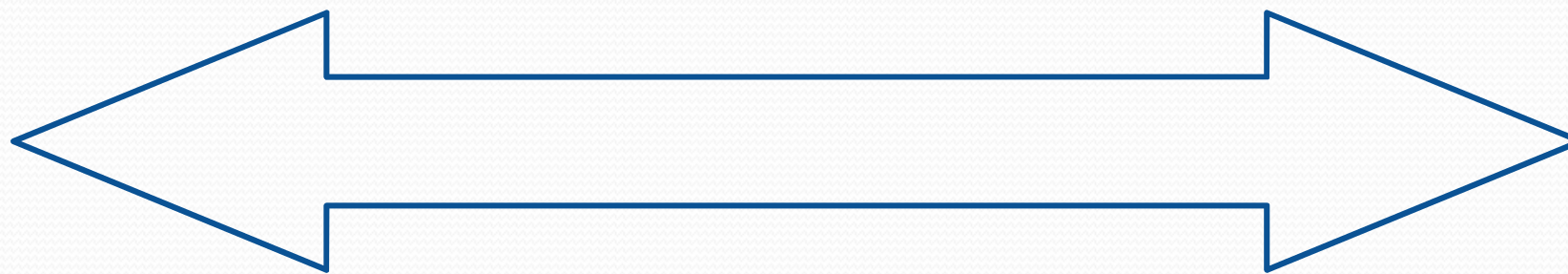
Economic analysis Islamic purchase tax deductions

Year	Amortisation	Finance cost	Total
1	200	50	250
2	200	50	250
3	200		200
4	200		200
5	200		200
Total	1,000	100	1,100

Tax systems classified

Legal approach

Economic approach



UK

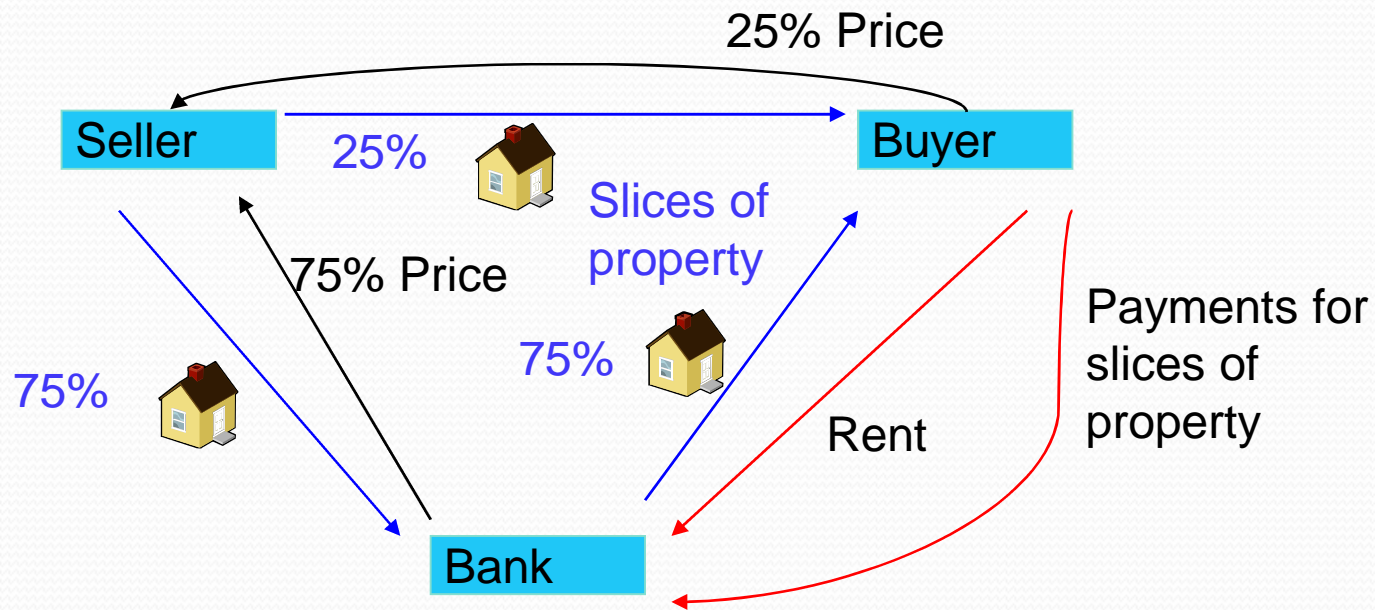
USA

Specific tax law needed for
Islamic finance

Zero or limited need for
specific tax law

Some countries such as the UK take a legalistic approach, others such as the UK and the Netherlands take an economic approach.

Diminishing musharaka contract - 25% deposit

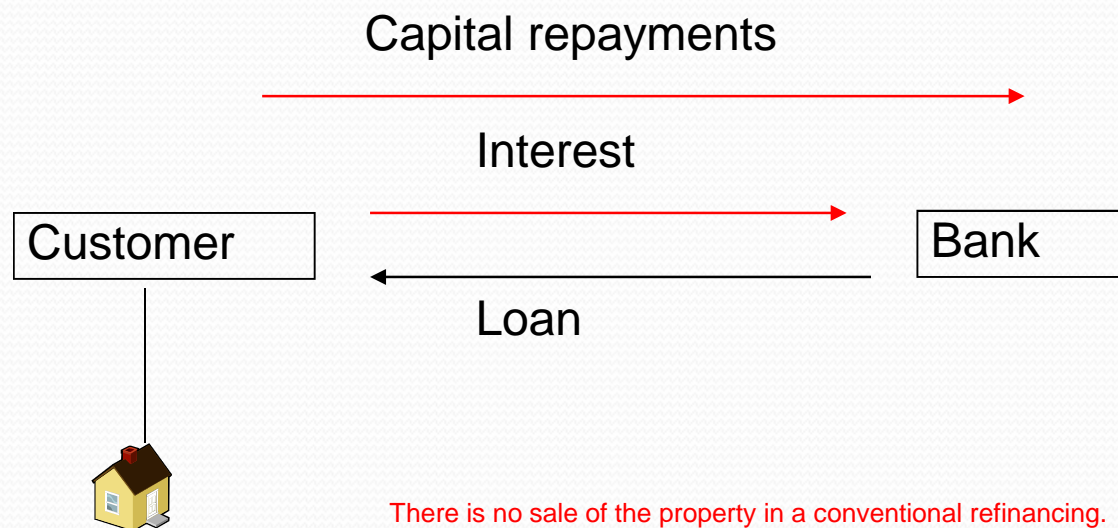


Buyer has sole occupancy and pays rent to Bank on proportion owned by Bank.

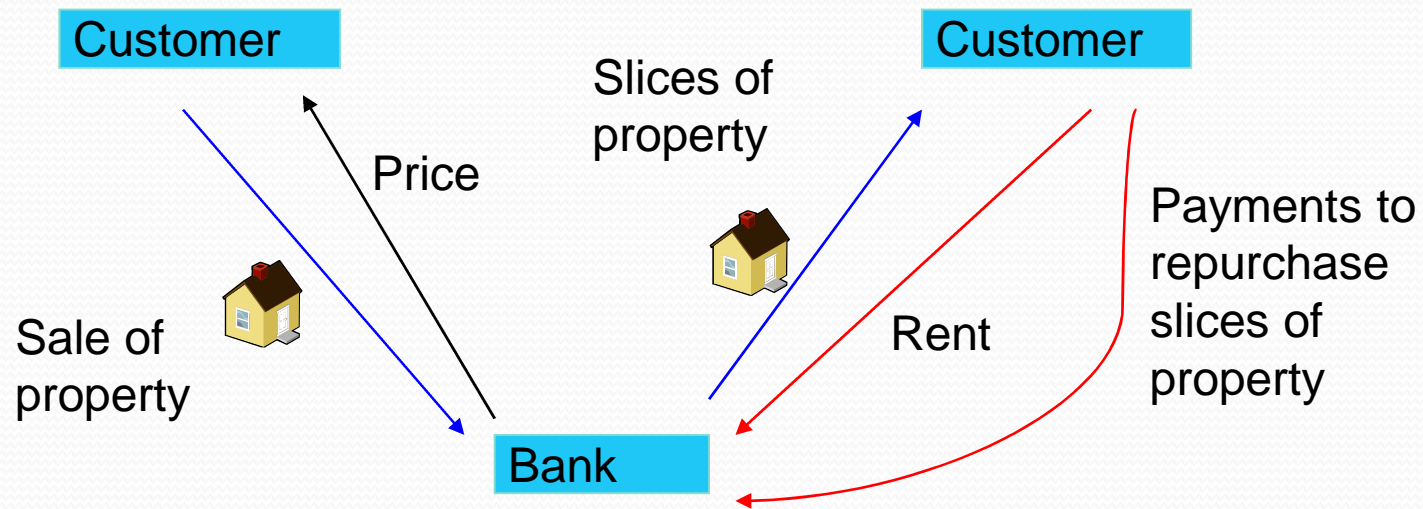
Multiple charges to real estate transfer tax?

75% of the property changes ownership twice so real estate transfer tax may be charged twice on that part.

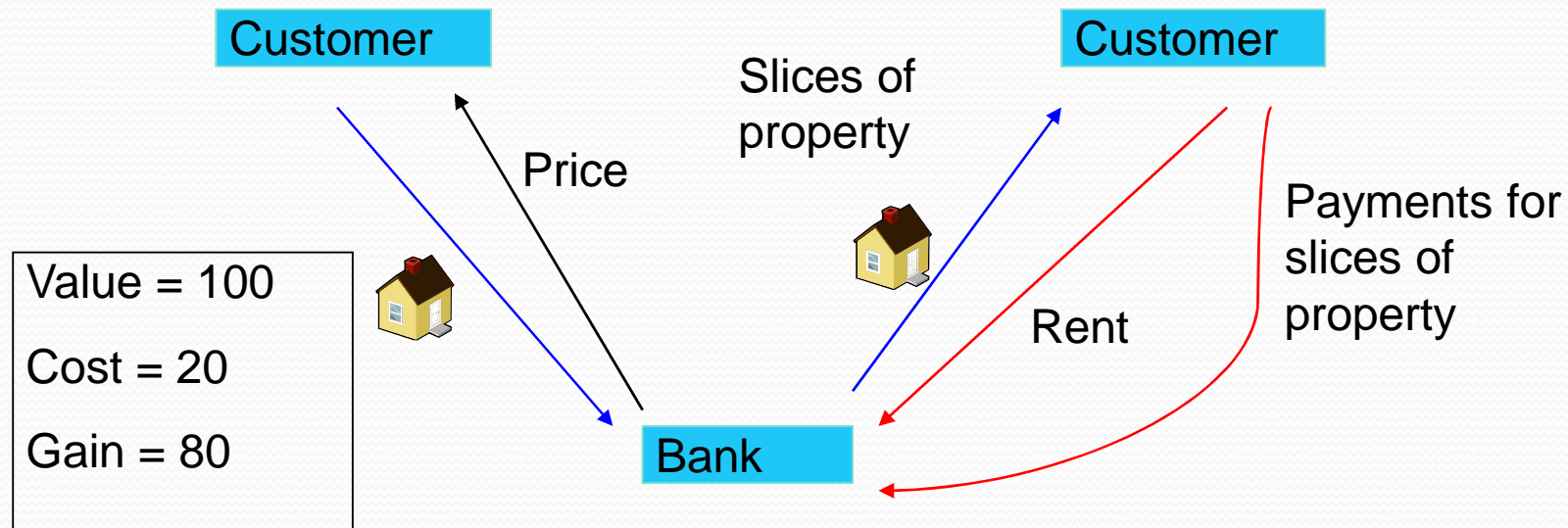
Conventional property refinancing



Islamic property refinancing

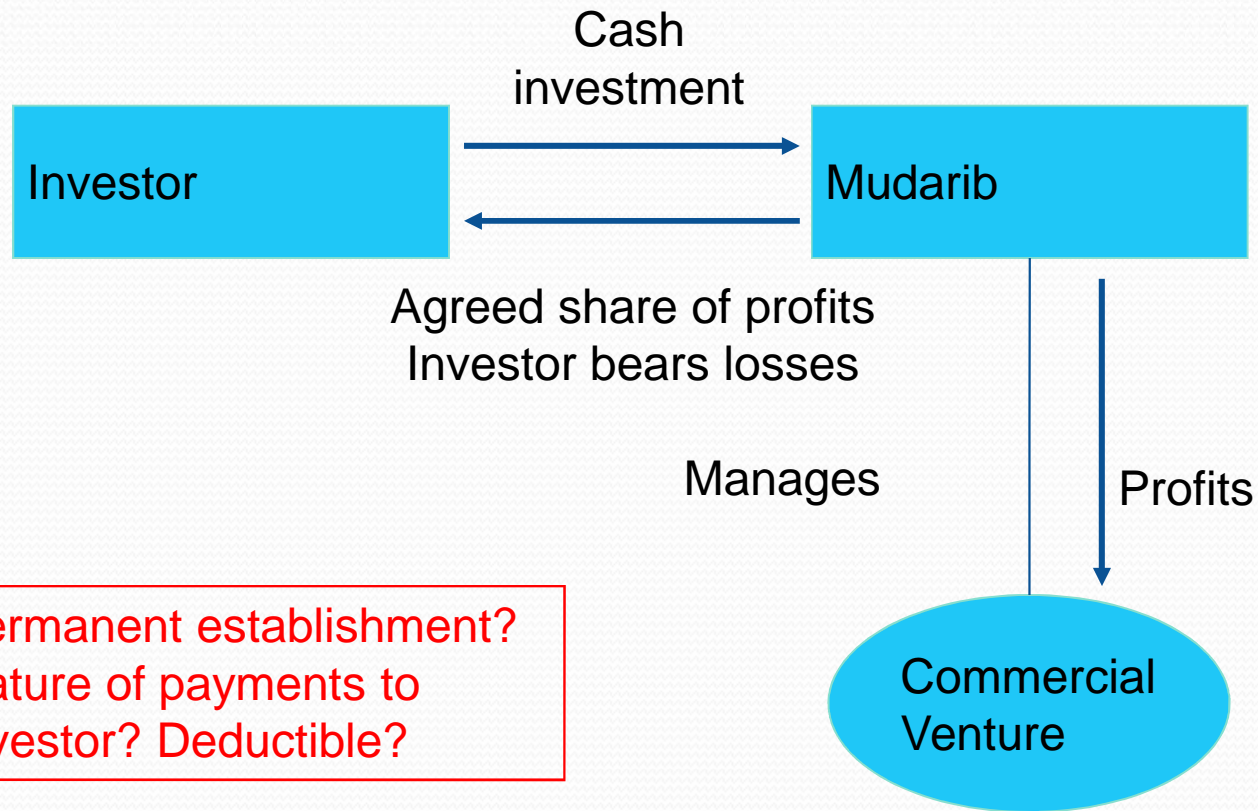


Capital gains tax on historic appreciation



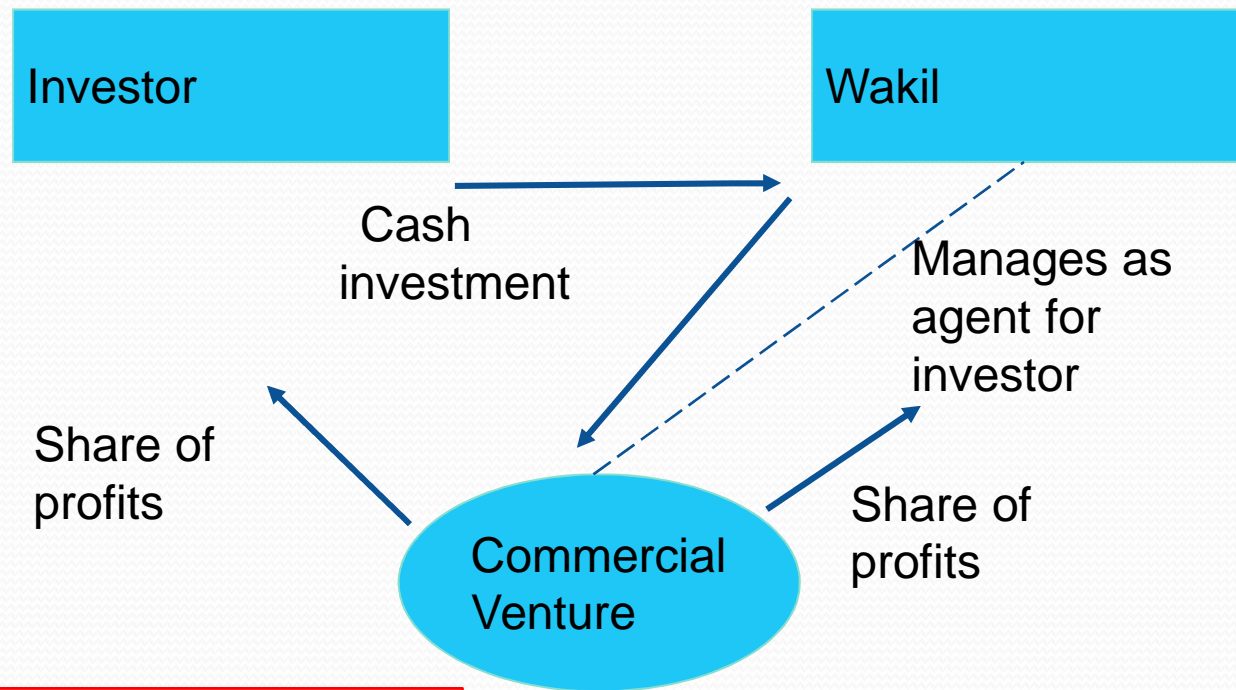
As well as the possible double real estate transfer tax discussed earlier, the sale of the property to the bank may trigger taxation of the unrealised capital gain.

Mudharaba



- Permanent establishment?
- Nature of payments to investor? Deductible?

Wakala

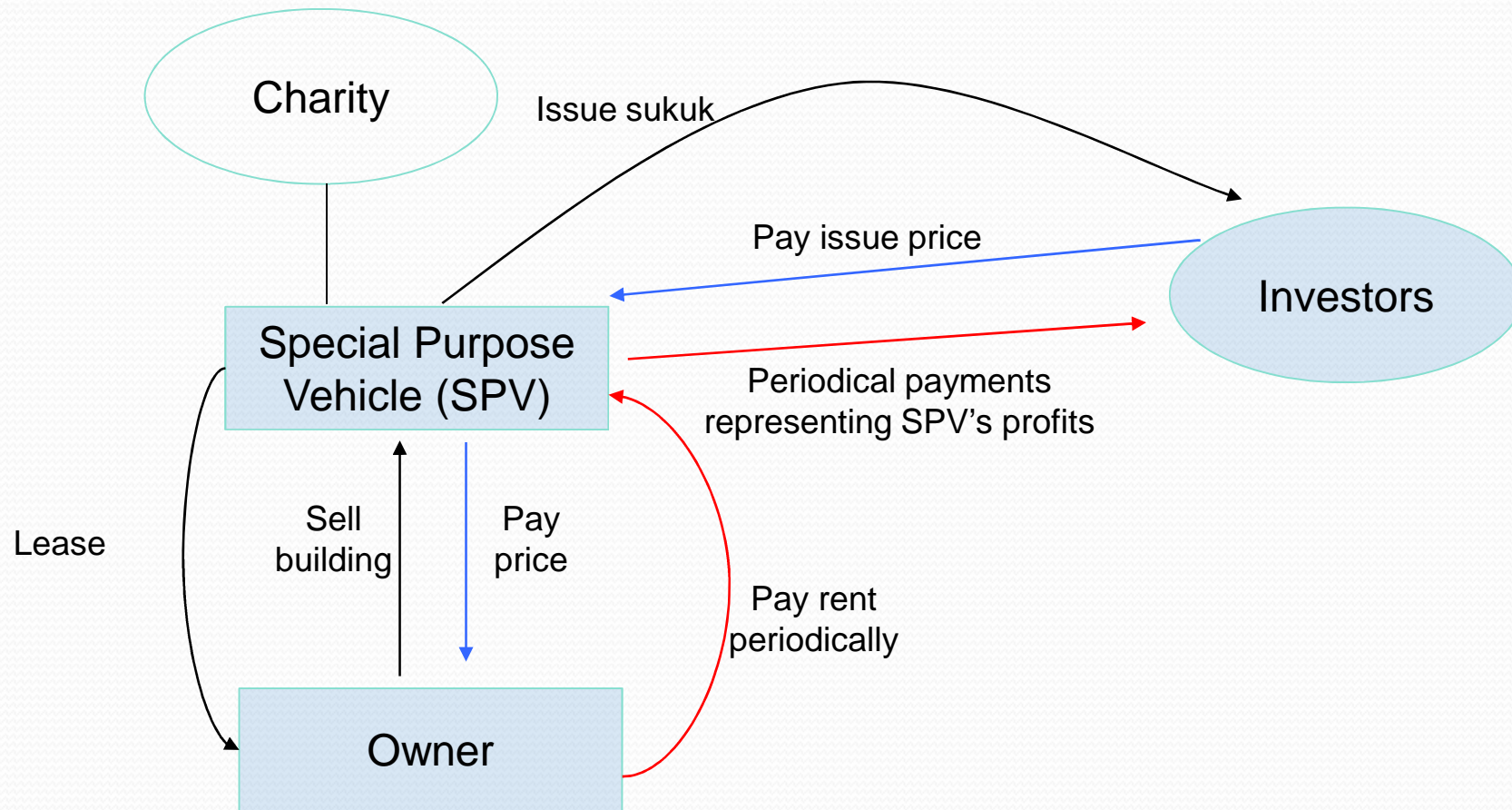


- Permanent establishment?
- Nature of payments to investor? Deductible?

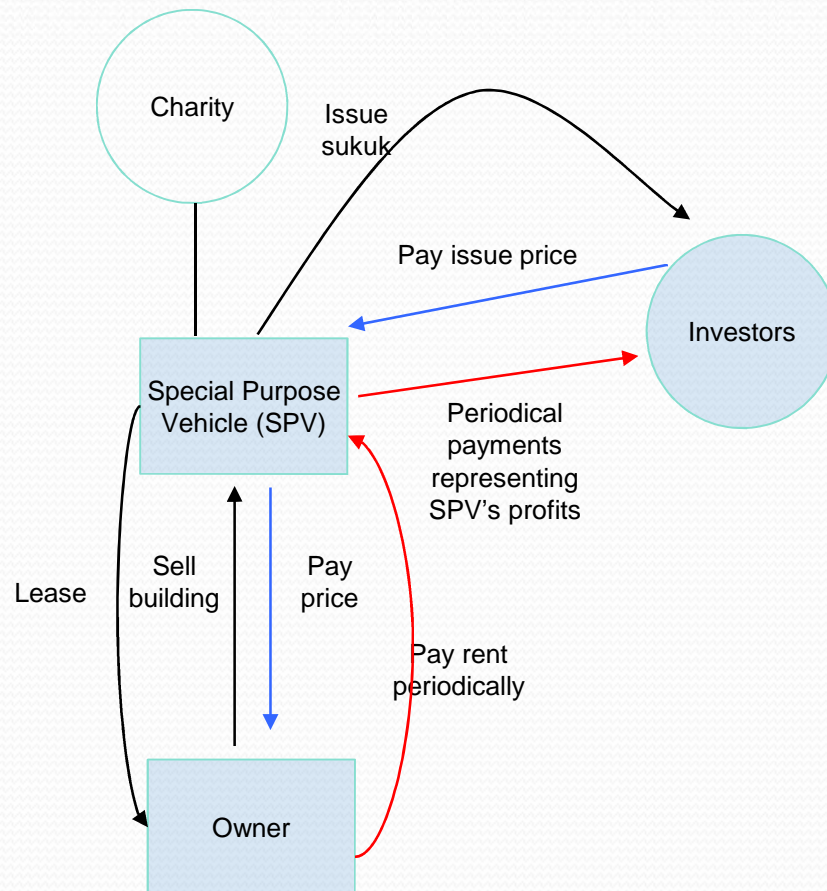
Ijarah sukuk

- The goal when structuring a sukuk is to replicate the economic characteristics of bonds without infringing the rules of Shariah. The most important requirement is that there must be no interest, which in turn means that there can be no legal debt involved.
- The goal is to design an instrument which:
 - can be bought and sold between different holders,
 - provides finance for a fixed period of time, typically three to five years although longer periods of time are used, and
 - from the perspective of investors, provides a flow of regular payments which has priority over the payment of rewards to ordinary shareholders, without involving interest.
- The manner in which these goals are achieved is most easily considered by looking at an example of a sukuk based upon an ijarah contract.
- The owner of a building wishes to use that building to raise finance. Accordingly, the owning company (the obligor) arranges for the creation of another company, typically a special purpose vehicle (SPV). This is a company which is not part of the obligor's group; the shares of the SPV are normally held by a charity. The SPV raises the cash needed to purchase the building from the obligor by issuing sukuk to the investors.
- Legally, the sukuk are certificates which entitle the investors to a fractional share of the income that the SPV will receive from renting the building back to the obligor. The SPV will normally declare itself as a trustee of the building on behalf of the sukuk investors, so that they have a beneficial entitlement to a proportionate share of the building and of the rent receivable from leasing it.
- During the life of the sukuk, the obligor will pay rent to the SPV which in turn will pay that money on to the investors. In economic terms, the investors have a prior claim on the profits generated by the owner from its business because part of those profits must be used to pay rent on the building to the SPV prior to any distribution of profits to the equity shareholders. However, this is achieved without creating a debt since leasing a building does not involve a debt claim.
- At the maturity of the sukuk, the obligor will purchase the building back from the SPV and this provides the SPV with cash to redeem the sukuk.

Ijarah sukuk



Ijarah sukuk



Tax questions

Transfer of the assets from originator to SPV and
Transfer of assets from SPV back to originator

- Transfer taxes?
- Taxation of built in capital gains?
- Recapture of previous tax depreciation?

Income flows

- Is SPV taxed on income received?
- Can SPV deduct payments to investors?
- Are investors taxed on payments to them?

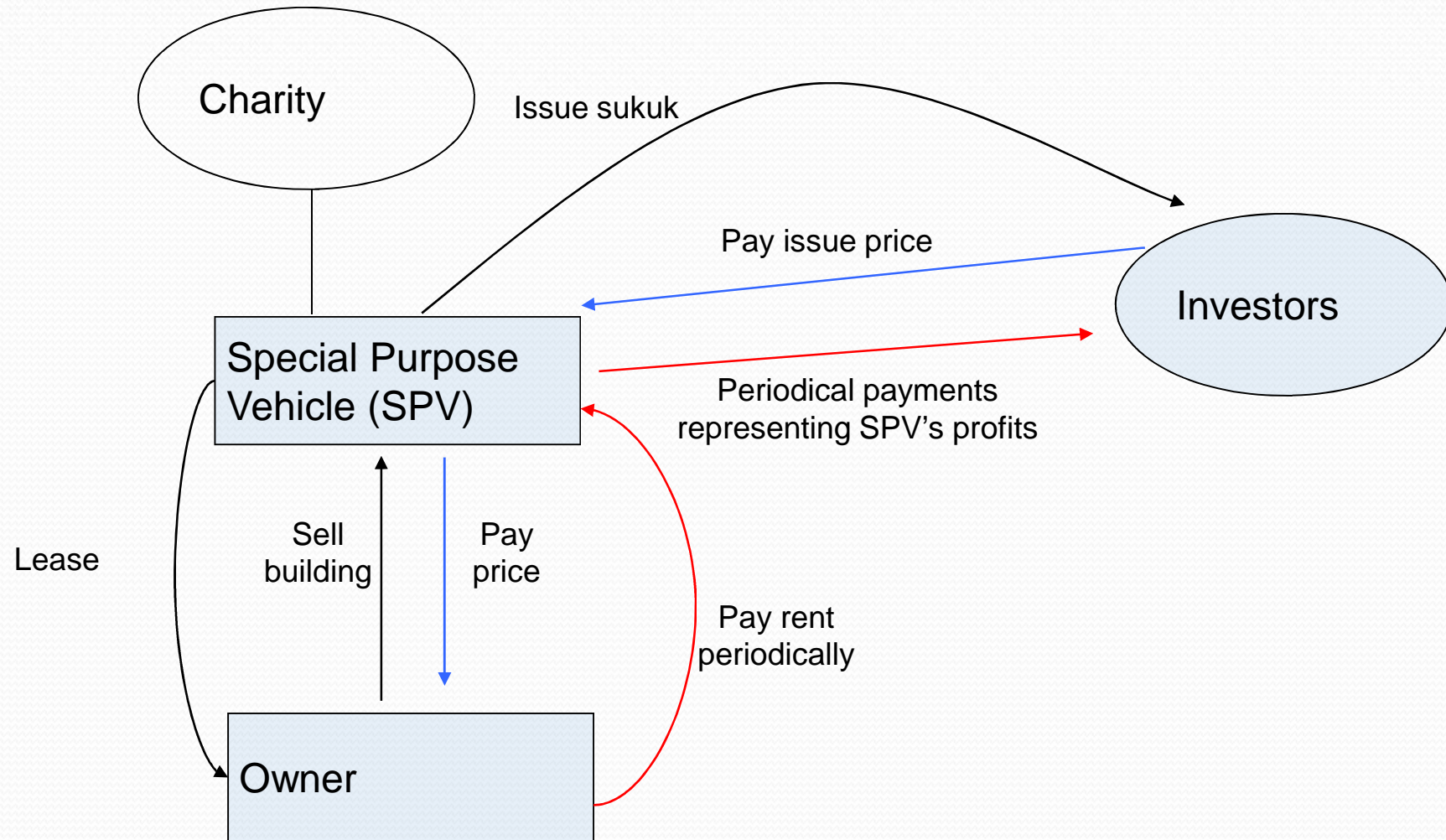
Transfer of sukuk – how taxed?

The tax questions are covered in more detail on the following slides.

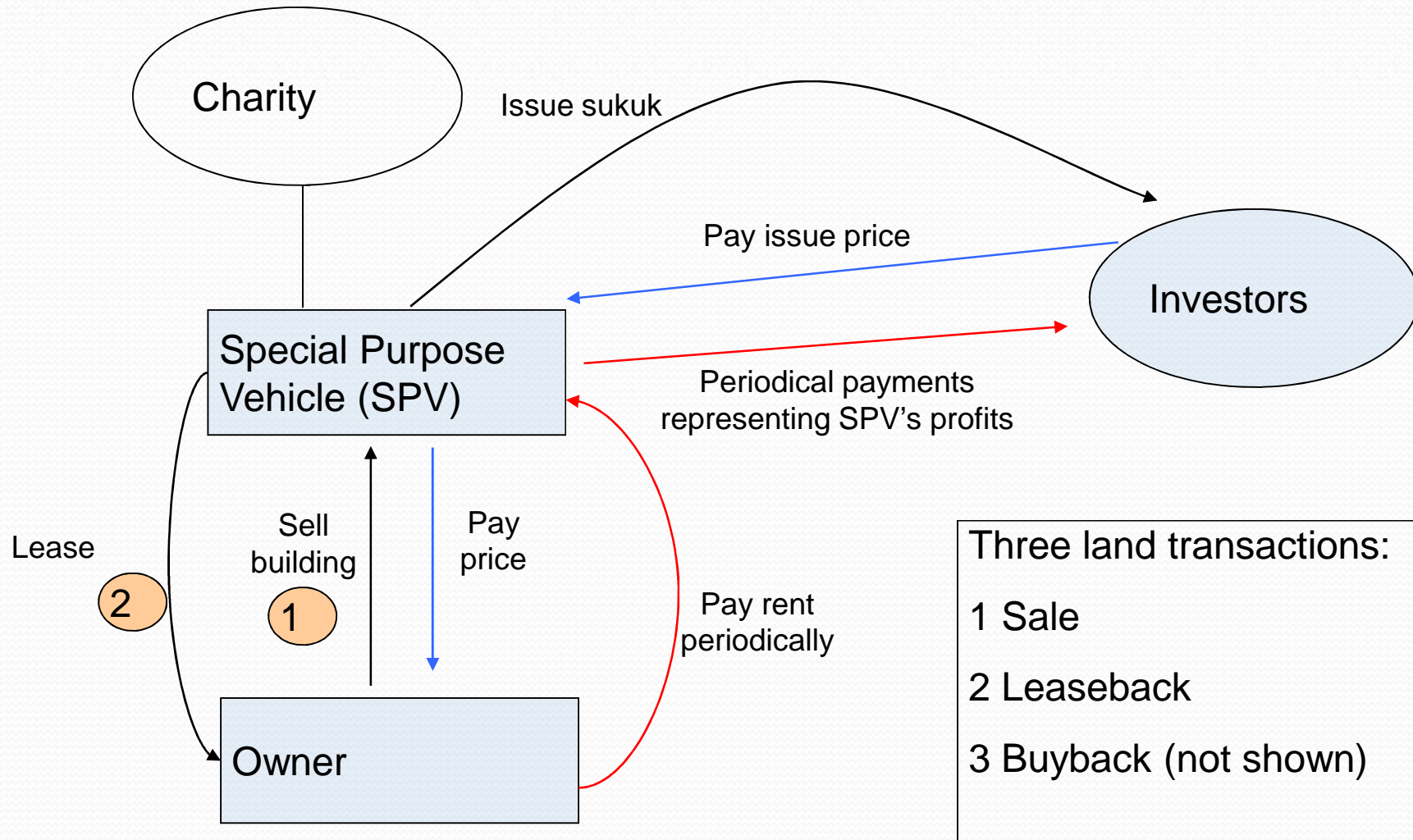
Tax costs for issuing SPV

- Income taxable
- No tax deduction in SPV?
 - Investor payments not interest

Transaction taxes: ijarah sukuk

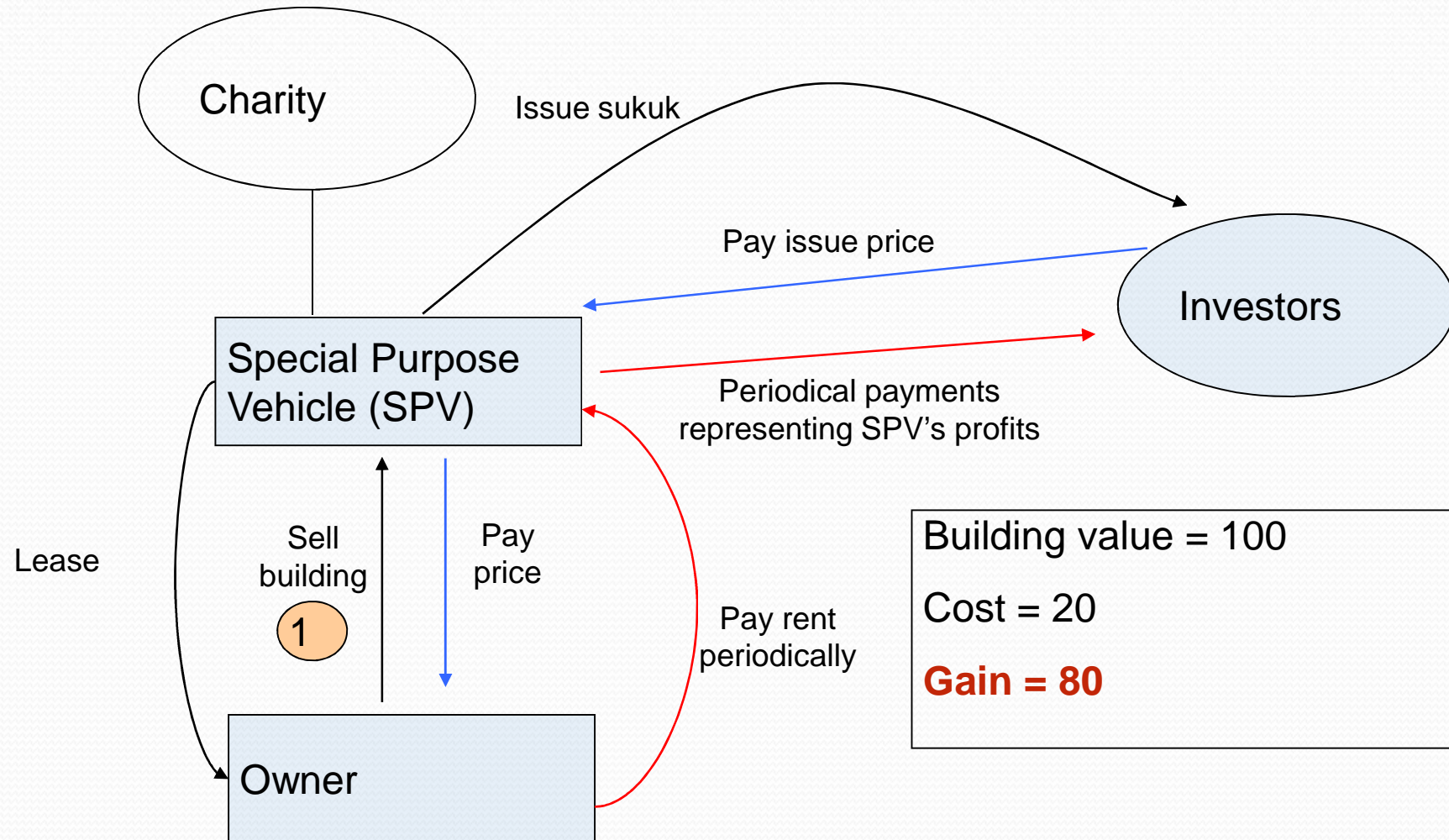


Multiple real estate transactions: Real estate transfer tax (RETT)



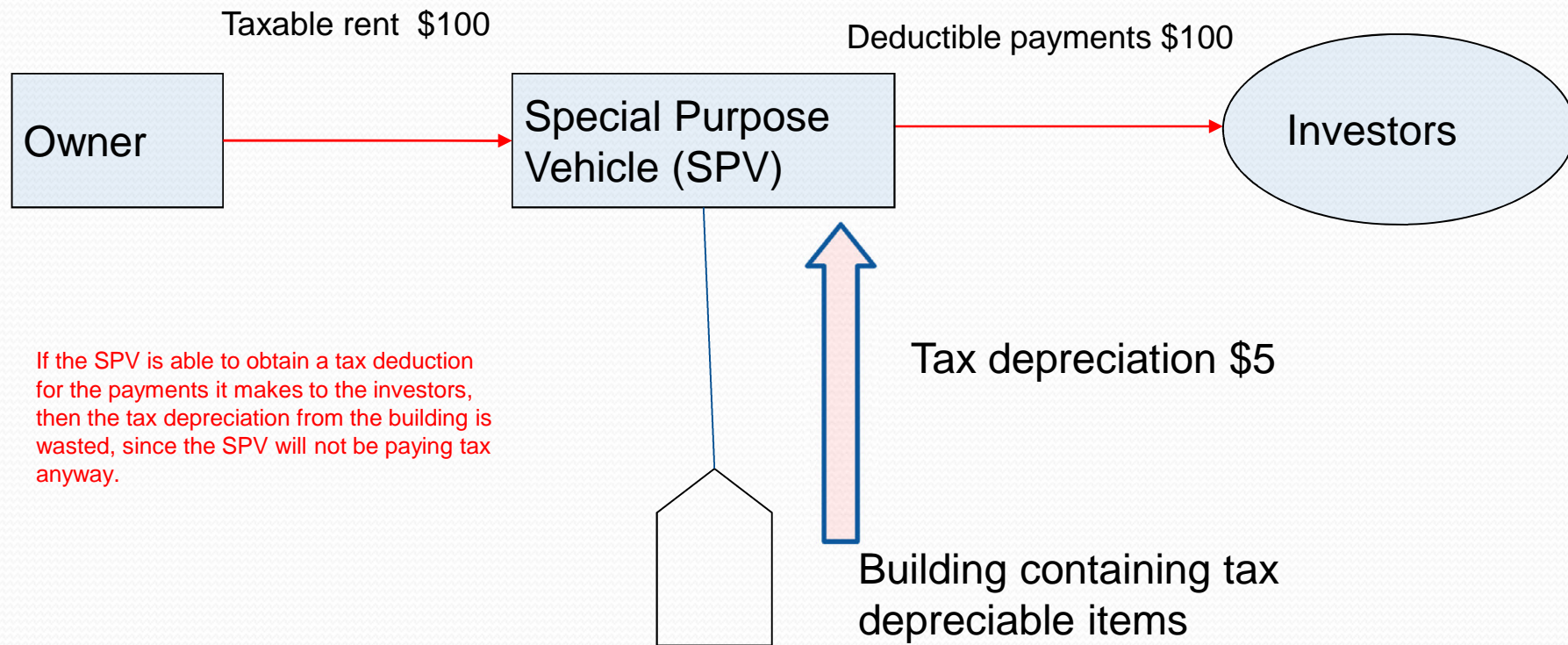
Depending on local tax law, each of the three land transactions may be subject to RETT.

Taxation of latent capital gains



The sale of the building to the SPV may trigger taxation of the inherent capital gain.

Wasted tax depreciation



Conclusions

- Tax law in most countries was developed for conventional finance.
- It frequently taxes Islamic finance more severely than conventional finance.
- In most cases, specific legislation is needed to give equality of tax treatment.