VAT and Islamic finance transactions: a discussion of the policy issues

By

Mohammed Amin

MBE FRSA MA FCA AMCT CTA(Fellow)

This report was written in November 2015.
It has not been updated since then.

1. Disclaimer

Taxation is a complex subject and specific professional advice should be sought before deciding to undertake, or refrain from undertaking, any action.

This research paper has been written purely to consider the taxation issues covered from the perspective of formulating tax policy. It is not intended to give professional advice to any person.

Accordingly, the author does not accept any legal responsibility to any person who acts, or refrains from acting, as a result of anything written in this paper.

The views expressed in this paper are purely the views of the author in his personal capacity and should not be attributed to any organisation with which the author may be affiliated.

2. Executive summary

Most discussion of the tax treatment of Islamic finance focuses on direct taxation. To help address this imbalance, this report looks at the VAT treatment of Islamic finance transactions.

The report was written by Mohammed Amin, who is a taxation specialist, in November 2015 as part of a wider research project. The research project did not complete, and the report was never published. Accordingly, Mohammed Amin is making it available in July 2020 for educational purposes only. It should not be relied upon for any other purpose. Apart from any other factor, the law in many of these jurisdictions may have changed.

The goal of publication is purely education for those who are interested in the conceptual challenges that Islamic finance presents for a VAT system.

Indirect taxes fall into several categories such as excise taxes, customs duties, sales taxes and value added tax (VAT) often also called a goods and services tax (GST). VAT is conceptually a tax on value added, but functions as a consumption tax on final consumers. The global VAT pioneer is the European Union which has the largest and most complex VAT regime.

The EU VAT regime has detailed provisions for conventional financial services which are generally treated as exempt for VAT purposes. The consequence is that consumers of such services are not required to pay VAT, but financial services companies are unable to recover VAT on most of their costs since the overwhelming majority of their supplies are exempt supplies. Alternatively, a jurisdiction may choose to make some financial services zero rated, as New Zealand permits banks to do for financial services supplied to non-exempt business customers.

Without seeking to be comprehensive, the report lists some of the most common transactions used in Islamic finance and carries out a “first principles” VAT analysis of those transactions. This VAT analysis is not based upon the tax laws of any particular country, but rather considers how a tax on value added might apply to such transactions taking into account the general principles of VAT.

The report does not seek to survey the large number of countries that have some form of VAT or GST. However, it looks at the VAT regimes of four jurisdictions, South Africa, Singapore, Malaysia, and the United Kingdom to consider how those countries have addressed the question of Islamic finance transactions within their VAT regime. It finds that South Africa, Singapore, and Malaysia have specifically modified their VAT law for Islamic finance transactions.

Conversely the UK has made no amendments to the VAT law applicable but has published guidance materials which explain how the existing VAT law should be applied in the context of Islamic finance transactions. Despite the UK not having modified its VAT law for Islamic finance, the report concludes that, by and large, it is possible to conduct Islamic finance transactions within the UK without incurring significant additional VAT costs.

After reviewing South Africa, Singapore, Malaysia and the UK, the report then proposes a method for classifying Islamic finance transactions into three categories:

1. Transactions which are very similar to the economically equivalent conventional transactions.
2. Peripheral transactions which arise in the course of structuring an Islamic finance transaction.
3. Transactions used for Islamic finance that are very different from economically equivalent conventional finance transactions.

For each of these categories it considers whether a VAT regime is likely to give rise to additional VAT costs compared with the equivalent conventional financial transactions.

In the final section, the report makes some general recommendations for governments which are legislating for a VAT regime that are intended to assist in achieving parity of treatment for conventional finance and Islamic finance. The report does not propose any specific legislative language but rather sets out a methodology for approaching the subject.

3. Introduction to sales taxes and value added tax (VAT)

Most countries operate a variety of taxes which have developed over a period of time, normally with growing complexity. Many countries levy taxes on consumption, which can fall into a number of categories:

Excise taxes

An excise or excise tax (sometimes called a duty of excise special tax) is an inland tax on the sale, or production for sale, of specific goods, or a tax on a good produced for sale, or sold, within a country or licensed for specific activities. Excises are distinguished from customs duties, which are taxes on importation.

For example, a country may levy a tax on the manufacturer of cigarettes. For each packet of 20 cigarettes that the manufacturer makes, he is required to pay an excise tax of, say, $1. While the tax is levied on the manufacturer, it is expected that the manufacturer will increase the sales price of cigarettes, so that ultimately the tax is borne by the person who buys and smokes the cigarettes.

The excise tax is paid only once, at the point that the cigarettes are manufactured. Subsequent sales of the cigarettes attract no additional excise tax.

Customs duties

Countries often charge customs duties on the importation of specified types of goods.

Continuing the cigarette example above, by itself the imposition of a $1 excise tax on the production of each packet of 20 cigarettes would make it potentially attractive for retailers to import ready-made cigarettes from overseas instead of buying cigarettes manufactured within the jurisdiction which had borne the $1 per packet excise duty.

Such obvious avoidance would be countered by the imposition of a customs duty on the import of each packet of cigarettes. Subject to any applicable international trade agreements, the customs duty might be set at a higher rate than $1 per packet of 20 cigarettes if the country wished to create an incentive for the local manufacture of cigarettes.

Sales taxes

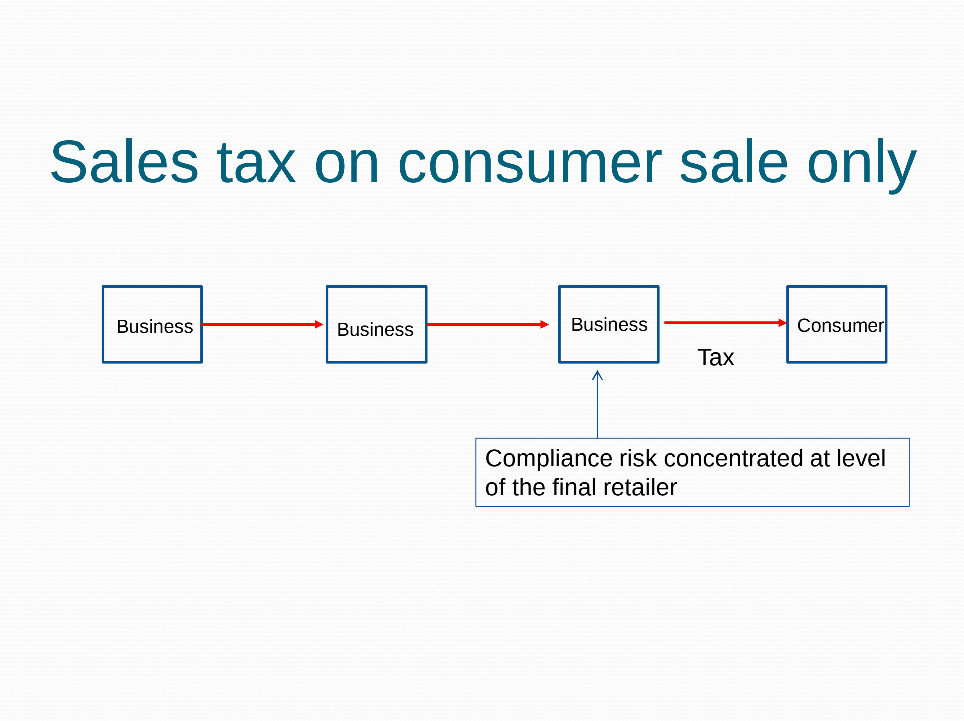
Many countries charge a sales tax. This is a tax levied on the sale of goods and services that is usually calculated as a percentage of the sale price. While responsibility for paying the tax rests with the seller, it will normally be added to the price that is paid by the buyer. This can be done explicitly, by stating a “without tax sales price” and then adding the sales tax, or implicitly where the price quoted to the buyer already includes the sales tax payable.

	Explicit	**Implicit**
Displayed price for items	$1.00	$1.20
Sales tax shown on invoice (say 20% rate)	0.20	-
Total amount payable	$1.20	$1.20

Goods are normally sold several times between the original manufacturer and the final consumer. Accordingly. countries may charge the tax only on the final retail sale, or charge the sales tax each time that the goods are sold.

Retail only sales tax

No tax is charged except when the goods are sold to a person who will not sell them again.

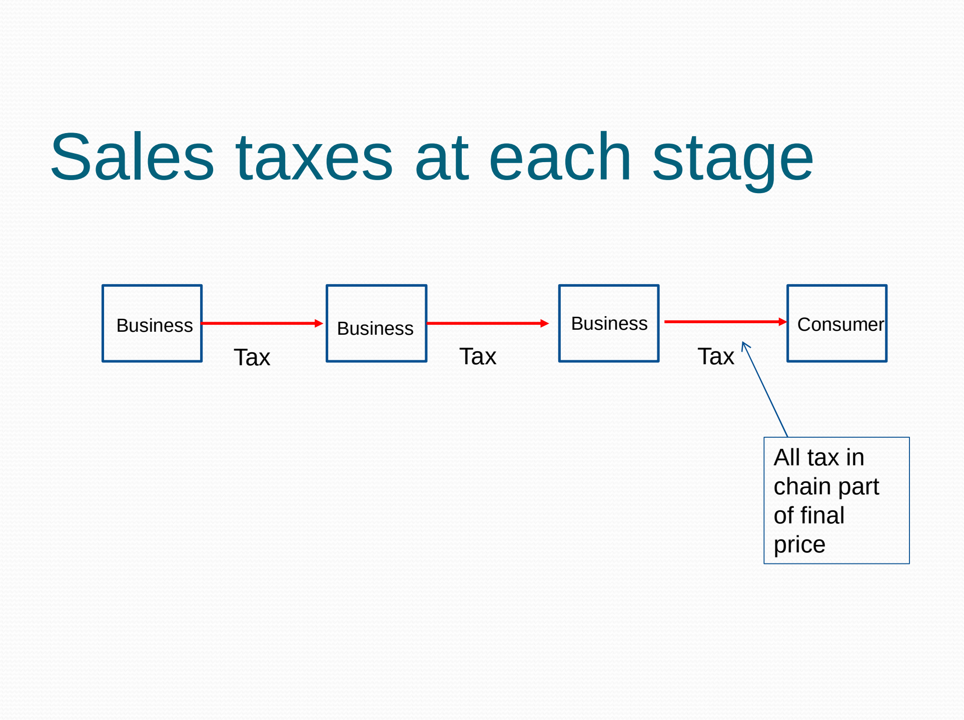


This policy gives rise to several issues:

1. A business selling to another business is not required to charge sales tax. However how does the business know that its alleged business customer is not going to consume the goods? One common approach is to require sales tax to be charged on every sale unless the purchaser can supply a tax authority registration number to confirm that the purchaser is a business and not a final consumer.
2. The tax collection requirement is only imposed upon the business selling to the final consumer. This will typically be the smallest business in the chain, and one which may be operating less formally than the larger businesses higher up the supply chain. In practice, these smaller businesses are the ones which are most likely to fail to comply with their sales tax collection requirements.
3. Businesses higher up the supply chain may purchase items which are not intended for resale, but which are used within the business. An example would be the purchase of stationery. Should sales of such items be subject to sales tax? How can such purchases be identified and taxed while enabling the businesses concerned to not pay sales tax on goods being purchased for resale, in a manner that can be conveniently policed by the taxing authority?

Sales tax at each level of sale

The above concerns can be addressed by requiring sales tax to be charged each time the goods are sold.



This approach reduces the compliance risk since some tax is collected each time the goods are sold down the supply chain. While at each stage the sales tax increases the cost of the goods to the business which buys them, that business should be able to economically recover the tax it has paid by marking up the price of the goods that it sells to its customer. Accordingly, in economic terms all of the tax is ultimately borne by the final consumer.

As the total tax burden increases with the number of stages in the supply chain, the operation of such a tax can act as a deterrent to business creation. Without it, the supply chain might run most efficiently with many businesses playing a role between the manufacturer and the final consumer, but their existence becomes less desirable if each intermediate sale is adding to the sales tax burden.

Exports

Countries normally try to encourage local manufacture by not seeking to tax foreign purchasers of goods made within that country.

If the sales tax is only chargeable on the final retail sale, it is straightforward to exempt from the tax export sales where the goods are shipped overseas. It can also be feasible to introduce an exemption or rebate mechanism where foreign persons conduct retail shopping within the territory with the intention of taking the goods with them when they leave the jurisdiction.

However, where tax is charged at each stage of the supply chain, it can be much more problematical determining what sales tax has previously been charged where goods are now to be exported. In the supply chain illustrated above, the final business which is to export the goods may have no way of determining what sales tax has been paid.

Accordingly, while the tax rules may permit the exporting business to not charge any further sales tax, it can be problematical trying to rebate sales taxes paid higher up the chain. As a consequence, a cascading sales tax paid at each level of the supply chain can be a deterrent to exports since it increases export prices.

Value added tax (VAT)

VAT is by definition a tax on “value added”. However, design decisions taken by taxing authorities in practice normally make it operate as a form of consumption tax on final consumer.

The definition of value added

Conceptually the value added by a business during a reporting period is measured by deducting from sales the cost of goods and services purchased from other businesses during that period. It can be illustrated by considering the following simplified income statement which covers a one-year period:

Sales revenue	$ 10,000
Cost of goods purchased and sold	(6,000)
Gross profit	$ 4,000
Employee wages	(2,000)
Electricity costs	(500)
Interest paid	(100)
Net profit	$ 1,400
Dividend paid	(800)
Profit retained in the business	$ 600

The value added may be calculated as follows:

Sales revenue	$ 10,000
Cost of goods purchased and sold	(6,000)
Electricity costs	(500)
Value added	$ 3,500

Employee wages, interest paid, and dividends paid are not considered a cost for the purposes of determining value added. Instead they are ways that the value added is shared between the workers, third party providers of finance and the business owners, as summarised below:

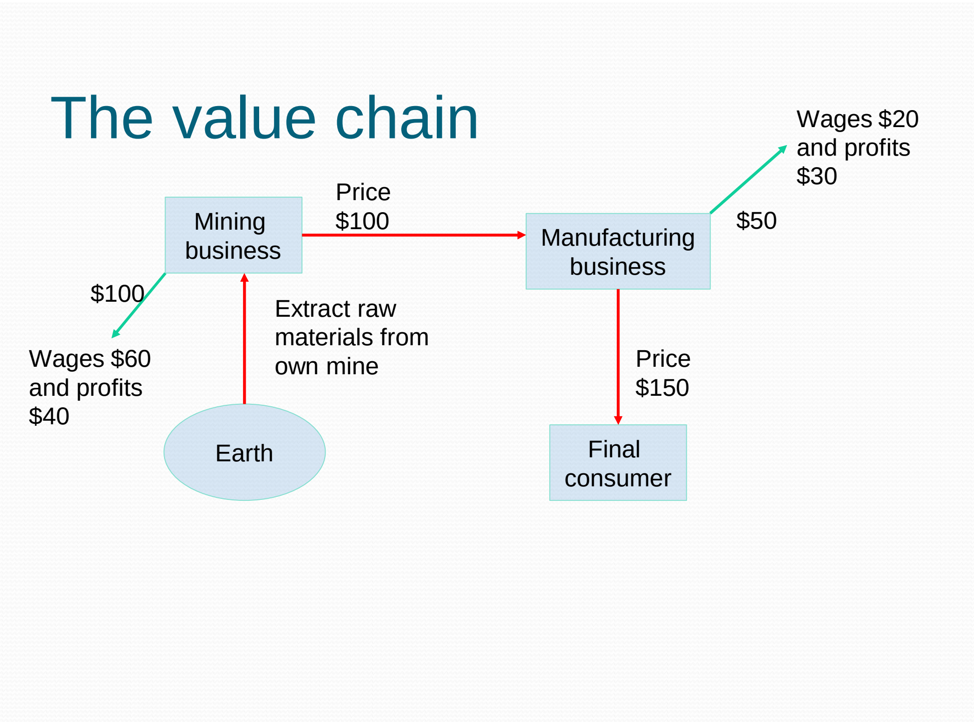
Employees’ share (wages)	$ 2,000
Financiers’ share (interest)	100
Owners’ share (dividends + retained profit)	1,400
Total value added	$ 3,500

There are a variety of definitional issues once one considers the complexity of real business operations. For example:

- Goods may be purchased during one period, but not all sold during that period. In the calculation of value added, one would deduct only the cost of goods sold during that period.
- Capital goods are purchased which will be used over multiple periods. In the calculation of value added, one would deduct the depreciation applicable to that period, computing depreciation in some manner that allocates the cost of the machine over its useful life.

Valued added tax conceptually

VAT as a tax on value added is illustrated below by considering a simplified two-stage value chain:



1. The mining business extracts raw materials from a mine that it owns. There is no cost to the business as the materials are extracted apart from employee wages, which are not deducted in computing value added. Accordingly, the mining business's value added is $100, equal to the selling price of the raw materials.
2. The manufacturing business sells its output to the final consumer for $150. Its costs comprise purchase of the raw materials for $100 and wages which are not deducted in computing value added. Accordingly, its value added is $50.

If VAT is to be charged at 20%, the VAT payable by each business should be as follows:

	Mining business	**Manufacturing business**
Value added	$100	$50
VAT payable at 20%	$20	$10

The total value added in the supply chain is $150. VAT at 20% totalling $30 is paid to the tax authority.

How VAT is operated in practice

As explained above, the computation of value added becomes complex in all but the simplest situations, once one starts to consider how to take account of inventories and capital goods which are used in periods different from the period in which they are purchased.

Accordingly, in most cases tax authorities require businesses to compute VAT as follows:

+ VAT charged on all sales during the period

– VAT paid on all purchases during the period

= VAT payable to the tax authority.

This is illustrated below for the value chain in the above diagram.

	Mining business	**Manufacturing business**
Sales	$100	$150
VAT charged on sales at 20%	$20	$30
Purchases	-	($100)
VAT paid on purchases	-	($20)
VAT paid to the tax authority	$20	$10

All of this VAT is borne by the final consumer, who pays $150 + $30 (representing 20% VAT) to purchase the goods which are then consumed.

It is essential to note that a business (such as the manufacturing business above) is able to recover the VAT it pays on its costs. That is achieved either by offset against VAT it has collected, as above, or by direct cash refund from the tax authorities if the amount of VAT the business has paid exceeds the VAT it has charged to its customers.

4. Conventional finance and VAT

To consider how conventional finance should be treated for VAT purposes, it helps to look again at the simplified income statement introduced above:

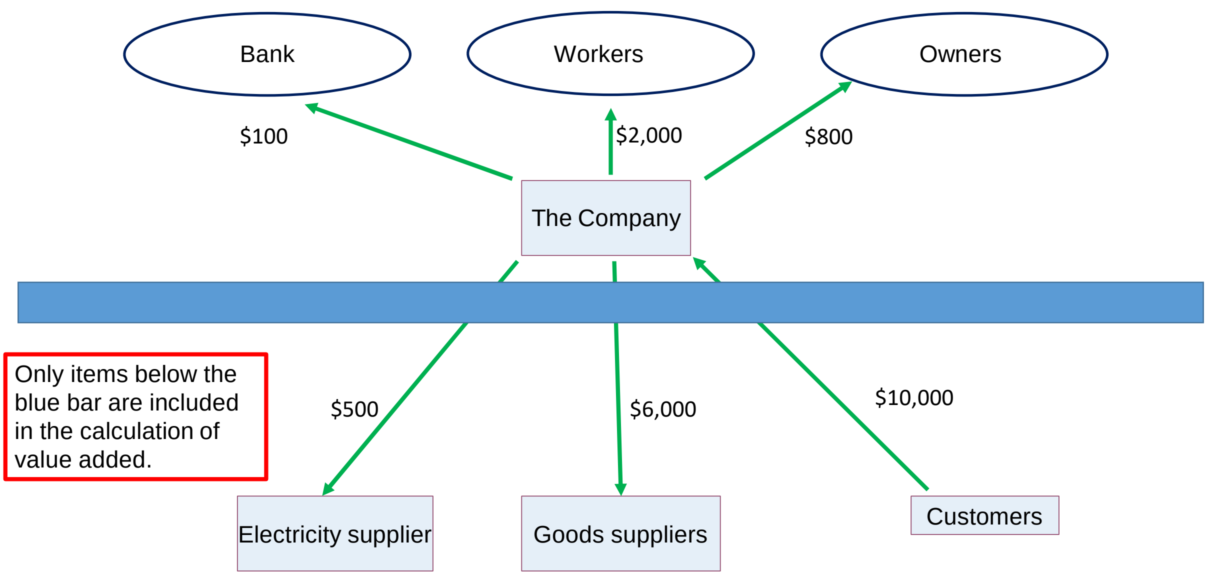
Sales revenue	$ 10,000
Cost of goods purchased and sold	(6,000)
Gross profit	$ 4,000
Employee wages	(2,000)
Electricity costs	(500)
Interest paid	(100)
Net profit	$ 1,400
Dividend paid	(800)
Profit retained in the business	$ 600

The items in this income statement can be segregated into two categories:

1. Those items which are included in the calculation of value added.
2. Those items which represent the allocation of value added amongst participants in the company's activities.

This is illustrated graphically below.

The income statement in pictorial form



Accordingly when the company makes payments to the workers as wages, to the company owners as dividends, and to the provider of finance as interest, the logic of value added tax requires that there be no VAT charged on those payments.

Looking specifically at the activities of banks, this means that the provision of finance is the provision of a service on which no VAT should be charged.

Implementations of VAT

The paper "An International Perspective on VAT" by Alain Charlet and Jeffrey Owens, published in Tax Notes International, Volume 59, Number 12, September 20, 2010 is available from the OECD website at https://www1.oecd.org/ctp/consumption/46073502.pdf It contains a brief history of VAT.

> *German businessman Wilhelm Von Siemens is credited with coming up with the idea of a VAT in the 1920s. What was only an idea has since been built into a system by the so-called father of VAT, Maurice Lauré, who was then the joint director of the French tax authorities. The VAT was implemented in France in 1954. Manufacturing-level VATs were introduced shortly thereafter in Côte d'Ivoire and Senegal in the 1960s, around the time that these former French colonies became independent. Brazil, by the fiscal reform of 1965, introduced a traditional VAT that applied at all stages of production. The VAT's expansion was limited to less than 10 countries in the late 1960s. In 1965 the VAT was not yet a worldwide success, as most general consumption taxes in the OECD were retail sales taxes. By 1989, however, 48 countries, primarily located in Western Europe and Latin America but also including a handful of developing countries, had adopted a VAT. The spread of the VAT in Europe was driven by the fact that it is a prerequisite for membership of the European Union* [EU] *(previously the European Economic Community). Its spread has accelerated since, with strong support from the IMF, as it has now been implemented in more than 140 countries, where it often accounts for one-fifth of the total tax revenue.*

It is clear from the above history that the primary impetus for the development of VAT has come from the European Union (previously the European Economic Community) taking into account the fact that France pioneered the tax, and the fact that the countries of the EU together constitute a very significant part of global GDP today, and constituted an even larger share looking back at the last fifty years.

Accordingly, any consideration of VAT implementations in practice must begin by looking at how VAT is implemented within the EU.

VAT in the European Union

Each member state of the EU implements VAT through national laws passed by that state's legislature. However, VAT is a harmonised European tax, governed by EU law, and member states are required to implement that law faithfully into their national legal systems.

If they fail to do so, the harmonised EU law is still applicable and takes priority over national law. For example, in the United Kingdom the European Communities Act 1972 (which was passed as an essential part of the UK's accession to the EU as it then was) makes the priority of EU law clear.

The principles for VAT in the EU were set out in the Sixth VAT Directive of 1977 which has since been recast and since 2007 the law has been contained in Directive 2006/112/EC. This document can be found by searching on the EU's Europa Lex website http://eur-lex.europa.eu/content/welcome/about.html which contains EU law.

VAT in the United Kingdom

The UK's implementation of VAT is required to comply fully with EU law as explained above. It can be found in the Value Added Tax Act 1994. Schedule 9 deals with "Exempt Supplies of Goods and Services". In Part I it lists the groups of exempt items, listing the groups alphabetically.

EXEMPTIONS PART I

INDEX TO EXEMPT SUPPLIES OF GOODS AND SERVICES

Betting, gaming and lotteries Group 4

Burial and cremation Group 8

Education Group 6

Finance Group 5

Fund raising events by charities and other qualifying bodies Group 12

Health and welfare Group 7

Insurance Group 2

Land Group 1

Postal services Group 3

Sport, sports competitions and physical education Group 10

Trade unions and professional bodies Group 9

Works of art etc Group 11

The two items which cover financial services, Group 2 "Insurance" and Group 5 "Finance", are both relatively short and are reproduced below as enacted in 1994:

GROUP 2 — INSURANCE

1 The provision of insurance and reinsurance by—

(a) a person permitted in accordance with section 2 of the Insurance Companies Act 1982 to carry on insurance business; or

(b) an insurer who belongs outside the United Kingdom against any risks or other things described in Schedules 1 and 2 to the Insurance Companies Act 1982.

2 The provision of insurance and reinsurance by the Export Credits Guarantee Department.

3 The making of arrangements for the provision of any insurance or reinsurance in items 1 and 2.

4 The handling of insurance claims by insurance brokers, insurance agents and persons permitted to carry on insurance business as described in item 1.

Note:

Item 4 does not include supplies by loss adjusters, average adjusters, motor assessors, surveyors and other experts, and legal services, in connection with the assessment of any claim.

GROUP 5 — FINANCE

1 The issue, transfer or receipt of, or any dealing with, money, any security for money or any note or order for the payment of money.

2 The making of any advance or the granting of any credit.

3 The provision of the facility of instalment credit finance in a hire-purchase, conditional sale or credit sale agreement for which facility a separate charge is made and disclosed to the recipient of the supply of goods.

4 The provision of administrative arrangements and documentation and the transfer of title to the goods in connection with the supply described in item 3 if the total consideration therefor is specified in the agreement and does not exceed £10.

5 The making of arrangements for any transaction comprised in item 1, 2, 3 or 4 or the underwriting of an issue within item 1.

6 The issue, transfer or receipt of, or any dealing with, any security or secondary security being—

(a) shares, stocks, bonds, notes (other than promissory notes), debentures, debenture stock or shares in an oil royalty; or

(b) any document relating to money, in any currency, which has been deposited with the issuer or some other person, being a document which recognises an obligation to pay a stated amount to bearer or to order, with or without interest, and being a document by the delivery of which, with or without endorsement, the right to receive that stated amount, with or without interest, is transferable; or

(c) any bill, note or other obligation of the Treasury or of a Government in any part of the world, being a document by the delivery of which, with or without endorsement, title is transferable, and not being an obligation which is or has been legal tender in any part of the world; or

(d) any letter of allotment or rights, any warrant conferring an option to acquire a security included in this item, any renounceable or scrip certificates, rights coupons, coupons representing dividends or interest on such a security, bond mandates or other documents conferring or containing evidence of title to or rights in respect of such a security; or

(e) units or other documents conferring rights under any trust established for the purpose, or having the effect of providing, for persons having funds available for investment, facilities for the participation by them as beneficiaries under the trust, in any profits or income arising from the acquisition, holding, management or disposal of any property whatsoever.

7 The making of arrangements for, or the underwriting of, any transaction within item 6.

8 The operation of any current, deposit or savings account.

9 The management of an authorised unit trust scheme or of a trust based scheme by the operator of the scheme.

Notes:

(1) Item 1 does not include anything included in item 6.

(2) This Group does not include the supply of a coin or a banknote as a collectors' piece or as an investment article.

(3) Item 2 includes the supply of credit by a person, in connection with a supply of goods or services by him, for which a separate charge is made and disclosed to the recipient of the supply of goods or services.

(4) This Group includes any supply by a person carrying on a credit card, charge card or similar payment card operation made in connection with that operation to a person who accepts the card used in the operation when presented to him in payment for goods or services.

(5) Item 7 includes the introduction to a person effecting transactions in securities or secondary securities within item 6 of a person seeking to acquire or dispose of such securities.

(6) In item 9—

(a) "authorised unit trust scheme" and "operator" have the same meanings as in section 207(1) of the Financial Services Act 1986;

(b) "trust based scheme" has the same meaning as in regulation 2(1)(b) of the Financial Services Act 1986 (Single Property Schemes) (Exemption) Regulations 1989.

Accordingly, the main activities carried out by insurance companies and banks as listed below will be exempt from VAT:

- The underwriting of general insurance risk and life insurance.
- The taking of deposits and the making of loans.
- The issue of shares and tradable debt securities on behalf of customers.

This has two economic consequences:

1. Customers who receive and pay for the above services do not have to pay VAT on top of the price of the service. That applies both for business customers who could recover the VAT on such services, and for retail customers who could not recover the VAT they pay.
2. The insurance companies and banks are not regarded as making taxable supplies in the course of their business, since the supplies they make are exempt from VAT. The consequence is that insurance companies and banks are not able to recover the VAT on the business costs (such as electricity, computer equipment, stationery) that they incur for their exempt activities. Instead that VAT is "irrecoverable" and represents a cost to the bank similar to other such as wages.

The exemption of financial services from VAT

As explained above, there are logical reasons for treating financial services as exempt from a tax on value added. However, legislatures when creating tax law often deviate from logical purity, and make rules which are designed to assist particular economic actors or to achieve non-fiscal goals. Accordingly, financial services are not always treated as being exempt from VAT. Some examples are considered below.

New Zealand

New Zealand has a tax called goods and services tax (GST) which is clearly a value added tax modelled on VAT as operated in the EU. It was legislated by The Goods and Services Tax Act 1985. (GSTA) As one would expect, financial services are exempted from VAT by GSTA 1985 section 14(1)(a):

14 Exempt supplies

(1) The following supplies of goods and services shall be exempt from tax:

(a) the supply of any financial services (together with the supply of any other goods and services, supplied by the supplier of those financial services, which are reasonably incidental and necessary to that supply of financial services), not being a supply referred to in subsection (1B):

Financial services are defined in GSTA 1985 s.3 which is not reproduced here, but is very similar to the definition in UK law quoted above.

What is interesting about New Zealand is that in certain circumstances financial services can be zero rated. This is governed by GSTA 1985 s.11A, reproduced below with non-relevant material excised:

11A Zero-rating of services

(1)…

(q) the services are financial services that are supplied in respect of a taxable period, by a registered person who has made an election under section 20F, to a registered person who makes supplies of goods and services such that taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (r) make up not less than 75% of the total value of the supplies in respect of—

(i) a 12-month period that includes the taxable period; or

(ii) a period acceptable to the Commissioner; or

(r) the services are financial services that are supplied in respect of a taxable period, by a registered person who has made an election under section 20F, to a person who is a member of a group of companies for the purposes of section IA 6 of the Income Tax Act 2007 and—

(i) the members of the group make supplies of goods and services to persons who are not members of the group in respect of—

(A) a 12-month period that includes the taxable period; or

(B) a period acceptable to the Commissioner; and

(ii) not less than 75% of the total value of the supplies referred to in subparagraph (i) consists of taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (q);

(r) the services are financial services that are supplied in respect of a taxable period, by a registered person who has made an election under section 20F, to a person who is a member of a group of companies for the purposes of section IA 6 of the Income Tax Act 2007 and—

(i) the members of the group make supplies of goods and services to persons who are not members of the group in respect of—

(A) a 12-month period that includes the taxable period; or

(B) a period acceptable to the Commissioner; and

(ii) not less than 75% of the total value of the supplies referred to in subparagraph (i) consists of taxable supplies that are not charged with tax at the rate of 0% under this paragraph or under paragraph (q);

If one looks past the details concerning groups of companies, what the above provision means is that when a bank provides financial services to a business, 75% of whose supplies are taxable (whether at a positive rate or at a zero rate), then the bank can elect to zero rate those financial services.

The zero rating has no economic consequences to the bank's customer. However, it means that the bank can recover GST paid on a greater proportion of its overhead costs, since it will now be making a higher proportion of taxable (albeit zero rated) supplies and a lower proportion of exempt supplies.

This provision of this election reduces the costs of New Zealand's banks below the level they would otherwise be, at a cost of reduced GST revenue to the New Zealand exchequer.

United Kingdom

As explained above, financial services are exempt supplies under UK VAT law, in order to be consistent with the rules that apply throughout the EU. However, UK VAT law allows the recovery of input tax (VAT on costs incurred by the business) in special cases. The legislation is contained in VATA 1994 s.26(2)(c) below:

26 Input tax allowable under section 25

(1) The amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period (that is input tax on supplies, acquisitions and importations in the period) as is allowable by or under regulations as being attributable to supplies within subsection (2) below.

(2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business—

(a) taxable supplies;

(b) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom;

(c) such other supplies outside the United Kingdom and such exempt supplies as the Treasury may by order specify for the purposes of this subsection.

The rest of VATA 1994 s.26 is not reproduced to save space.

The Treasury has made an order, Statutory Instrument 1999 Number 3121 which is reproduced below:

1999 No. 3121 VALUE ADDED TAX

The Value Added Tax (Input Tax) (Specified Supplies) Order 1999

The Treasury, in exercise of the powers conferred on them by section 26(2)(c) of the Value Added Tax Act 1994(a) and of all other powers enabling them in that behalf, hereby make the following Order:

1. This Order may be cited as the Value Added Tax (Input Tax) (Specified Supplies) Order 1999 and shall come into force on 1st January 2000 and shall have effect in relation to supplies made on or after that date.

2. The supplies described in articles 3 and 4 below are hereby specified for the purposes of section 26(2)(c) of the Value Added Tax Act 1994.

3. Services–

(a) which are supplied to a person who belongs outside the member States;

(b) which are directly linked to the export of goods to a place outside the member States; or

(c) which consist of the provision of intermediary services within the meaning of item 4 of Group 2, or item 5 of Group 5, of Schedule 9 to the Value Added Tax Act 1994 in relation to any transaction specified in paragraph (a) or (b) above,

provided the supply is exempt, or would have been exempt if made in the United Kingdom, by virtue of any item of Group 2, or any of items 1 to 6 and item 8 of Group 5, of Schedule 9 to the Value Added Tax Act 1994.

4. Supplies made either in or outside the United Kingdom which fall, or would fall, within item 1 or 2 of Group 15 of Schedule 9 to the Value Added Tax Act 1994 (investment gold).

5. The Value Added Tax (Input Tax) (Specified Supplies) Order 1992(b) is hereby revoked.

The key provision is 3(a) above, which has the effect of exempting services within Group 5 items 1-6 and 8, which are listed earlier and which comprise the majority of financial services, where the financial services are "*supplied to a person who belongs outside the member States;*", in other words outside the EU.

The statutory instrument requires close reading to determine that category 3(a) is not linked to 3(b) or 3(c). However, this is made clear by the instruction manuals which HM Revenue & Customs (HMRC) use for their own staff and which they publish on the HMRC website.

The Specified Supplies Order, SI 1999/3121

The Treasury has made an order, as discussed above, to allow recovery of VAT in the UK which is incurred on cost components of the supplies listed in Article 169 of the principal VAT Directive (2006/112/EC) (Formerly Article 17(3) of the Sixth Directive). The supplies that give rise to a right to deduct because of this order are:

- *financial services supplied to persons belonging outside the member states or directly related to an export of goods;*
- *insurance services supplied to persons belonging outside the member states or directly related to an export of goods; and*
- *supplies of investment gold.*

Extracted from the page http://www.hmrc.gov.uk/manuals/pemanual/pe1150.htm#5 "PE1150 - Partial exemption basics and the standard method: UK law"

Accordingly, the UK enables banks operating in the UK which provide financial services to persons outside the EU to recover VAT on overhead costs relating to the provision of those services. As with the New Zealand example before, this reduces the costs of those banks. It acts as a minor incentive to continuing to provide those services from the UK rather than setting up overseas operations to provide those services, which would reduce UK employment and business activity.

5. Some transactions used in Islamic finance

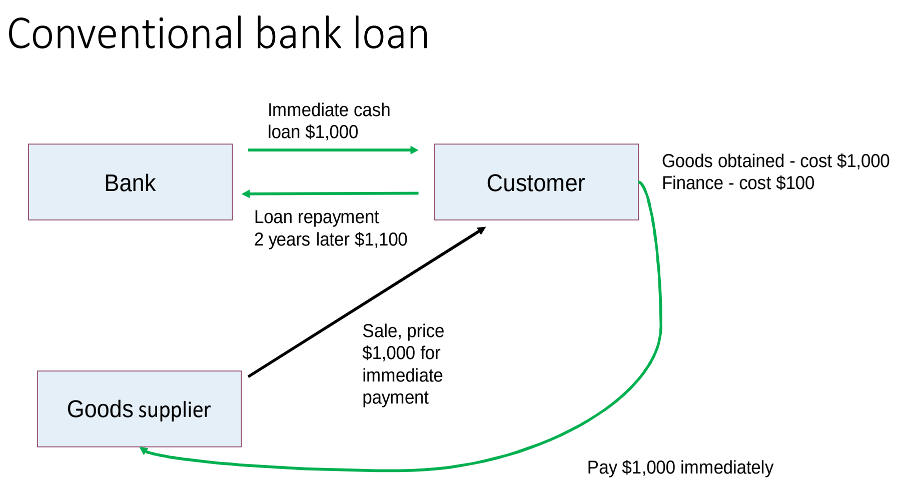
The purpose of Islamic financial services firms is to provide services that meet the financial needs of their customers in a manner that Islamic scholars consider compliant with Shariah.

As the financial needs of Muslim customers and non-Muslim customers are essentially the same, for most services provided by conventional financial services firms there is an analogous service provided by Islamic financial services firms. However, this is not always the case. For some conventional financial services, such as credit derivatives, as far as the author is aware, there is no currently available Islamic analogue.

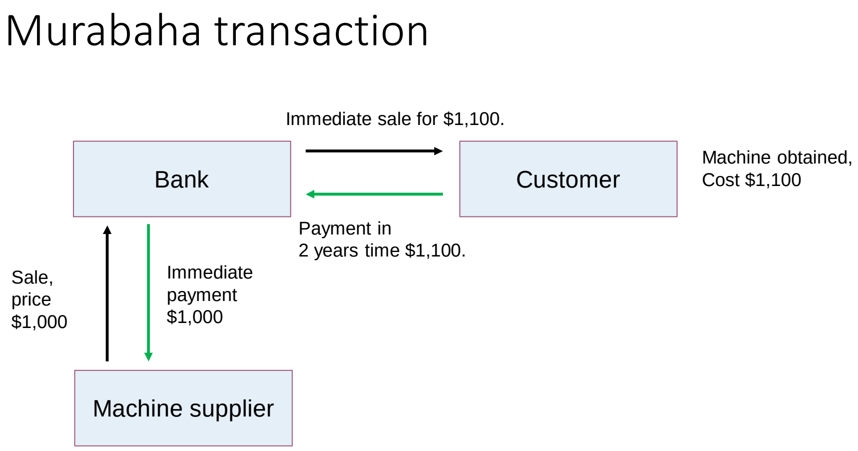
Without seeking to be comprehensive, some of the transactions used in Islamic finance are outlined below, with the goal of emphasising those features which give rise to potentially different VAT consequences when compared with the analogous conventional financial service.

Murabaha (purchase and resale)

If the customer of a conventional bank requires finance to purchase an asset, the conventional bank will make a loan to the customer who then purchases the asset. In due course the customer will repay the loan plus interest.



The analogous Islamic finance transaction is murabaha, where the bank will purchase the desired asset and re-sell it to the customer at a higher price with a disclosed mark-up, with the sale price being payable at some future date, either in one lump sum or in instalments. No interest is charged. This is illustrated below for the purchase of a machine, where the bank enables the customer to delay paying for the machine until two years have elapsed.



VAT analysis of murabaha

In the case of a conventional bank loan, there is a taxable supply (i.e. a supply subject to VAT) of the machine by the machine supplier to the customer valued at $1,000. VAT would be charged on this amount, at say 20%. If the customer is carrying on a business which makes taxable supplies (i.e. not exempt supplies) it would be able to recover the $200 VAT. If the customer is a retail customer (i.e. not in business) or is carrying on a business making exempt supplies, the $200 VAT would not be recoverable, resulting in the machine having an aggregate cost to the customer of $1,200, being the purchase price plus the non-recoverable VAT.

In the case of the murabaha transaction, there are two supplies of the machine:

1. The machine maker supplies the machine to the bank for a price of $1,000 on which it charges VAT (say 20%). The total amount of cash payable by the bank to the machine maker is $1,200.
2. The bank supplies the machine to the customer for a price of $1,100. As a supply of goods, this should be subject to VAT, prima facie at 20% giving rise to a VAT charge of $220. This has several potential implications:
    a. The bank should be able to recover the $200 VAT it paid on the purchase of the machine, since it has used the machine to make a taxable (i.e. non-exempt) supply. Accordingly, the bank would pay the $220 VAT it has charged the customer, less the $200 it recovers by offset, to the tax authority, making a tax payment of $20.
    b. Under UK VAT law, which is the same as elsewhere in the EU, where a business incurs costs which are partly used to make exempt supplies and partly used to make taxable supplies, the costs must be

apportioned on a reasonable basis to determine what part relates to making taxable supplies. VAT on that portion of the costs is then recoverable. Accordingly, the bank may be able to recover VAT on part of its costs, since it is making a taxable supply of the machine.

c. The VAT cash flows are not shown on the diagram. The bank and the customer need to agree whether the customer will pay the $220 VAT to the bank immediately from the customer's own resources, or whether credit is to be given so that the $220 VAT will be paid in two years' time when the customer pays the $1,100 purchase price of the machine.
d. The customer may, or may not, be able to recover VAT on the purchase price of the machine. If the customer can recover the VAT, it represents merely a cash flow issue. However, if the customer cannot recover the VAT (either because it is a retail customer or is a customer engaged in a business making exempt supplies) then the VAT of $220 becomes a cost to the customer. In that case the aggregate cost to the customer of using Islamic finance is higher than it would have been with conventional finance.
    i. Aggregate cost with conventional finance = $1,000 machine + $200 VAT + $100 interest = $1,300.
    ii. Aggregate cost with murabaha transaction = $1,100 machine + $220 VAT = $1,320.
    iii. The difference represents VAT at 20% on the $100 implied finance cost represented by the murabaha transaction's uplift in the purchase price of the machine.

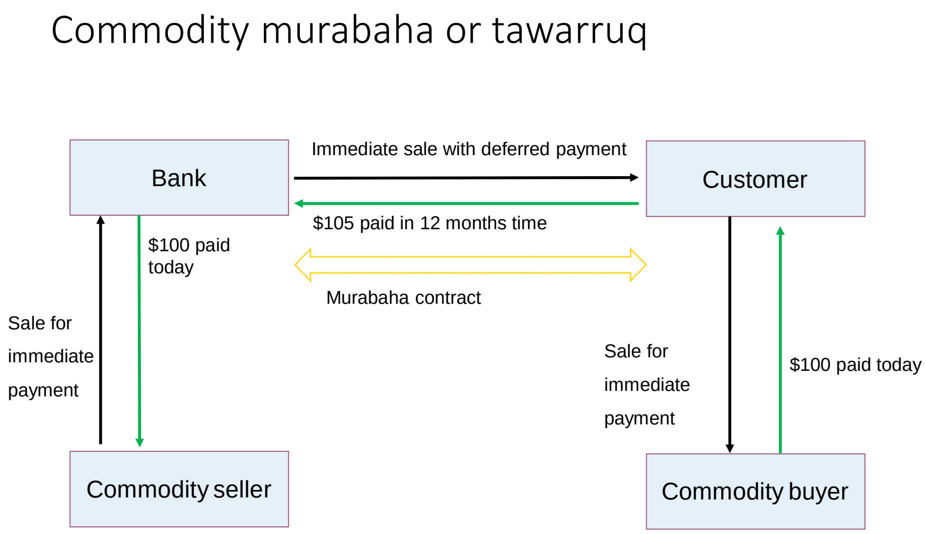
The above VAT analysis is from first principles. This report discusses later how some countries have made specific provisions for the VAT treatment of some Islamic finance transactions and how such laws would apply to the above transaction.

Commodity murabaha or tawarruq

In many cases customers require finance from banks not for the purchase of specific assets but for other business purposes such as the payment of wages.

A conventional bank will simply meet this need by lending money to the customer and charging interest. The loan may be secured on an asset that the customer already owns, or it may be unsecured. For example, $100 may be lent today, with $105 being repayable in 12 months' time, giving a finance cost of 5% per year.

One commonly used method for an Islamic bank to provide cash to a customer is to engage in a commodity murabaha transaction, also known as tawarruq. This is illustrated below.



In this example, the bank will purchase a commodity, for example copper, for a price of $100, making immediate payment to the commodity seller. The bank will then sell the copper to the customer, with immediate delivery, at a price of $105.

However, the customer is not required to pay the $105 price to the bank until 12 months have elapsed. As soon as the customer owns the copper, it sells the copper for its open market value, which is $100 (ignoring any small bid/offer spread) for immediate delivery and immediate payment.

After the above transactions, the customer owns no copper but is in possession of $100 of cash. The customer is also obliged to pay the bank $105 in 12 months' time. Accordingly, apart from any minor transaction costs, the economics of the transaction for both the bank and the customer are the same as for a 5% interest bearing loan for one year.

VAT analysis of commodity murabaha or tawarruq

There are three ownership changes of the copper. Each of these represents a supply of goods, which should be subject to VAT in the absence of any special provisions.

1. The sale of copper by the commodity seller to the bank should present no VAT difficulties. This is a straightforward taxable supply of $100 of copper on which VAT (say 20%) of $20 is charged.
2. The bank uses the copper it has purchased for $100 + VAT of $20 to make a taxable supply to the customer of $105 + VAT of $21. Under the commodity murabaha agreement, the bank has agreed to allow the customer to defer payment of the $105 price for 12 months. The bank and the customer need to agree whether the $21 VAT is to be paid by the customer to the bank immediately, or whether it is also to be deferred for 12 months. As mentioned

above in the case of murabaha, making taxable supplies in this manner may allow the bank to recover some of the VAT it suffers on its overhead costs.

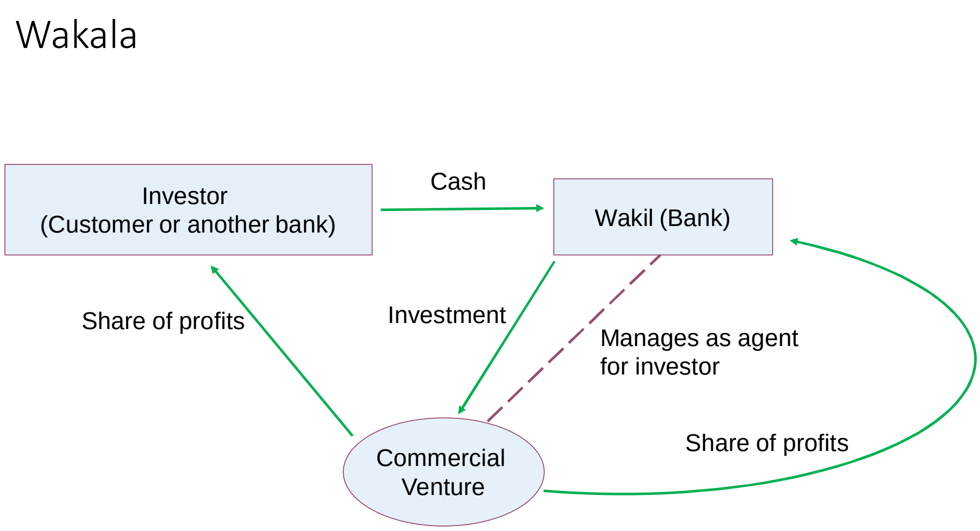
3. The VAT treatment of the sale of the copper by the customer to the commodity buyer for $100 is likely to depend on whether the customer is in business or is a retail customer.
    a. If the customer is in business, then the sale of copper for $100 will be a taxable sale subject to VAT at (say) 20%. The customer will collect $20 of VAT from the commodity buyer, but has $21 of VAT paid on its purchase to offset, resulting in a net refund of VAT of $1 by the tax authority to the customer. This should apply even if the rest of the customer's business consists of making exempt supplies.
    b. However, if the customer is not in business, then the sale of the copper for $100 to the commodity buyer does not appear to be a sale in the course of a business. Accordingly, no VAT would be chargeable. Critically, the customer also has no way of recovering the $21 VAT that it has to pay the bank on its purchase of the copper. Accordingly, the customer of the Islamic bank has a $21 cost (irrecoverable VAT) that does not arise for the customer of the conventional bank.

Later this report considers what amelioration for the above outcome may be possible either under general VAT principles or under specific legislation for Islamic finance.

Wakala

Wakala is a form of agency often used in transactions involving banks, either bank to bank or bank to retail customer.

It is illustrated below.



The economics of the arrangement are usually that the wakil (the agent, here a bank) keeps all of the profits beyond a specified share that is paid to the principal (here either a customer or another bank). The arrangement is often used for inter-bank lodgements of cash, instead of using a commodity murabaha transaction between the two banks.

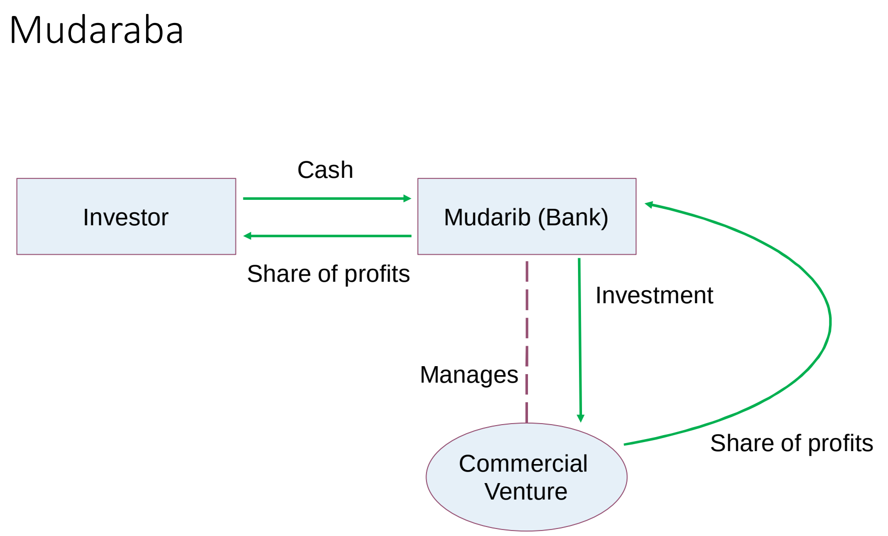
Mudaraba

Mudaraba is often used as a way of providing a bank investment account. The customer pays money into the account which the bank uses for a commercial purpose, normally part of its general business activities.

The mudaraba may be unrestricted, where the mudarib or agent is entirely unfettered regarding how it invests the money, or restricted, where the mudarib can only operate within parameters agreed with the investing principal.

The bank will typically pay a proportion of the profits earned to the investor, the precise proportion depending on the arrangements which have been agreed. If there are losses, Shariah scholars require that losses should be borne entirely by the principal.

Mudaraba is illustrated below.



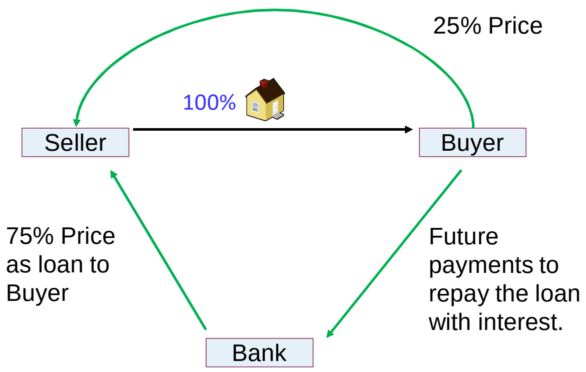
In the United Kingdom, banks are not permitted to offer bank accounts which fully comply with the above requirements, as UK law governing banking requires that unless a bank is insolvent bank accounts must always be repayable at face value. Accordingly, a solvent bank is not permitted to have losses borne by customers which have deposited money with it. However more complex arrangements can be used to achieve a strictly Shariah compliant mudaraba arrangement, for non-retail customers, but not one structured in the form of a bank deposit.

Diminishing musharaka

Diminishing musharaka is commonly used for the provision of real estate finance.

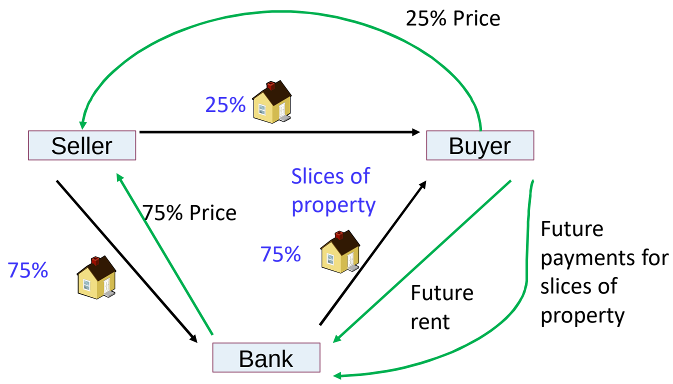
In the case of the conventional mortgage illustrated below, the bank finances 75% of the purchase price by making a loan to the buyer. Typically, the loan will be at floating rate of interest, which may be reset periodically, for example annually.

Conventional mortgage with 25% deposit



A transaction with the same economic consequences can be achieved using diminishing musharaka as illustrated below.

Diminishing musharaka contract with effective 25% deposit



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

In the case of diminishing musharaka, the bank and the buyer purchase the real estate jointly. In this example the buyer purchases 25%, corresponding to buyer's available resources, while the bank purchases 75%. However, buyer occupies the entire property, and pays rent to the bank on the proportion owned by the bank.

In practice, the level of rent is set by reference to prevailing interest rates and will be re-set periodically in the same manner that interest on a mortgage loan might be re-set. During the course of the arrangement, the buyer will gradually buy out the bank's share of the real estate. As the buyer does so, the level of rent will fall as the rent will be payable on only the reduced percentage of the property owned by the bank.

While diminishing musharaka has been illustrated using real estate, it can also be used for other types of asset where shared ownership is possible.

VAT analysis of diminishing musharaka

In the case of the conventional mortgage, there is a single supply of the real estate by the seller to the buyer. VAT may be chargeable, depending upon the type of real estate and the applicable VAT rules. Meanwhile the bank's provision of a loan will normally be an exempt financial service.

With diminishing musharaka, 75% of the real estate is sold twice, once by the seller to the bank and then again, in stage, by the bank to the buyer. There is also a supply of the right to occupy 75% of the real estate, as the bank begins by renting 75% of the property to the buyer. These additional supplies may give rise to VAT being charged, which could significantly exceed the VAT chargeable in the case of the conventional mortgage.

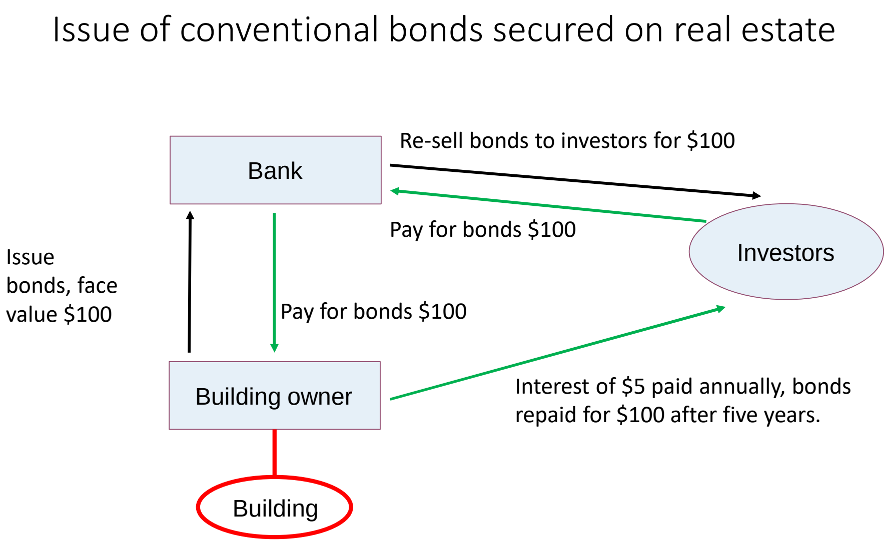
If the buyer is able to recover all applicable VAT, any VAT charges will involve no more than a small cash-flow issue if there is a time lag between the buyer paying the VAT and recovering it by offset or refund. However if the buyer is carrying on a non-taxable business (and is therefore unable to recover VAT) or is a retail purchaser not in business, then any VAT chargeable which exceeds the VAT chargeable with a conventional mortgage will represent an incremental cost arising from the use of Islamic finance.

Ijarah sukuk based on real estate

It is common for larger businesses to borrow directly from investors, as well as borrowing from banks. When such borrowings are made for short periods of time, typically under 12 months, the borrowing instruments are normally referred to as "commercial paper" while longer dated instruments are normally called "bonds."

Such bonds are normally tradable, and usually listed on a stock exchange to ensure that there is a ready market in which they can be bought and sold. Many bond issues are unsecured, while in other cases the bonds may be secured on specific assets such as real estate, so if the bond issuer defaults, the bond investors can foreclose on the asset.

The issue of a bond is illustrated below.

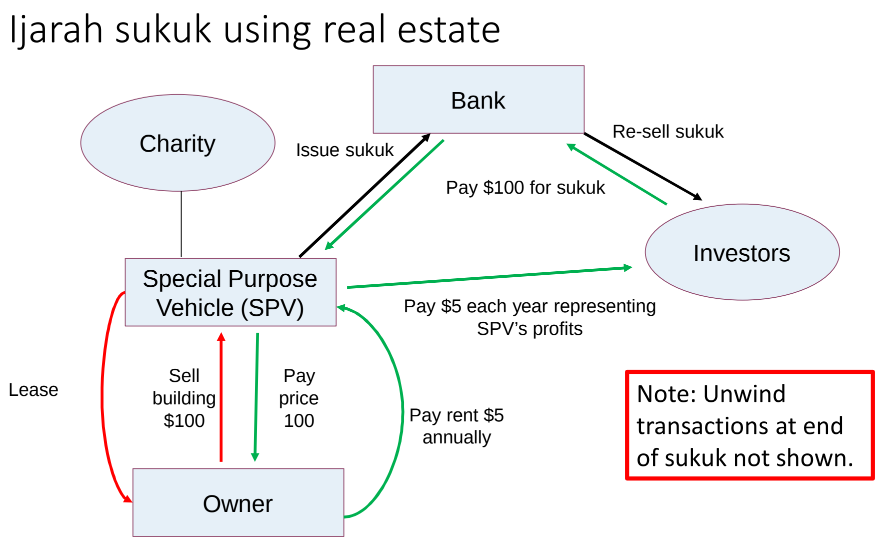


In this example the bank facilitates the issue of the bonds by purchasing the entire issue of $100 from the borrower (the building owner) and then re-selling the bonds to third party investors. For simplicity, the bank is shown as buying the bonds at the same price at which it re-sells them, in which case it would charge the building owner a service fee for the transaction. In practice it is more common for the bank to purchase the bonds from the issuer for a lower price than that at which the bank re-sells the bonds to the investors.

The bonds are secured on the building, so if the building owner defaults on paying either the annual interest of $5 or the redemption amount of $100 after five years, the investors may foreclose on the building.

It is important to note that there is no ownership change or transfer of the building. In every country with whose tax system the author is familiar, this transaction would not cause any taxes to become payable in respect of the building, with the possible exception of minor registration duties in respect of the legal security given over the building to the holders for the time being of the bonds.

The Islamic finance transaction which has the same economic consequences is significantly more complex. It involves the issue of sukuk and is illustrated below.



The above diagram summarises the following transactions which are required to enable the issue of the sukuk and their final redemption while complying with the requirements set down by Shariah scholars.

1. Owner is a company.
2. Today Charity which is not connected with Owner creates a company called Special Purpose Vehicle (SPV). This transaction would normally be facilitated by the bank.
3. Owner owns a building. Today, after SPV has been formed, Owner sells that building to SPV for a price of $100 payable in 30 days' time.
4. Today Owner gives SPV a purchase undertaking by promising that if in five years' time SPV offers to sell the building to Owner for a price of $100, Owner will buy.
5. Today SPV gives Owner a sale undertaking by promising that if in five years' time Owner offers to buy the building from SPV for a price of $100, SPV will sell.
6. Today SPV rents the building to Owner with a lease which is five years long. The rent is $5 per year, payable once a year with the first payment in 12 months' time.
7. SPV creates sukuk certificates under which it holds the building, the lease and the benefit of the Owner's purchase undertaking as trustee for whoever is the owner of the sukuk certificates.
8. Between today and day 30 the sukuk certificates are sold by SPV to the bank for a total price of $100.
9. Between today and day 30 the bank sells the sukuk to the investors for $100.
10. On day 30, SPV pays the $100 to Owner which is owed for the purchase of the building.

11. In 12 months' time, Owner pays rent of $5 to SPV. SPV immediately passes that rent on to the investors in proportion to their ownership of the sukuk certificates. The same happens at the end of years 2, 3, 4 and 5.
12. Also at the end of year 5, Owner offers to buy the building from SPV for a price of $100. SPV agrees to sell, as it has promised to do under the terms of its sale undertaking. Owner pays $100 to SPV and SPV transfers ownership of the building to Owner.
13. SPV passes the $100 sale price of the building on to the investors in proportion to their ownership of the sukuk certificates.
14. The sukuk certificates are cancelled as they have no further value as SPV has no remaining assets.
15. After completion of the above transactions, as SPV should have no assets and no liabilities, SPV will be liquidated.

VAT analysis of the sukuk transactions

The above sukuk transaction gives rise to many possible tax consequences. For example:

- Many countries charge specific taxes on the transfer of real estate and on its leasing.
- The sale of the real estate may give rise to taxes on capital gains.
- The sukuk instruments represent an undivided share in the ownership interest in the building. Accordingly, their sale by the bank to the investors, or later by one investor to another, may give rise to taxation similar to that charged on real estate.

The above issues are out of scope for this report which concentrates entirely on VAT. However, a number of VAT issues potentially arise.

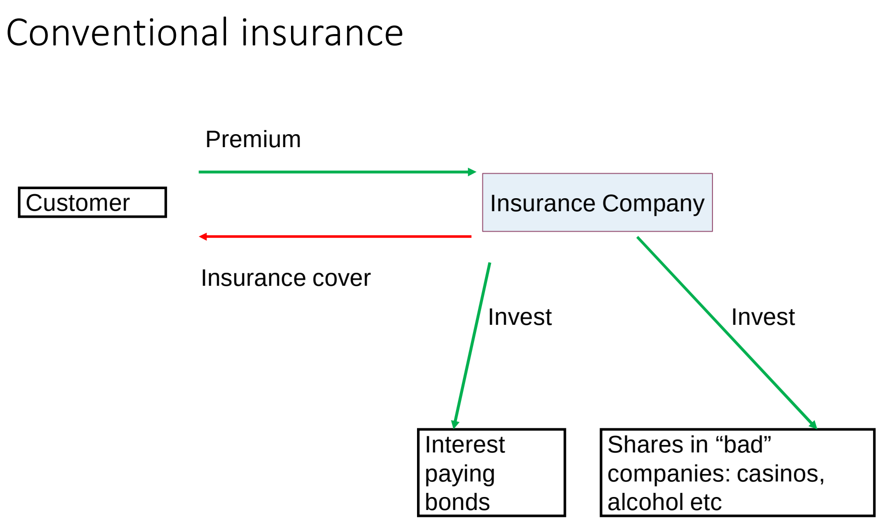
1. The sale of real estate may be an exempt supply, or it may be a taxable supply. In the UK the supply of newly constructed real estate is taxable, and there is an election which can be made in respect of existing real estate (the so-called "option to tax") to bring such real estate into the VAT regime. Accordingly supplies of such real estate, whether by sale or by leasing it, give rise to taxable supplies for VAT purposes. This is normally desirable where the customer is in business and able to recover VAT on all of its costs, as it enables the building owner to recover VAT on costs (such as repairs) which otherwise could not be recovered. As a result, the following supplies of the building need to be considered:
    a. The sale of the building by the owner to the SPV.
    b. The rental of the building by the SPV to the owner.
    c. The final sale of the building by the SPV to the owner.
2. The sukuk certificates represent fractional ownership interests in the building. Accordingly, one needs to consider the VAT implications of their issue by the SPV to the bank, their sale by the bank to the investors, and any subsequent sales by one investor to another. Is this the sale of a financial instrument which would normally be an exempt transaction for VAT purposes, or is it

treated as the sale of a part interest in a building, which would normally be a taxable supply for VAT purposes?

3. The VAT treatment of the annual payment of $5 by the SPV to the investors requires consideration. Prima facie this is not a supply for VAT purposes, just as the payment of dividends is not a supply. Instead the SPV is simply paying over to the investors money that belongs to them as they have fractional ownership interests in the building and are therefore entitled to the rent that SPV receives.

Takaful for property and casualty risks

Shariah scholars consider that conventional insurance has several failings from a religious perspective. This can be illustrated by looking at the following model of conventional property and casualty insurance.



The customer pays a premium to an insurance company in exchange for the insurance company assuming the insured risk. Pending the payment of claims, the insurance company will typically invest the cash received as premiums, and also invest its capital and reserves, in interest paying bonds and in the shares of commercial companies.

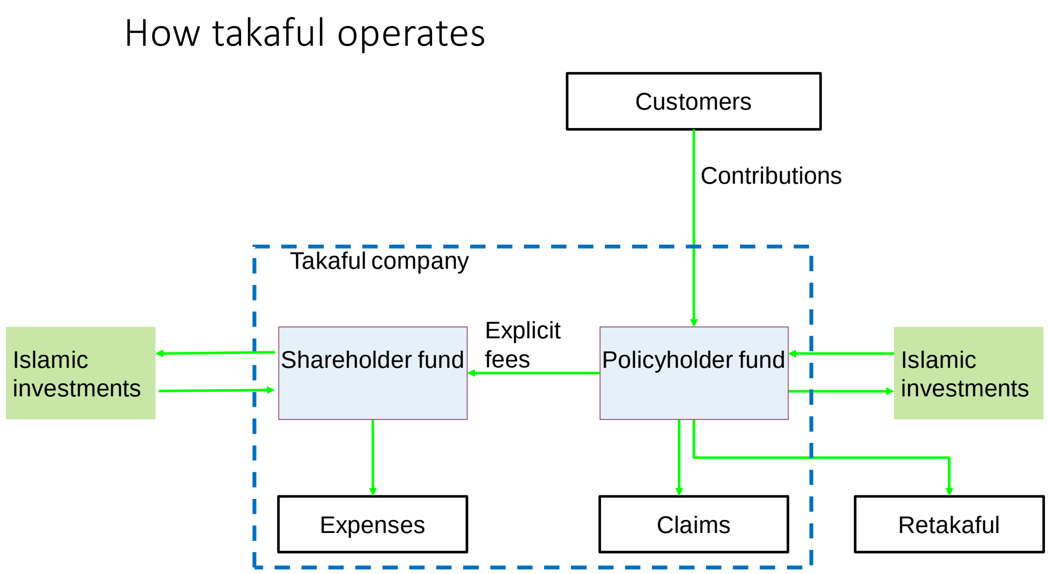
Shariah scholars have several concerns with these arrangements:

1. The interest paying bonds in which the insurance company invests violate the prohibition of "riba."
2. Many of the commercial companies in whose shares the insurance company invests will conduct activities such as the production of alcohol; activities that Muslims should not be engaged in.
3. The insurance contract between the customer and the insurance company has an unacceptable level of uncertainty, "gharar." At the end of the insurance period, if the risk has transpired the customer will have received a potentially

relatively large payout from the insurance company in exchange for a relatively small premium. Conversely if the risk has not transpired, the customer will have paid out the premium and received nothing for it, in the view of the Shariah scholars.

Concerns (1) and (2) above could be rectified within the conventional insurance framework, simply by the insurance company choosing different share investments and different investments instead of bonds, for example by investing in sukuk. However concern (3) is not easily rectified within the conventional insurance framework as it goes to the heart of the insurance contract.

Accordingly takaful has been developed to address concern (3) above, as well as addressing concerns (1) and (2). It is illustrated below.



In the case of takaful, as with a conventional insurance arrangement, customers pay premiums to a company, here the takaful company, and in return their claims will be paid if the insured risks transpire. The takaful company invests the premiums received, and also invests its own capital and reserves, in Islamically permissible investments, thereby addressing concerns (1) and (2) above.

Concern (3) is addressed by the manner in which the takaful company operates. Within the company there is strict segregation between the shareholder fund and the policyholder fund.

The shareholder fund consists of the originally subscribed capital plus any accumulated profits that have not been paid out as dividends. The shareholder fund pays for the operating expenses of the company and receives an explicit fee from the policyholder fund.

The policyholder fund receives the premiums (generally referred to in takaful as "contributions") from the policyholders, and uses these premiums to pay the explicit fee to the shareholders fund and to pay claims if the insured risks transpire.

While the money is held by the takaful company in the policyholder fund, it is invested in Islamically permissible investments which are owned for the benefit of the policyholder fund. The policyholder fund will also typically reinsure some of its risks with a third party, preferably with a Shariah compliant retakaful operator; otherwise Shariah scholars sometimes permit conventional reinsurance to be purchased under the religious doctrine of necessity.

Any surpluses in the policyholder fund belong only to the customers, and may be paid to them in cash after the risk period expires, or may be used to reduce premiums (contributions) in future periods. If there is a deficit in the policyholder fund the shareholder fund will make an interest free loan to the policyholder fund, to be repaid out of future surpluses.

The above represents the simplest form of takaful. Shariah scholars also permit other models. For example, the shareholder fund may be allowed a participation in underwriting surpluses that arise in the policyholder fund.

VAT analysis of takaful

From a VAT perspective, there are no significant differences between the conventional insurance structure and the takaful structure. In both cases the contract between the customer and the company is clearly a contract of insurance from a VAT perspective, and the supply that the company makes is an exempt supply of insurance services. The same applies to the retakaful contract.

There is no conceptual difference between a conventional insurance company making investments and paying claims and a takaful company making investments and paying claims. (As we have seen above, the precise type of investments made can give rise to VAT issues, but those are most appropriately dealt with by considering the investments themselves, as with murabaha above.)

Accordingly, there appears to be no requirement for special VAT rules for takaful.

Asset management

Asset management is a significant part of the conventional financial services industry. It covers the operation of closed ended investment companies, open ended investment companies and funds, venture capital and real estate funds.

VAT analysis of Shariah compliant asset management

All of the above have analogues in the Shariah compliant asset management industry. However apart from the details of specific transactions, and the selection or avoidance of specific types of investments, there are no conceptual differences between conventional asset management and Shariah compliant asset management.

Accordingly there appears to be no requirement for special VAT rules for Shariah compliant asset management.

6. Country approaches to Islamic finance and VAT

A number of countries that operate VAT systems have given consideration to how Islamic finance transactions should be treated for VAT purposes.

The review of some of those countries in this section is not intended to provide comprehensive geographical coverage. Instead the goal is to look at how Islamic finance has been treated for VAT purposes in some countries which have relatively sophisticated tax systems, and which have given serious consideration to Islamic finance.

It shows that a relatively consistent pattern of treatment is emerging. That should not be a surprise given the exchange of knowledge that takes place between tax administrations.

South Africa

South Africa has a relatively small Muslim population. The Wikipedia article "Religion in South Africa" explains that the 2001 census contained a question about religion, but the 2011 census did not. The 2001 census found that Muslims constituted 1.46% of South Africans. Despite this relatively low percentage of Muslims, the relevant South African tax law contains provisions for Islamic finance, perhaps because the Muslim community in South Africa has been present for a long time and is reasonably well represented in business.

South African VAT legislation

The South African VAT regime is set out in the Value-Added Tax Act, 1991 (Act No. 89 of 1991). Section 8A reproduced below deals with Islamic finance.

8A. Sharia compliant financing arrangements

1) For the purposes of this Act, in the case of any murabaha as defined in section 24JA(1) of the Income Tax Act—

a) the bank financier shall be deemed not to have acquired or supplied goods under the sharia arrangement;

b) the client shall be deemed to have acquired the goods—

i) from the seller for consideration equal to the amount paid by the bank financier to the seller; and

ii) at such time as the supply was made by the seller by virtue of the transaction between the seller and the bank financier; and

c) any premium paid or payable to the bank financier by the client shall be deemed to be consideration in respect of an exempt a financial service supplied by the bank financier as contemplated in section 2(1)(f):

Provided that this paragraph shall not apply to the extent to which the consideration constitutes any fee, commission or similar charge.

2) For the purposes of this Act, in the case of any diminishing musharaka as defined in section 24JA(1) of the Income Tax Act—

a) the bank shall be deemed not to have acquired or supplied goods under the sharia arrangement;

b)

i) where the bank and the client jointly acquire goods, the client shall be deemed to have acquired the bank's interest in the goods—

aa) for an amount equal to the amount payable by the bank in respect of its interest in the goods; and

bb) at the time that the seller of the goods was divested of any interest in the goods by virtue of the transaction between the seller and the bank; or

ii) where the bank acquires an interest in the goods from the client, the client shall be deemed not to have supplied an interest in the goods to the bank; and

c) any amount contemplated in section 24JA(5)(d) of the Income Tax Act paid or payable to the bank by the client shall be deemed to be consideration in respect of an exempt financial service supplied by the bank as contemplated in section 2(1)(f):

Provided that this paragraph shall not apply to the extent to which the consideration constitutes any fee, commission or similar charge.

Consequently, for a murabaha transaction the client is deemed to have acquired the goods from the original seller, for the original sales price, and can recover (or not recover depending on the client's VAT status) VAT accordingly.

Conversely the murabaha mark-up received by the bank is treated as an exempt supply of financial services. Accordingly, in our murabaha example discussed earlier, the customer would be treated as purchasing a machine for $1,000 + $200 VAT, and would be in the same economic position as if it had taken out a conventional bank loan. No VAT would arise on the bank's $100 mark-up under the murabaha transaction.

Similarly, in the case of a musharaka transaction, the buyer is deemed to acquire the goods directly from the original seller at the price that the original seller charged the bank. Accordingly the risk of the diminishing musharaka transaction giving rise to incremental VAT costs is eliminated.

The definitions of murabaha and musharaka applied are contained in the Income Tax Act, 1962 (Act No. 58 of 1962) section 24JA which is reproduced below to illustrate the approach adopted to the definitions by South Africa. Parts of the section have been excised for conciseness.

24JA. Sharia compliant financing arrangements

1) For the purposes of this section—

‘diminishing musharaka’ means a sharia arrangement between a bank and a client of that bank whereby—

a)

i) the bank and the client jointly acquire an asset from a third party (the seller); or

ii) the bank acquires an interest in an asset from the client;

b) the client will acquire the bank’s interest in the asset after the acquisition of the asset by the bank as contemplated in paragraph (a);

and

c) the amount of consideration payable by the client to the bank for the acquisition of the interest of the bank in the asset will be paid over a period of time as agreed between the client and the bank;

‘mudaraba’ means a sharia arrangement between a bank and a client of that bank, whereby—

a) funds are deposited with the bank by the client;

b) the anticipated return in respect of the sharia arrangement is dependent on the amount deposited by the client in combination with the duration of the period for which the funds are deposited;

c) the bank invests the funds deposited by the client in other sharia arrangements;

d) the client bears the risk of the loss in respect of the sharia arrangements contemplated in paragraph (c); and

e) the return in respect of the sharia arrangements contemplated in paragraph (c) is divided between the client and the bank as agreed at the time that the client deposits the funds with the bank;

‘murabaha’ means a sharia arrangement between a financier and a client of that financier, one of which is a bank, whereby—

a) the financier will acquire an asset from a third party (the seller) for the benefit of the client on such terms and conditions as are agreed upon between the client and the seller;

b) the client-

i) will acquire the asset from the financier within 180 days after the acquisition of the asset by the financier contemplated in paragraph (a); and

ii) agrees to pay to the financier a total amount that-

aa) exceeds the amount payable by the financier to the seller as consideration to acquire the asset;

bb) is calculated with reference to the consideration payable by the financier to the seller in combination with the duration of the sharia arrangement; and *cc) may not exceed the amount agreed upon between the financier and the client when the sharia arrangement is entered into; and*

c) no amount is received by or accrues to the financier in respect of that asset other than an amount contemplated in paragraph (b)(ii);

"sharia arrangement" means an arrangement that is—

a) open for participation by members of the general public; and

b) presented as compliant with sharia law when the members of the general public are invited to participate therein.

"sukuk" means a sharia arrangement whereby-

a) the government of the Republic disposes of an interest in an asset to a trust; and

b) the disposal of the interest in the asset to the trust by the government is subject to an agreement in terms of which the government undertakes to reacquire on a future date from that trust the interest in the asset disposed of at a cost equal to the cost paid by the trust to the government to obtain the asset.

2) Any amount received by or accrued to a client in terms of a mudaraba is deemed to be interest as defined in section 24J(1).

3) Where any murabaha is entered into between a financier and a client of that financier as contemplated in paragraph (a) of the definition of 'murabaha'—

a) the financier is deemed not to have acquired or disposed of the asset under the sharia arrangement;

b) the client is deemed to have acquired the asset from the seller—

i) for consideration equal to the amount paid by the financier to the seller; and

ii) at such time as the financier acquired the asset from the seller by virtue of the transaction between the seller and the financier;

c) the murabaha is deemed to be an instrument for the purposes of section 24J;

d) the difference between the amount of consideration paid for the asset by the financier to the seller and the consideration payable to the financier by the client to acquire the asset as contemplated in paragraph (b)(ii) of the definition of 'murabaha' is deemed to be a premium paid for the purposes of section 24J; and

e) the amount of consideration paid by the financier to acquire the asset as contemplated in paragraph (a) of the definition of 'murabaha' is deemed to be an issue price for the purposes of section 24J.

5) For the purposes of determining the tax on income of the client in respect of a diminishing musharaka—

a) where the bank and the client jointly acquire an asset, the client is deemed to have acquired the bank's interest in the asset—

i) for an amount equal to the amount paid by the bank in respect of its interest in the asset; and

ii) at the time that the seller of the asset was divested of its interest in the asset by virtue of the transaction between the seller and the bank; or

b) where the bank acquires an interest in an asset from the client, the client is deemed not to have disposed of the interest in the asset or to have acquired that interest from the bank.

6)

a) For the purposes of subsection (5), where an instalment is paid by the client to the bank, a portion of that instalment, the amount of which must be determined in accordance with paragraph (b), is deemed to be interest as defined in section 24J(1);

b)The amount contemplated in paragraph (a) must be determined in accordance with the formula—

$X = A - B$

in which formula—

i) 'X' represents the amount to be determined;

ii) 'A' represents the total amount of the instalment payable by the client to the bank;

iii) 'B' represents the expenditure incurred by the bank to acquire the portion of the interest in the asset transferred to the client in exchange for the instalment payable by the client to the bank; and

iv) 'C' represents the total number of instalments payable by the client to the bank in respect of the consideration contemplated in paragraph (c) of the definition of 'diminishing musharaka'.

7) Where any sukuk is entered into-

a) the trust is deemed not to have acquired the asset from the government of the Republic under the sharia arrangement;

b) the government is deemed not to have disposed of or re-acquired the asset; and

c) any consideration paid by the government in respect of the use of the asset held by the trust is deemed to be interest as defined in section 24J(1).

Singapore

The Pew Research Center's "Global Religious Diversity" report, published in April 2014, stated that approximately 14% of Singaporeans are Muslim. Furthermore, Singapore is a leading financial centre with large Muslim majority neighbours in the form of Malaysia and Indonesia. Accordingly it has been relatively early in legislating for the tax treatment of Islamic finance.

Singapore VAT legislation

The VAT law of Singapore is contained in the Goods and Services Tax Act, originally legislated in 1993 and revised in 2005.

The Fourth Schedule deals with Exempt Supplies, including financial services, and there are specific provisions for Islamic finance which are reproduced below, while excising other parts of the schedule.

Schedule 4

PART I EXEMPT SUPPLIES Finance

1. The following financial services:

…

(r) the provision of financing in connection with a qualifying Islamic financial arrangement in relation to non-residential property, for which the provider of the financing derives an effective return;

(ra) the provision of financing in connection with a qualifying Islamic financial arrangement in relation to an asset, for which the provider of the financing derives an effective return;

(rb) the provision of financing in connection with a qualifying Islamic financial arrangement in relation to an asset which is jointly acquired by a provider of the financing and a purchaser, for which the provider of the financing derives an effective return;

(rc) the provision of financing in connection with a qualifying Islamic financial arrangement in relation to the construction of an asset, for which the provider of the financing derives an effective return;

(s) the issue or transfer of ownership of Islamic debt securities under an Islamic debt securities arrangement;

(t) the provision of financing under an Islamic debt securities arrangement for which the provider of the financing derives an effective return;

(u) the provision of financing by one bank to another bank under a qualifying Islamic agency arrangement.

PART III INTERPRETATION AND APPLICATION

Interpretation

1. In this Schedule —

…

"effective return" means —

(a) in the case of a qualifying Islamic financial arrangement in relation to non-residential property in the circumstances described in paragraph (a)(ii)(A) of the definition of that arrangement, the difference between the price of the non-residential property sold by the

provider of the financing to the purchaser over the cost of the non-residential property bought by the provider of the financing;

(b) in the case of a qualifying Islamic financial arrangement in relation to non-residential property in the circumstances described in paragraph (a)(ii)(B) of the definition of that arrangement, the difference between the total of the lease payments made by the purchaser over the cost of the non-residential property bought by the provider of the financing;

(c) in the case of a qualifying Islamic financial arrangement in relation to an asset acquired by a provider of the financing, the difference between the price of the asset sold by the provider of the financing to the bank over the cost of the asset bought by the bank on behalf of the provider of the financing;

(d) in the case of a qualifying Islamic financial arrangement in relation to an asset jointly acquired by a provider of the financing and a purchaser, the difference between the total amount of —

> *(i) the money payable by the purchaser for the interest in the asset belonging to the provider of the financing;*
>
> *(ii) any lease payments for the lease of the asset;*
>
> *(iii) any moneys payable for the subsequent use of any portion of the asset referred to in sub-paragraph (c)(v) of the definition of "qualifying Islamic financial arrangement", as may be applicable; and*
>
> *(iv) any moneys payable in the event of an early termination of the arrangement referred to in sub-paragraph (c)(vi) of the definition of "qualifying Islamic financial arrangement", as may be applicable,*

and the money provided by the provider of the financing for the joint purchase of the asset;

(e) in the case of a qualifying Islamic financial arrangement in relation to the construction of an asset where the asset is constructed or a comparable asset substituted therefor, the difference between the total amount of money payable by the purchaser for the asset or the comparable asset and the amount of money provided by the provider of the financing for the construction of the asset; and

(f) in the case of an Islamic debt securities arrangement, the payments referred to in paragraph (b) of the definition of "Islamic debt securities;

"equity security" means any interest in or right to a share in the capital of a body corporate or any option to acquire any such interest or right but excludes a contract of insurance and an estate or interest in land, other than an estate or interest as mortgagee or chargeholder;

"Islamic debt securities" means debt securities and trust certificates —

(a) which are endorsed by any Shari'ah council or body, or by any committee formed for the purpose of providing guidance on compliance with Shari'ah law; and

(b) where the amounts payable from such securities and trust certificates are periodic and supported by a regular stream of receipts from underlying assets;

"Islamic debt securities arrangement" means an arrangement under which —

(a) immovable properties in Singapore, or all or part of the beneficial interest therein, are acquired by a special purpose vehicle from a person (referred to in this definition as the originator) where the acquisition is funded through the issuance of Islamic debt securities by the special purpose vehicle;

(b) the immovable properties are leased by the special purpose vehicle to the originator; and

(c) the immovable properties, or all or part of the beneficial interest therein referred to in paragraph (a), re-acquired by the originator upon the maturity of the Islamic debt securities;

"life insurance contract" means a contract for the provision of a life policy within the meaning of the Insurance Act (Cap. 142);

"Monetary Authority of Singapore" means the Monetary Authority of Singapore established under section 3 of the Monetary Authority of Singapore Act (Cap. 186);

"non-residential property" means any land, building, flat or tenement other than any land, building, flat or tenement described in paragraph 2(a), (b) and (c) of Part I;

"qualifying Islamic financial arrangement" means an arrangement which is endorsed by any Shari'ah council or body or by any committee formed for the purpose of providing guidance on compliance with Shari'ah law, and —

(a) in relation to non-residential property, is an arrangement that is entered into between a provider of the financing and a purchaser whereby —

> *(i) the provider of the financing acquires all or part of the beneficial interest in the non-residential property from the seller with a view to selling the same to the purchaser; and*
>
> *(ii) the provider of the financing —*
>
> > *(A) immediately sells such beneficial interest to the purchaser (whether for consideration of a lump sum payment or instalment payments); or*
> >
> > *(B) immediately leases such beneficial interest to the purchaser with an option for the purchaser to acquire the non-residential property;*

(b) in relation to an asset which is acquired by a provider of the financing, is an arrangement that is entered into between the provider of the financing and a bank whereby —

> *(i) the provider of the financing appoints the bank as an agent to acquire the asset on its behalf, with a view to selling the asset to the bank;*
>
> *(ii) the provider of the financing immediately sells the asset to the bank (whether for consideration of a lump sum payment or instalment payments);*
>
> *(iii) the bank immediately sells the asset to another person at the same price at which the asset was first acquired on behalf of the provider of the financing by the bank; and*
>
> *(iv) the bank is not required to effect payment to the provider of the financing until after the asset is sold;*

(c) in relation to the asset which is jointly acquired by a provider of the financing and a purchaser, is an arrangement that is entered into between the provider of the financing and the purchaser whereby —

> *(i) the provider of the financing (or its agent) acquires partial interest in the asset with a view to selling its interest in the asset to the purchaser;*
>
> *(ii) the provider of the financing (or its agent) sells its interest in the asset to the purchaser on a periodic basis for an amount of money determined at the start of the arrangement;*
>
> *(iii) the provider of the financing (or its agent) leases the portion of its interest in the asset that has yet to be sold to the purchaser for an amount of money determined at the start of the arrangement;*
>
> *(iv) the provider of the financing (or its agent) appoints the purchaser, or a third party, to take on the obligations in connection with the use of the asset, including its maintenance and insurance;*
>
> *(v) in the event the asset is not in existence at the time of the joint purchase, and the provider of the financing (or its agent) leases the unsold portion of its interest in the asset to the purchaser, an amount of money may be paid by the purchaser to the provider of the financing (or its agent) for the subsequent use of that portion of the asset;*
>
> *(vi) in the event of an early termination of the arrangement, the purchaser purchases the remaining unsold portion of the interest in the asset belonging to the provider of the financing (or its agent) for an amount of money determined at the start of the arrangement;*
>
> *(vii) in the event the purchaser is unable to pay the amount of money in sub-paragraph (vi), the provider of the financing (or its agent) may sell the asset to a third party at a price lower than the outstanding amount payable by the purchaser; and*
>
> *(viii) the purchaser purchases the whole of the interest in the asset belonging to the provider of the financing (or its agent) upon the expiry of the arrangement and obtains full ownership of the asset;*

(d) in relation to the construction of an asset, is an arrangement that is entered into between a provider of the financing and a purchaser whereby —

> *(i) at the request of the purchaser and in accordance to the purchaser's specifications, the provider of the financing commissions the purchaser to construct an asset, for an amount of money, with a view to selling the completed asset to the purchaser;*
>
> *(ii) either —*
>
> > *(A) the provider of the financing (or its agent) leases the asset to the purchaser with an option for the purchaser to acquire the asset; or*

(B) the purchaser undertakes to purchase the asset from the provider of the financing (or its agent) after the completed asset has been transferred to the provider of the financing in accordance with sub-paragraph (v)(A);

(iii) the purchaser procures the construction of the asset by a third party;

(iv) the provider of the financing (or its agent) makes periodic payments to the purchaser for the construction of the asset;

(v) one of the following events takes place:

(A) the purchaser transfers the ownership of the asset to the provider of the financing (or its agent) on a mutually agreed date on or after the completion of the construction of the asset by the third party;

(B) the purchaser returns all the periodic payments received to the provider of the financing (or its agent) and cancels the lease arrangement referred to in sub-paragraph (ii)(A); or

(C) the provider of the financing (or its agent) agrees to the substitution of the asset that is the subject of the lease arrangement in sub-paragraph (ii)(A) or the purchase undertaking in sub-paragraph (ii)(B) with a comparable asset, and the purchaser transfers the ownership of the comparable asset to the provider of the financing (or its agent), on a mutually agreed date;

(vi) the provider of the financing (or its agent) does not take physical delivery of the asset or the comparable asset, as the case may be; and

(vii) at the end of the arrangement, the provider of the financing (or its agent) transfers ownership of the asset or the comparable asset, as the case may be, to the purchaser pursuant to —

(A) the lease arrangement referred to in sub-paragraph (ii)(A) (except upon the occurrence of the event in sub-paragraph (v)(B)); or

(B) the purchase undertaking referred to in sub-paragraph (ii)(B),

as the case may be;

"qualifying Islamic agency arrangement" means an arrangement —

(a) which is endorsed by any Shari'ah council or body, or by any committee formed for the purpose of providing guidance on compliance with Shari'ah law; and

(b) whereby —

(i) a bank appoints another bank as an agent of the first-mentioned bank for a fee, to use the first-mentioned bank's funds with a view of generating an expected gain;

(ii) the second-mentioned bank returns the first-mentioned bank's funds and the expected gain at the end of the arrangement; and

(iii) the second-mentioned bank retains any gains in excess of the expected gain;

"special purpose vehicle", in relation to an Islamic debt securities arrangement, means a company whose only business is to acquire the originator's immovable properties in Singapore, lease them back to the originator and transfer such properties to the originator upon the maturity of the Islamic debt securities;

The above legislation has the following favourable VAT consequences for the Islamic finance transactions being discussed in this report.

For murabaha financing, paragraph 1(ra) treats the provision of the financing as an exempt financial service. The effective return earned by the bank is an exempt supply. Accordingly in our example above the customer would not be faced with VAT being charged on the mark-up earned by the bank.

As long ago as 2006, Singapore changed its tax law to ensure that a bank which engages in a murabaha financing of non-residential real estate is able to recover all of the GST on its purchase, rather than the fixed recovery rate then applicable of 76%, and to avoid charging VAT on its mark-up.

Similarly paragraph 1(rb) would treat the bank's effective return on the diminishing musharaka transaction as an exempt supply.

The economic return on "Islamic debt securities" (sukuk) is also treated as an exempt supply.

Malaysia

Malaysia is a country whose population is about 61% Muslim. Its government has vigorously promoted Islamic finance for several decades.

Malaysian legislation on VAT

Malaysia has a value added tax system legislated for in the Goods and Services Tax Act 2014 which came into force relatively recently, 1 April 2015.

Islamic financial arrangements

These are defined in GSTA 2014 s.2(1) as follows:

"Islamic financial arrangement" means a written contract which relates to a supply of financing in accordance with the principles of Syariah;

Special GST treatment for Islamic financial arrangements

GSTA 2014 Schedule 2 is headed *"Matters to be treated as neither a supply of goods nor a supply of services."*

GSTA 2014 Sch 2 paragraph 5 is headed *"Supply of goods or services under Islamic financial arrangement."*

It states:

5. Where any person makes a supply of goods or services under an Islamic financial arrangement, any supply made in such arrangement other than the provision of financing shall be treated as neither a supply of goods nor a supply of services.

The apparently straightforward consequence is that such supplies are ignored for GST purposes. However, the statute does not give details of exactly how it is to be ascertained which supplies are to be excluded from being supplies of goods or services.

Royal Malaysian Customs have issued a series of guides to the Goods and Services Tax, one of which has the title "Guide on Islamic Banking." This goes through a number of Islamic finance transactions, itemising the supplies that take place, and explaining how the legislation quoted above is applied in practice.

United Kingdom

The Muslim population of the UK is about 5%. However as one of the world's pre-eminent financial services centres, entities in the UK have carried out Islamic finance transactions for many years.

In the early 2000's the UK began legislating for Islamic finance, initially to eliminate the double real estate transfer tax (stamp duty / stamp duty land tax) charge on Islamic residential mortgages, and then legislating in a manner that would allow Islamic banks and their customers to receive appropriate tax treatment for Islamic finance transactions when computing taxes on profits and gains.

As a member of the European Union, the UK has to follow EU rules when implementing VAT within its domestic tax law. This means that, unlike the position with direct taxes, the UK has not been able to pioneer any innovative approaches with regard to the application of VAT to Islamic finance transactions. This contrasts with the position of countries such as Singapore and South Africa which have the freedom to legislate for VAT as they wish.

Published UK Guidance on Islamic finance and VAT

There is no specific UK VAT law governing Islamic finance. However HMRC has set out its views on how UK VAT law applies to several common Islamic finance transactions in the instruction material it provides to its own staff in the form of HMRC Manuals, which are published on the HMRC website.

It should be borne in mind that guidance materials do not change the law and indeed have no legal force. Accordingly the fact that the UK has not needed to legislate specifically for the VAT treatment of Islamic finance demonstrates that, by and large, the VAT regime applicable in the UK (and indeed throughout the EU since VAT is a tax that is harmonised across the EU) is capable of dealing with many, if not most, Islamic finance transactions without giving rise to excessive VAT costs compared with the equivalent conventional finance transactions.

VATFIN8600 - Islamic products: current and savings accounts

This is available from http://www.hmrc.gov.uk/manuals/vatfinmanual/vatfin8600.htm It explains the main types of banking services offered by Islamic banks, and how they will be treated for VAT purposes.

With regard to mudaraba bank accounts, the HMRC guidance points out that VAT can become chargeable:

"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 VAT 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. See paragraph 7.1 of VAT Notice 701/49 Finance."

VATFIN8200 - Islamic products: Price plus "profit"

This is available from http://www.hmrc.gov.uk/manuals/vatfinmanual/VATFIN8200.htm It explains the VAT treatment of murabaha transactions.

Where goods are sold with title to the asset passing *"from the bank to the customer the sale is treated in the same way as a credit sale (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."

Consequently the customer should be in the same VAT position as if a conventional loan had been borrowed and used to purchase the asset, so the form of finance used does not change the amount of VAT (if any) that the customer has to pay in respect of the purchase of the asset, while the charge for the finance is exempt from VAT.

VAT Notice 701/9: commodities and terminal markets

This document which is available at https://www.gov.uk/government/publications/vat-notice-7019-commodities-and-terminal-markets/vat-notice-7019-commodities-and-terminal-markets does not mention Islamic finance. However the UK VAT regime for commodities and terminal markets requires careful consideration as many international commodity murabaha transactions take place on the London markets.

As discussed in the section "VAT analysis of commodity murabaha or tawarruq" on page 26 the VAT treatment from first principles becomes problematical, particularly if the customer is not engaged in a business which makes taxable supplies as significant VAT costs can arise which would not arise with a conventional interest bearing loan.

The UK VAT regime for commodities and terminal markets, taken together with the UK's special warehousing regime, significantly ameliorates, and in most cases eliminates, these potential problems.

While VAT Notice 701/9 covers many types of transaction, the one most likely to be encountered in Islamic finance is the sale of an identifiable commodity. For example, the subject of the commodity murabaha transaction may consist of copper where individually numbered bars of pure copper are bought and sold to achieve the desired economic consequences. Such transactions in copper would take place on the London Metal Exchange (LME), which is one of the terminal markets listed in VAT Notice 701/9 section 4.

The LME uses a number of warehouses, both in the UK and overseas, as illustrated on its website at https://www.lme.com/trading/warehousing-and-brands/warehousing/warehouse-locations/ Where the copper is located in the UK, it will be held within a special warehousing regime, as provided for in the VAT Act 1994 section 18 which is reproduced below but abridged for clarity to exclude text which is not needed to analyse the commodity murabaha transaction:

18 Place and time of acquisition or supply

(1) Where—

(a) any goods have been removed from a place outside the member States and have entered the territory of the Community;

(b) the material time for any acquisition of those goods from another member State or for any supply of those goods is while they are subject to a warehousing regime and before the duty point; and

(c)…

then the acquisition or supply mentioned in paragraph (b) above shall be treated for the purposes of this Act as taking place outside the United Kingdom.

(2)…

(a) …

(b) …

(i) …

(ii) …

(3) …

(4) …

(a) …

(b) …

(i) …

(ii) …

(5) The Commissioners may by regulations make provision—

(a) …

(b) …

(6) In this section—

"dutiable goods" means any goods which are subject—

(a) to a duty of excise; or

(b) in accordance with any provision for the time being having effect for transitional purposes in connection with the accession of any State to the European Communities, to any Community customs duty or agricultural levy of the European Community;

"the duty point", in relation to any goods, means—

(a) …

(b) … the time when any Community customs debt in respect of duty on the entry of the goods into the territory of the Community would be incurred or, as the case may be, the corresponding time in relation to any such duty or levy as is mentioned in paragraph (b) of the definition of dutiable goods;

"material time"—

(a) in relation to any acquisition or supply the time of which is determined in accordance with regulations under section 6(14) or 12(3), means such time as may be prescribed for the purpose of this section by those regulations;

(b) in relation to any other acquisition, means the time of the event which, in relation to the acquisition, is the first relevant event for the purposes of taxing it; and

(c) in relation to any other supply, means the time when the supply would be treated as taking place in accordance with subsection (2) of section 6if paragraph (c) of that subsection were omitted;

"warehouse" means any warehouse where goods may be stored in any member State without payment of any one or more of the following, that is to say—

(a) Community customs duty;

(b) any agricultural levy of the European Community;

(c) VAT on the importation of the goods into any member State;

(d) any duty of excise or any duty which is equivalent in another member State to a duty of excise.

(7) References in this section to goods being subject to a warehousing regime is are reference to goods being kept in a warehouse or being transported between warehouses (whether in the same or different member States) without the payment in a member State of any duty, levy or VAT; and references to the removal of goods from a warehousing regime shall be construed accordingly.

Accordingly in the commodity murabaha example, provided that the Commodity Seller and the Commodity Buyer are members of the LME, and provided the Bank and the Customer engage LME members to buy and sell the copper on their behalf, no VAT should arise as legally all of the transactions will be between LME members, either as principals or as agents with the copper never leaving the warehousing regime which allows sales of the copper to be treated as taking place outside the UK.

The application of the law is most easily seen in the UK Statutory Instrument which sets out the law that VAT notice 701/9 is explaining. That is The Value Added Tax (Terminal Markets) Order 1973. Despite its age, it is still in force although it has been amended many times. The operative provision is reproduced below, with non-relevant provisions excluded for clarity:

3 (1) The following supplies of goods or services in the course of dealings on a terminal market to which this order applies are hereby zero-rated, subject to the conditions specified in this Article –

(a) the sale by or to a member of the market of any goods, other than investment gold, ordinarily dealt with on the market,

(b)…

(c) …

(2) The zero-rating of a sale by virtue of paragraph (1)(a) above is subject to the condition that the sale is either –

(a) a sale which, as a result of other dealings on the market, does not lead to a delivery of the goods by the seller to the buyer, or

(b) a sale by and to a member of the market which –

(i) if the market is the London Metal Exchange, is a sale between members entitled to deal in the ring,

(ii)…

(iii)…

(iv)…

(3)…

In the commodity murabaha transaction discussed above, the following sales do not lead to a delivery of the goods by the seller to the buyer:

1. Commodity seller's sale to the bank, because the bank re-sells the copper to the customer.
2. The bank's sale to the customer, since the customer re-sells the copper to the commodity buyer.

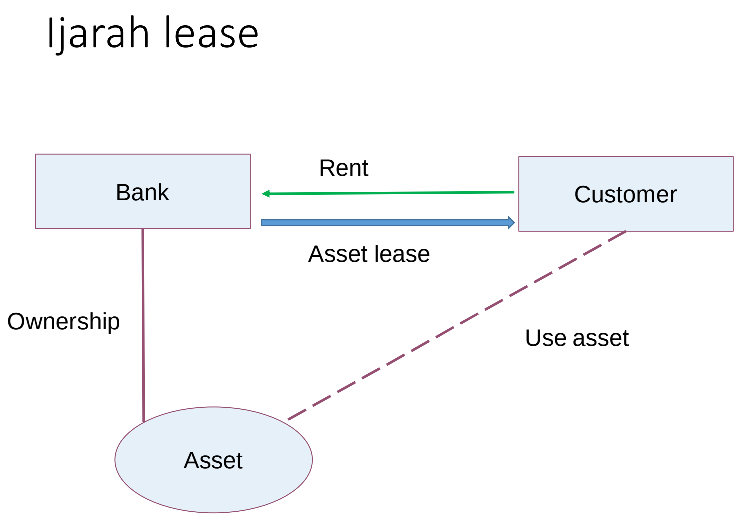
Furthermore, the copper is either located physically outside the UK, or if it is within the UK it will be within the special warehousing regime and never leaves that regime during the transactions. Accordingly UK VAT law allows the commodity murabaha transactions to take place without VAT. The copper sales will be zero rated supplies, apart from the bank's mark-up in the murabaha transaction, which will be treated as the exempt supply of the right to defer payment, i.e. credit, as discussed earlier.

7. Classification of Islamic finance transactions

The review of specific Islamic finance transactions and the country VAT rules suggests that Islamic finance transactions fall into a number of categories, each of which give rise to different issues when considering how they should be treated for VAT purposes.

Transactions which are very similar to the economically equivalent conventional transactions

Some Islamic finance transactions involve almost identical transactions to their conventional counterparts. A simple example is leasing which complies with the rules set by Shariah scholars for ijarah transactions shown in the diagram below.



The structure in the diagram does not look any different from a conventional asset lease. There are of course some differences of detail.

In a conventional full payout finance lease, the Customer is obligated to make lease payments which, in economic terms, cover the full cost of the asset to the bank and the bank's pre-determined financial return (assuming a fixed rate lease), with all of the economic risks in the asset passing to the customer under the terms of the lease.

Shariah scholars do not permit this if the lease contract is to satisfy the Shariah requirements for an ijarah contract. Instead they require the bank to retain more of the ownership risk, even though sometimes some of that retained ownership risk may be passed to the customer by side agreements separate from the ijarah lease contract.

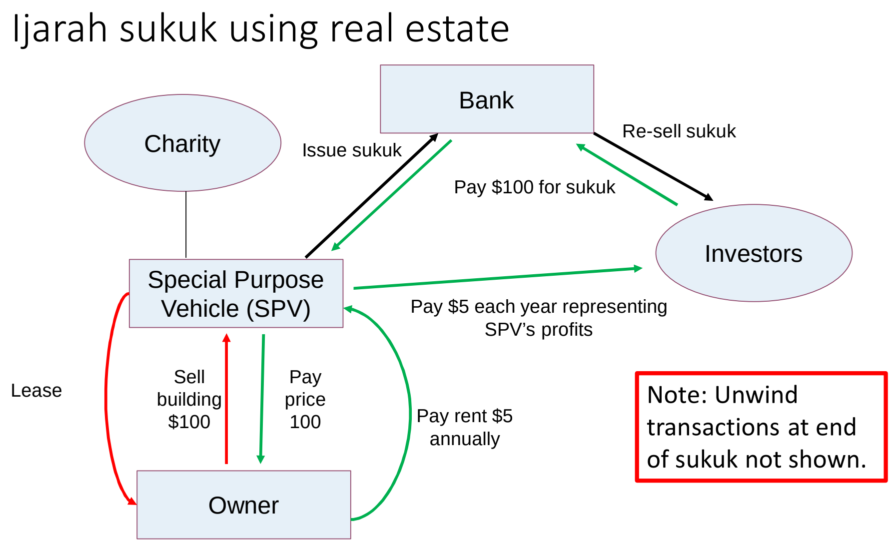
Accordingly an ijarah lease contract should not raise any significant VAT issues that are not raised by a conventional leasing contract.

The same will be true for other Islamic finance transactions which are structurally virtually identical to their conventional counterparts, in terms of the entities involved and their roles in the transaction and the cash flows.

For example, as seen before countries have found it relatively straightforward to set our rules for the VAT treatment of murabaha transactions where the bank purchases an asset and then re-sells it to a customer, with payment being deferred, where the customer will retain the asset for continuing use.

Peripheral transactions which arise in the course of structuring an Islamic finance transaction

This can be illustrated by the sukuk transaction discussed earlier.



In the case of a conventional bond issue, money passes from investors to the borrowing entity. In the conventional bond structure, the borrowing entity is the owner of the building on which the bonds may, or may not be, secured. That entity will then make a stream of fixed payments to the investors.

For a sukuk issue, the investors' money is received by the special purpose vehicle, which will then make a stream of payments to the bond investors.

It is of course necessary for the tax authorities to specify VAT rules governing the issue to the investors of the instruments, and the VAT treatment of the stream of payments made to the investors, to ensure that their VAT treatment is comparable with the issue of the conventional bond and the stream of interest paid on the conventional bond.

However implementing the sukuk structure necessitates carrying out a significant number of transactions which are simply not required for a conventional bond issue.

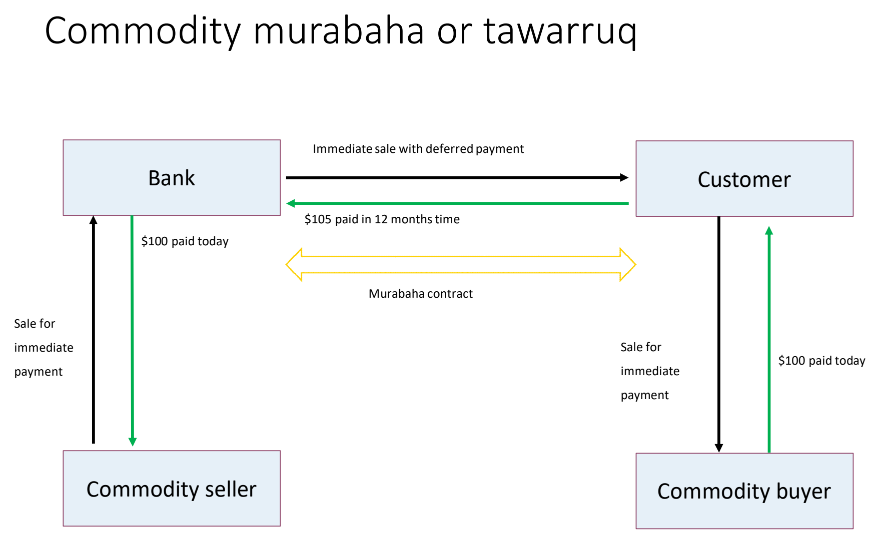
There will be existing VAT law applicable to such transactions, as they are similar to transactions that might be carried out in the course of a conventional real estate sale and leaseback transactions.

Accordingly, it may be the case that existing VAT law is adequate to allow these peripheral transactions to be carried out with adverse VAT costs in the form of VAT charges that cannot be recovered by the party that pays them. (If that occurs, then the sukuk transaction will be suffering taxation that would not arise with a conventional bond issue.)

Conversely, it may be necessary to bring in specific legislation as has been required in the UK for direct tax purposes and for the UK's real estate transfer tax (called stamp duty land tax.)

Transactions used for Islamic finance that are very different from economically equivalent conventional finance transactions

The most obvious example of such a transaction is a commodity murabaha or tawarruq transaction. This achieves the same economic outcome as a fixed term interest bearing loan, but as illustrated earlier the transactions are completely different from those of a loan transaction.



Such transactions can involve multiple supplies of goods or services, which would not exist in the case of the equivalent conventional finance transaction. This situation creates the greatest risk of the Islamic finance transaction giving rise to VAT costs, which would not arise in the case of the equivalent finance transaction.

In the case of the bank, since it will be a registered person for VAT purposes, the risk of VAT disadvantage is small.

1. Where the bank purchases assets, those assets will be used for the purpose of making taxable supplies. Accordingly, VAT paid when such assets are purchased should be recovered by offset against VAT charged when the goods are supplied onwards to the bank's customer.
2. While most of the activities of the bank will be exempt for VAT purposes, limiting its ability to recover VAT on its overhead costs, making more taxable supplies as in sub-paragraph 1 is likely to improve the bank's ability to recover VAT on its overhead costs, rather than reduce it, since overheads are normally apportioned in the ratio of the banks exempt / taxable supplies.

However the position is very different in the case of the customer.

Customer in business and only making taxable supplies

If the customer is engaged in a business which makes taxable supplies, then it will be able to recover VAT on all of the costs which it bears. Accordingly any VAT charged to the customer by the bank during the commodity murabaha transactions will be recoverable. At worst, there will be a small negative cash flow effect, if the customer has to pay the VAT to the bank at a date earlier than the date when it obtains effective relief for the VAT by offset or repayment.

Customer not in business, or conducting a business that makes significant exempt supplies

In this case, the customer will only be able to recover part (if it is making some taxable supplies) or none (if it is only making exempt supplies or is not in business) of any VAT it is charged by the bank. The VAT it cannot recover will be an incremental cost that would not arise in the case of a conventional interest-bearing loan.

We have seen that, in the case of the UK, the rules applicable to terminal markets along with the regime for customs warehouses enables the above potential VAT costs to be avoided.

8. Policy recommendations

This section sets out some recommendations for governments who are legislating for a VAT regime. They are intended to achieve parity of treatment for conventional finance and Islamic finance.

VAT treatment of conventional financial services

Before considering Islamic finance, a decision is required regarding how conventional financial services should be treated for VAT purposes. There are three logical possibilities.

Standard rated?

Financial services could be treated as a supply of services which is taxable at the standard rate applicable to other services. As the financial services industry creates a significant amount of value added, this would be helpful for government tax revenue.

There would be no cost to businesses (apart from businesses carrying on exempt activities or businesses which are too small to register for VAT) as they would be able to recover any VAT charged on the financial services that they consume.

There would however be a significant cost to retail consumers of financial services as VAT would be charged which they could not recover.

Exempt?

Financial services could be treated as exempt, which is the case for most financial services within the EU.

This avoids making financial services more expensive for retail consumers and for businesses which are unable to recover VAT. Conversely the government loses the tax revenue that it would otherwise collect if financial services were standard rated.

A certain amount of complexity arises regarding the VAT affairs of financial services companies since some of their services will be standard rated and some will be exempt, so an appropriate apportionment is required of the VAT that they pay on their costs to determine what proportion is recoverable.

Zero rated?

Financial services could be treated as supplies which are taxable but at a zero rate. The result is that financial services do not become more expensive to retail consumers. However financial services companies are then able to recover all of the VAT on their costs since their supplies will be zero rated supplies rather than exempt supplies.

We have seen in the case of New Zealand and the UK that the government chooses to make certain categories of financial services zero rated which has the effect of reducing the costs of the financial services companies providing those services since they are able to recover more VAT than would be the case if those financial services had been treated as exempt.

How Islamic finance transactions are identified

If VAT rules are to be amended for Islamic finance transactions, taxpayers need to be able to identify such transactions in order to decide whether any special VAT rules for Islamic finance are applicable.

Broadly speaking, there are two distinct approaches for identifying transactions eligible for special VAT treatment as Islamic finance transactions.

By explicit reference to Shariah

Tax law can refer explicitly to Islamic finance or to the transactions being Shariah compliant. The sections earlier covering the VAT law applicable in South Africa and in Singapore show this approach being taken.

- South African VAT law in Value-Added Tax Act, 1991 section 8A. "Sharia compliant financing arrangements" expressly refers to the transactions being Shariah compliant.
- Similarly, Singapore VAT law in the Goods and Services Tax Act expressly refers to "qualifying Islamic financial arrangements."

By economic analysis

As explained on the page "British Government Policy on Islamic Finance" at https://www.mohammedamin.com/Islamic_finance/British_Government_Policy_on_Islamic_finance.html the United Kingdom has carefully avoided any reference to Islamic finance or Shariah in drafting those parts of its direct tax law which seek to equalise the tax treatment of conventional finance and Islamic finance.

Instead, it has proceeded by defining certain transactions in structural and economic terms, and then specifying the applicable tax treatment.

The result is that the direct tax treatment specified is applicable regardless of whether the transactions are carried out by Muslims or non-Muslims, Islamic financial institutions or conventional financial institutions and regardless of whether the transactions are Shariah compliant or not. All that matters is the economic and structural analysis.

The same approach could be followed by other countries which wished to legislate to eliminate any additional tax burdens on Islamic financial transactions, but which wished to avoid express reference to religious matters in their tax law.

In the case of the UK, although for direct tax purposes it needed to legislate and therefore specified various economic tests to identify transactions that should benefit from the special tax regime introduced to facilitate Islamic finance, for indirect tax purposes it did not need to legislate.

Instead the VAT rules applicable to credit sale transactions, alongside the rules for terminal markets and customs warehouses, have by and large proved sufficient to cater for Islamic finance.

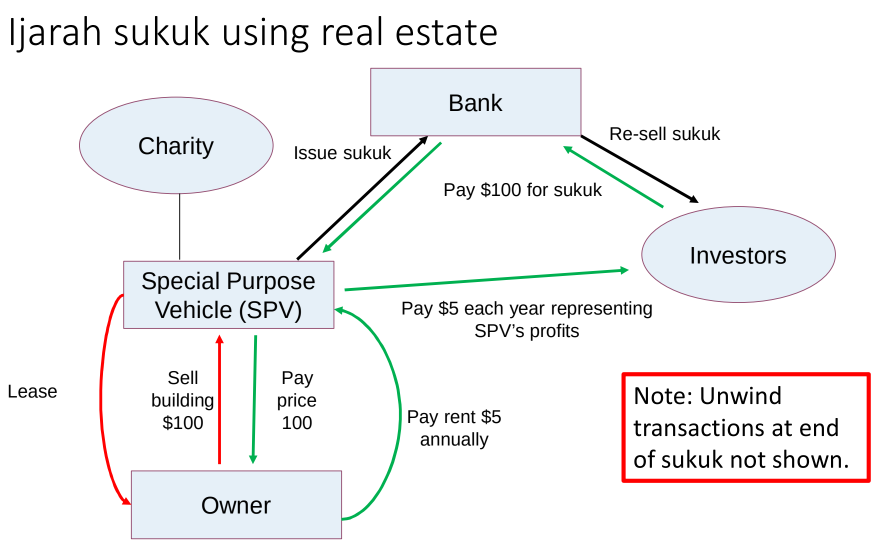
Transactions which are very similar to the economically equivalent conventional transactions

Specific legislation for such Islamic finance transactions is unlikely to be required.

For example, if the VAT rules cater adequately for conventional finance leases, they are likely to cater adequately for Shariah compliant ijarah leases.

Peripheral transactions which arise in the course of structuring an Islamic finance transaction

As seen above with the sukuk transaction, sometimes an Islamic finance transaction will require many associated peripheral transactions.



Legislators need to ensure that the generally applicable VAT regime in their country does not give rise to additional VAT costs on such peripheral transactions which would not arise in the case of a conventional finance transaction which did not need such peripheral transactions.

Transactions used for Islamic finance that are very different from economically equivalent conventional finance transactions

Transactions of this nature are the ones most likely to give rise to additional VAT costs that would not arise on the economically equivalent conventional finance transactions. We have seen this above with commodity murabaha transactions.

Legislators who wish to encourage the use of Islamic finance within their jurisdictions should proceed as follows:

1. Identify which Islamic finance transactions are likely to fall into this category.
2. Analyse the VAT treatment of such transactions under existing VAT law, taking into account all of the different categories of participant such as:
    a. A business which is registered for VAT, all of whose other activities are fully taxable, and which is therefore able to recover all VAT on its costs.
    b. A business which carries on exempt activities either entirely or to a substantial extent and which is therefore unable to recover all of the VAT on its costs.
    c. A retail consumer who is not engaged in business and who is therefore unable to recover VAT on any costs.
3. Consider whether any VAT costs (after taking account of any VAT that is recoverable) arise to the participants in the transaction, taking account of all of the above categories of participants.
4. Assess whether such VAT costs would arise in the economically equivalent conventional finance transaction.
5. If there are additional VAT costs, consider what changes in the law are required to eliminate these while ensuring that such changes will not create opportunities for tax avoidance or tax evasion.

As a simple example, if the existing tax laws of the jurisdiction would cause a retail consumer to suffer VAT when engaging in a commodity murabaha transaction, the law might be changed to designate a particular commodity (for example commodities of a specified type located in specified warehouses) which could be purchased and sold by any participant without the obligation to charge VAT until the commodity is concerned were removed from the specified warehouses.

If the jurisdiction already provides that certain commodities can be bought and sold without a VAT charge (for example many foodstuffs are zero rated in the UK) then such legislative action will not be needed, as banks and their customers will be able to structure commodity murabaha transactions without suffering a VAT cost.