Chartered Institute of Taxation Harrow & North London Branch

Islamic Finance - Tax Implications

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Background text to accompany the presentation

1 Introduction

Taxation systems differ from country to country. However, most countries have systems of corporate and individual taxation that seek to tax profits from trading and investment income, while giving some form of deduction for financing costs in computing taxable income.

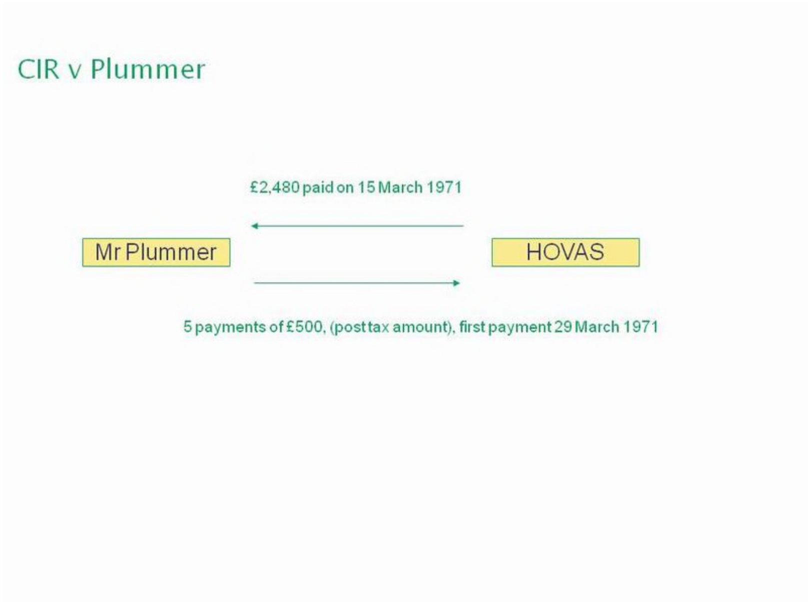
Islamic finance presents a challenge for such tax systems, as they have generally been developed within a framework of conventional financial transactions. Accordingly, this chapter discusses some of the generic challenges that common Islamic finance transactions pose for tax systems.

It then discusses how these challenges are being addressed by the UK. The UK is chosen both because of London's leading position in international finance and because the UK is ahead of all major economies in adapting its tax system to facilitate Islamic finance. Accordingly, its example may be followed by other countries which have similar legal and taxation systems.

2 Types of tax systems

One of the factors that distinguish tax systems from one another is the relative emphasis they each place on "form" and "substance." In this context, "form" is used to describe putting significant emphasis upon the legal form of a transaction, in other words how is the transaction classified from a legal perspective? In contrast, "substance" is used to denote an approach of basing the tax treatment primarily upon the economic reality of a transaction. Tax systems based entirely on "form" or entirely on "substance" do not exist. Instead, there is a spectrum, with countries combining the two elements in varying degrees. Furthermore, different parts of a country's tax system may have distinct positions on the spectrum.

To illustrate the distinction between form and substance, it is helpful to review a UK tax case, Commissioners of Inland Revenue (CIR) V. Plummer, citation 54 Tax Cases 1. While the case was heard several decades ago, and its specific facts have been superseded by subsequent changes in UK tax law, it illustrates the form and substance distinction very clearly.



The facts of the case are relatively simple. On 15 March 1971, a charity called HOVAS paid £2,480 to Mr Plummer. In exchange, he undertook to make five annual payments to HOVAS under a deed of covenant, with the first payment due on 29 March 1971. The amount of each annual payment was whatever sum, after deduction of all taxes, amounted to £500.

The substance of the transaction was that Mr Plummer was borrowing £2,480 from HOVAS and repaying this in five annual instalments of £500; effectively borrowing at a relatively small rate of interest.

Under the legal form adopted, each of the £500 payments was treated as a larger gross payment from which Mr Plummer was entitled to withhold and retain income tax at the standard rate. For example, at the tax rate then prevailing, the first payment was legally a gross payment of £851.06. As a charity, HOVAS was entitled to a refund from the Inland Revenue of the tax withheld of £351.06, making the transaction very attractive to HOVAS; an internal rate of return of 27% was mentioned during the litigation.

Under the tax law then prevailing, Mr Plummer was entitled to offset the gross payment of £851.06 when computing his liability to higher rate tax, but not standard rate tax. The standard rate tax relief was already achieved by him deducting and retaining the £351.06. Accordingly, the transaction was also extremely attractive to Mr Plummer.

The tax authorities litigated and the case went through every level of the UK court system. Mr Plummer was successful before the Special Commissioners, before the High Court in 1977, before the Court of Appeal in 1978 (where the judges decided 3-0 in his favour) and before the House of Lords in 1979 (where the judges decided 3-2 in his favour).

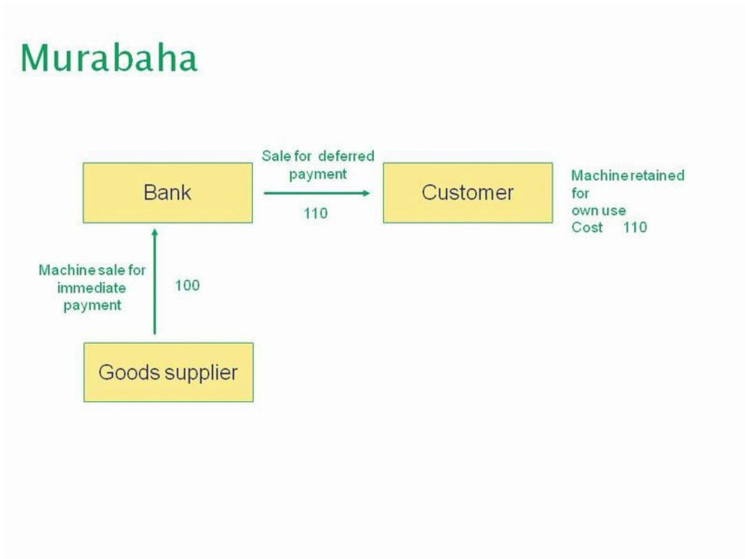
The case is instructive to read as the legal arguments were directed almost entirely to the legal form of the transactions and whether the detailed stipulations of UK tax law had been complied with. The Inland Revenue did not attempt to argue that the transaction should simply be taxed on its economic substance as such an argument would find no support in UK tax law. (The courts might well take a different approach today, given the way case law has subsequently evolved in the UK.)

The author surveyed how a number of Western countries treat certain Islamic finance transactions. It became clear that the closer a country's tax system is towards the substance end of the spectrum (taxing the economic outcome), the less the specific adaptation needed to enable Islamic finance transactions to be conducted with the appropriate outcomes; namely that economic income is taxed and economic finance costs receive tax relief.

Conversely, tax systems based upon form, such as the UK, need specific legislation. The distinction can be seen with some specific Islamic finance structures, as discussed below.

3 Specific Islamic finance structures and their generic taxation challenges

3.1 Murabaha



The above diagram illustrates a straightforward murabaha transaction. The customer wishes to have use of a machine but cannot afford the purchase price. Instead, a bank will buy that machine for, say, £100 and sell it to the customer for a price of £110, payable at some point in the future. The customer obtains immediate use of a machine worth £100, and has an obligation to pay £110 in, say, two years' time. The extra £10 that the customer pays is clearly, in economic terms, the cost of the finance. However, the legal form of the transaction is that the customer is paying £110 to the bank to purchase the machine. From a taxation perspective, there are two alternative ways that the customer could be treated.

(a) The customer has contracted to pay £110 to purchase a machine. That amount, £110, represents its cost and is the depreciable amount for tax purposes if the machine is eligible for tax depreciation. Accordingly, there is no separate recognition of the finance cost built into the transaction price. Instead, tax relief will be given over the life of the machine since the depreciable amount is £110 instead of the cash price of £100. Conversely, if the asset being purchased is not eligible for tax depreciation, then no tax relief will be obtained for the finance cost.

(b) The alternative approach is to decompose the transaction in accordance with the economic reality. As the machine could have been purchased for £100 with payment being made immediately, the uplift in the purchase price of £10 in consideration of a two-year deferral in payment is treated separately as a finance cost. Accordingly, the cost of the machine for tax depreciation purposes is recorded as £100. Meanwhile, the £10 finance cost is amortised over the two-year deferral period obtained in exchange for this cost.

3.1.1 Use of murabaha for real estate acquisition

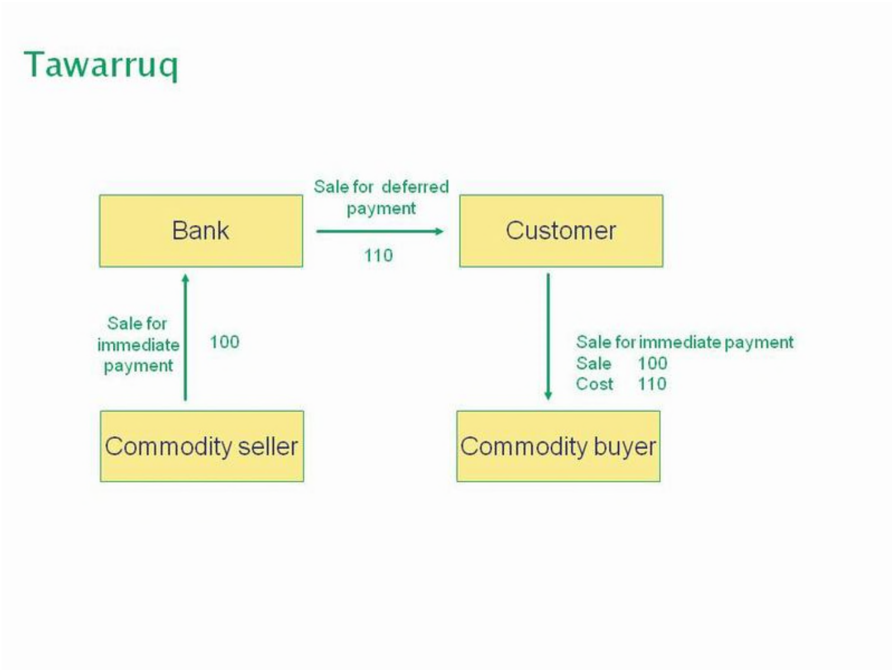
Murabaha transactions were one of the earliest forms used for Islamic property acquisition, as a replacement for conventional mortgages.

Most countries have some form of real estate transfer tax. In the case of a conventional mortgage, real estate transfer tax is paid only once when the customer buys the property from a third party (whether using his own money or a bank mortgage). However, if a murabaha transaction is used there are two separate real estate acquisitions:

- one by the bank from the third-party selling the property and
- a second by the customer purchasing the property from the bank at a higher price.

Accordingly, a murabaha transaction creates the very real possibility of double real estate transfer tax. This was the situation in the UK until specific legislation was enacted to abolish the double charge to facilitate Islamic property acquisitions.

3.2 Tawarruq



In this case, the customer has a desire for cash which the bank wishes to provide without creating an interest-bearing loan.

The bank will buy something that can be sold very easily afterwards, with little difference between the bid/offer (buy/sell) prices. A typical example would be a quantity of copper bought on a commodity market. The bank buys the copper, immediately paying £100 for it, and transfers ownership to the customer at a price of £110 payable in, say, two years' time.

The customer can then immediately sell the copper for a price of about £100. This gives him cash equal to what the bank has laid out, £100, and an obligation to pay the bank £110 in two years' time. The extra £10 is in economic terms the cost of the finance.

The issue to be decided is whether the customer is entitled to a tax deduction. The customer has purchased an amount of copper at a price of £110 payable in two years' time, and sold that copper for £100 with the price being payable immediately. Accordingly, the customer has suffered a loss of £10. Is this loss tax deductible? The answer is not self-evident.

If the tax system of the country concerned decomposes the transaction into its economic substance, then it is clear that the customer has obtained the immediate use of £100 in exchange for the obligation to pay £110 in two years' time. That extra £10 would then be treated as a finance cost and tax deductible if an equivalent payment of interest would have been tax deductible. (Many countries have limitations on the circumstances in which interest expenses are tax deductible, which are beyond the scope of this chapter. Instead, the goal is to examine whether a cost of Islamic finance obtains equivalent tax treatment to conventional finance used in the same circumstances.)

However, the tax systems of some countries will not decompose the transaction as analysed above. The legal form is that the customer has purchased an amount of copper at a price of £110 and then sold that copper, for immediate payment, at a price of £100. Accordingly, its loss has arisen on the purchase and resale of copper.

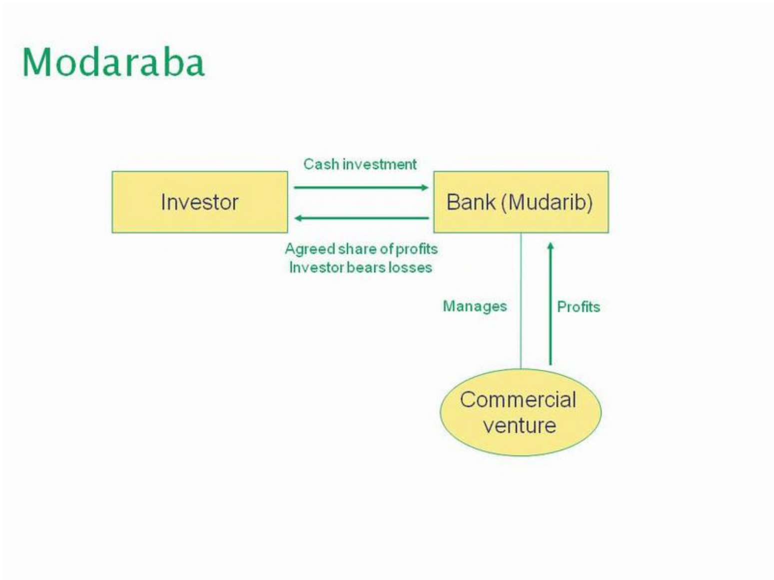
Such a loss on the purchase and resale of a commodity may not be tax deductible. In the UK, for example, unless the customer can show that it is trading (as understood by tax law) in copper, it will not be entitled to deduct the £10 loss against its other income. Furthermore, even if the customer regularly trades in copper, this transaction does not look like a legitimate trading transaction since the customer knew that it would suffer a £10 loss when it commenced the transaction. (Trading is normally done with a view to profit.) Accordingly, under UK tax law (before the recent changes to facilitate Islamic finance), the customer would not be expected to obtain tax relief for its £10 cost.

For both murabaha and tawarruq one also needs to consider transaction costs such as transfer taxes. However detailed analysis is beyond the scope of this chapter.

3.3 Mudaraba deposit account

Islamic banks typically offer two distinct forms of accounts: current accounts, which are repayable in full but which give the investor no economic return, and savings accounts, which at least conceptually are exposed to the risk of loss but where the customer participates in the profits made by the bank from the use of the customer's money.

One such form of savings account is a mudaraba deposit. This is illustrated in the following diagram.



In a mudaraba transaction, the investor (the depositor in the bank) provides cash to the bank (acting as mudarib) to invest that money in a commercial venture, with the bank as mudarib managing that commercial venture. Typically, in the case of a bank the commercial venture will consist of the full range of its operating assets, both loans (transacted in Islamic form) to customers and financial assets held in the bank's treasury operations to ensure that the bank has sufficiently liquidity to repay its current account and savings accounts customers when required.

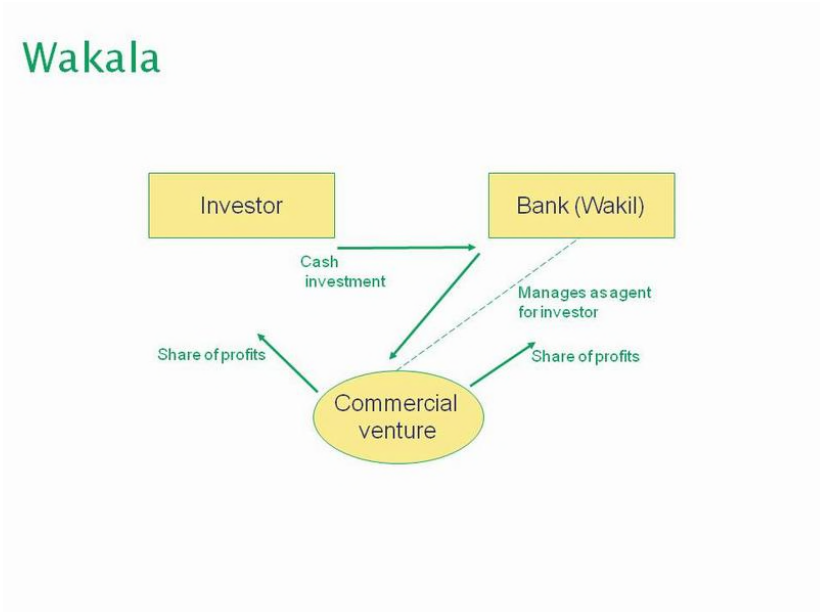
If there are profits from the bank's operations, those profits are shared between the bank and the customer on an agreed basis. Typically, the customer obtains a return similar to market interest rates while the bank keeps any excess return as a reward for organising the transactions.

Most tax systems would be expected to tax the investor on the profits paid to it. Similarly, one would expect the bank to be taxed on all the profits that it makes from its operations while receiving a deduction for the profit sharing payments that it makes to its customers.

However, many countries such as the UK have very detailed tax laws. For example, the UK has always been concerned that parties providing finance may disguise what is in substance equity finance as debt to obtain the benefit of a tax deduction for interest. Accordingly, one of the many specific provisions regarding interest in the UK tax code is section 209(2)(e)(iii) of the Income and Corporation Taxes Act (ICTA) 1988. This applies to interest paid on "securities under which the consideration given… is… dependent on the results of the company's business." The effect is that the interest paid is treated as a distribution, in other words as a company dividend which means that it is not tax deductible. In the absence of specific legislation, this provision would most likely apply to the profit-sharing payments which the bank makes to its customer under the mudaraba contract.

3.4 Wakala in a banking context

Another form of contract which can be used for an investor to provide money to a bank to earn an economic return is a wakala contract.



In wakala, as with mudaraba, cash is going from the customer as an investor and is used to finance a commercial venture with the profits of the commercial venture being shared between the investor and the bank (the wakil) in agreed proportions.

In this context, the key difference between wakala and mudaraba is the legal relationship. In the mudaraba contract referred to above, the bank borrows the cash investment from the customer and becomes legally indebted to the customer so that the legal form of the contract is that of a deposit. Conversely in wakala it is assumed that the bank (the wakil) is legally acting as an agent for the customer, so the money never becomes the bank's property.

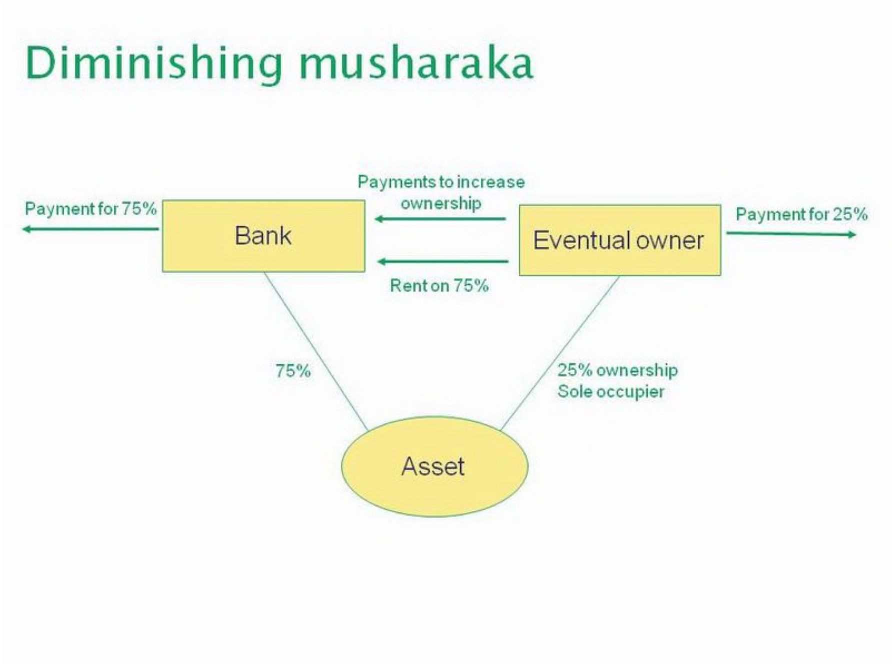
That distinction will matter in the event of the bank's insolvency. In a mudaraba contract, if a bank has taken what is a deposit at law and then becomes insolvent, the investor is limited to claiming in the bank's insolvency along with its other creditors. With a wakala contract, if the agent bank becomes insolvent the investor should have a direct legal claim on the underlying commercial venture.

While this chapter draws the above clear distinction between a mudaraba contract and a wakala contract, the distinction may not be so clear in practice. For example, the bank's standard wakala contract may permit the bank to commingle the customer's funds with those of other customers, making it impossible for a customer to trace his funds in the event of the bank's insolvency. If so, the customer will not have any stronger protection from the bank's insolvency in the case of a wakala contract than with a mudaraba contract.

The role of the bank in acting as agent for the customer may have significant consequences in international transactions. The approach of many countries is not to tax foreign persons unless they have a taxable presence within the country in the form of a "permanent establishment." However, the bank acting as agent for the customer in providing funds to the underlying commercial venture may be sufficient to cause the customer to have a permanent establishment within that country since the bank as agent is taking commercial decisions on the customer's behalf. The consequence may be to make the customer taxable on the profit paid to it whereas interest paid on a conventional bank deposit to a foreign person may not have been taxed by that country, either due to the country's domestic tax law or because many double taxation treaties give exclusive taxing rights on interest to the country where the customer is resident rather than to the country of source. Accordingly, replacing a conventional deposit with a wakala contract gives a risk of creating a taxable presence in the country where the bank is located.

3.5 Diminishing musharaka

This is often used for people buying houses for owner occupation instead of a conventional mortgage, but can also be used for the purchase of investment property. It is illustrated in the following diagram.



Diminishing musharaka is used when one party, here called the eventual owner, wants to buy an asset but cannot afford to pay for all of it. In the diagram, on day one the bank buys 75% of the asset, for example a building, while the eventual owner buys 25%. Under the contract between the eventual owner and the bank, the eventual owner has immediate rights to sole occupation.

The eventual owner pays rent to the bank on the 75% of the property that it doesn't own. Then, over the life of the arrangement, as well as paying the rent, the eventual owner will make additional payments to the bank to purchase additional slices of the asset.

The price for the additional slices of the asset will be set out in the diminishing musharaka agreement. While any price formula can be used, in practice two arrangements are most common:

(a) The price is equal to the original cost to the bank. In this situation, the bank does not benefit from increases in the value of the property; its economic return derives entirely from the rent that it receives.

(b) The price of each slice is equal to the market value of that fraction of the property on the date when the eventual owner purchases that slice. In this case, the bank is also benefiting from any growth in value of the property.

At first sight, one would expect the eventual owner to receive tax relief for the rent that it is paying to the bank. This rent is being paid to enable the eventual owner to occupy the whole of the building even though it only owns 25% initially.

However, upon a closer analysis, tax relief for the whole rent is not entirely certain. This is because the eventual owner also has the right to purchase the bank's share of the property over an extended time period.

If the purchase of additional slices will be at market value, then the rent that the eventual owner is paying does no more than entitle it to occupy the property. The level of the rent is likely to be the same as the rent that is paid in conventional property rental transactions where there is no intention for the tenant to purchase the property. Accordingly, in this scenario the entire rent should be tax deductible.

The analysis is different if the eventual owner is entitled to purchase of the bank's share of the property at a price equal to the original price paid by the bank. In this situation, the rent paid by the eventual owner achieves two things:

(i) entitlement to occupy the property, and

(ii) preservation of the entitlement to purchase the property at the bank's original cost

This preservation of the entitlement to purchase at original cost has the nature of the payment for an option to the purchase of the building, rather than being a payment for the right to occupy the building. This can be demonstrated by considering the amount of the rent: one would expect this to be higher than the level that would be paid by a conventional tenant merely for the occupation of the property, as the eventual owner has greater rights than would a conventional tenant. Logically this additional element of the rent should be denied tax relief as being linked with the entitlement to purchase the property at the bank's original cost.

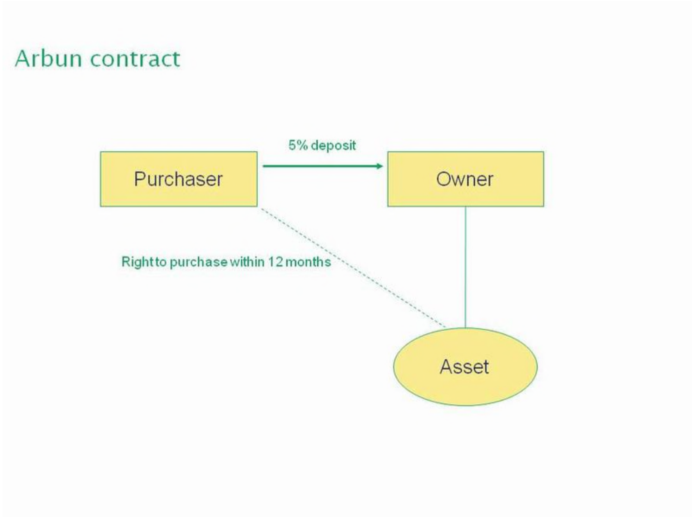
3.5.1 Securitisation of diminishing musharaka contracts

Banks which lend money on conventional mortgages often manage their balance sheets by securitising the mortgages. The normal approach is for the bank to sell the mortgages to a special purpose vehicle which finances the acquisition by issuing bonds to investors. Such securitisation transactions with conventional mortgages typically involve little or no transaction taxes.

However, consider the position of a bank which has entered into a number of diminishing musharaka transactions. If it wishes to transfer these transactions to a special purpose vehicle, it will most probably be involved in real estate transfers as the bank's participation in a diminishing musharaka contract involves the bank owning the property. Accordingly, securitisation potentially involves a further charge to real estate transfer tax.

3.6 Arbun

An arbun contract has the effect of replicating a call option.



In this example, the purchaser enters into a contract with the owner for the purchase of the asset, with the transaction to be completed at any time within the next 12 months at the election of the purchaser. A deposit is paid, in this example 5%, but the purchaser also has the right to withdraw from the purchase transaction albeit then forfeiting the deposit.

In economic terms, the transaction is no different from a call option with the deposit being equivalent to the option premium. However, it raises the question of how the owner is treated for tax purposes when entering into the contract for the sale of the property. At its simplest, does the transaction fall to be taxed when the original contract is entered into or at some later stage when it becomes clear that the purchaser will not exercise its right to revoke the transaction?

3.7 Sukuk

The goal when structuring a sukuk is to replicate the characteristics of bonds without infringing the rules of Shariah. The most important requirement is that there must be no interest, which in turn means that there can be no legal debt involved.

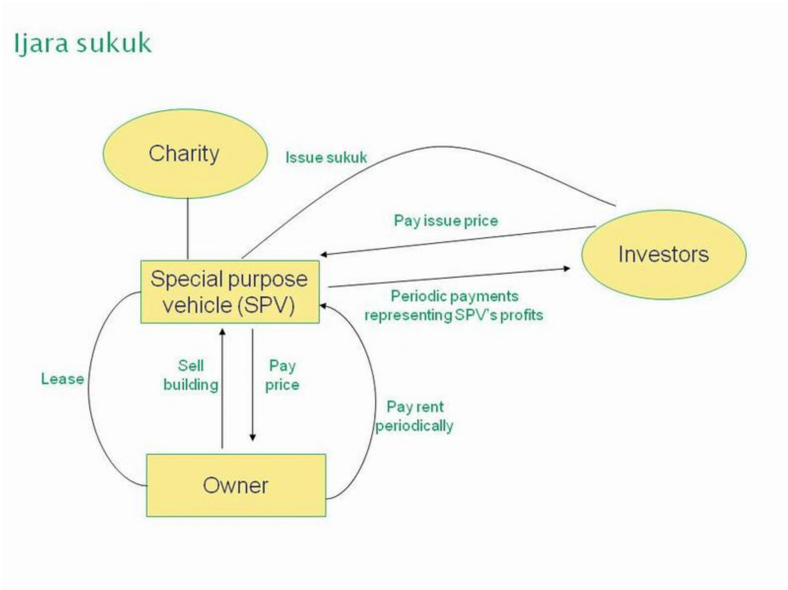
The goal is to design an instrument which:

- can be bought and sold between different holders,
- provides finance for a fixed period, typically three to five years although longer periods of time are used, and
- from the perspective of investors, provides a flow of regular payments which has priority over the payment of rewards to ordinary shareholders, without involving interest.

The way these goals are achieved is most easily considered by looking at a couple of examples.

3.7.1 Ijara sukuk

The diagram below illustrates how an ijara sukuk transaction would normally be arranged.



The owner of a building wishes to use that building to raise finance. Accordingly, the owning company arranges for the creation of another company, typically a special purpose vehicle (SPV). This is a company which is not part of the owner company's group; the shares of the SPV are normally held by a charity. The SPV raises the cash needed to purchase the building by issuing sukuk to the investors.

Legally, the sukuk are certificates which entitle the investors to a fractional share of the income that the SPV will receive from renting the building back to the owner. The SPV will normally declare itself as a trustee of the building on behalf of the sukuk investors, so that they have a beneficial entitlement to a proportionate share of the building and of the rent receivable from leasing it.

During the life of the sukuk, the owner will pay rent to the SPV which in turn will pay that money on to the investors. In economic terms, the investors have a prior claim on the profits generated by the owner from its business because part of those profits must be used to pay rent on the building to the SPV prior to any distribution of profits to the equity shareholders. However, this is achieved without creating a debt since leasing a building does not involve a debt claim.

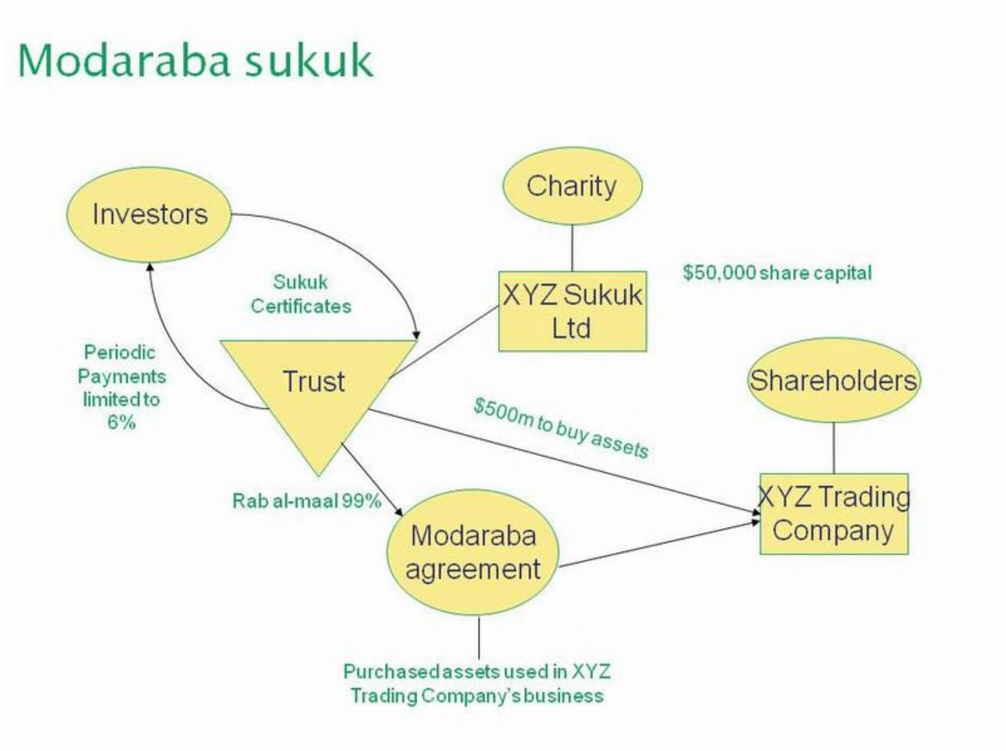
At the end of the sukuk period, the owner will purchase the building back from the SPV and this provides the SPV with cash to repay the sukuk investors.

This transaction raises several potential taxation questions. Firstly, there are three land transactions, namely the original sale of the building to the SPV, the lease of the building by the SPV back to the original owner and finally the re-acquisition of the building by the owner. Each of these is potentially subject to real estate transfer tax or similar taxes on the leasing of land. Furthermore, the building may have appreciated in value between the original purchase by the owner and its sale to the SPV. Accordingly, the sale transaction may trigger a taxable capital gain.

When one considers the SPV, it is receiving rental income on the building which would normally be taxable. It then passes on that rental income to the sukuk holders who are therefore suffering taxation prior to receiving their cash. Conversely, if they had invested in conventional interest-bearing bonds, such bonds normally pay their interest gross without withholding tax.

3.7.2 Mudaraba sukuk

The diagram below shows how a particular mudaraba sukuk was structured.



The sponsor was a company which had a collection of assets that were being used in its business. It wished to raise an additional $500m of finance. To achieve this, it set up the SPV, XYZ Sukuk Ltd, with share capital of $50,000. The SPV issued sukuk certificates to the investors for $500m and used the cash generated to purchase that amount of assets from XYZ Trading Company.

These assets were not rented back to the trading company, but instead used by the trust established by XYZ Sukuk Ltd to contribute, as “Rab al maal” (capital provider), to a mudaraba agreement under which XYZ Trading Company would use the assets in its business, acting as mudarib. Nearly all (99%) of the profits generated from the use of these assets were to be paid to the trust, but subject to an overall limit of 6% of the investment (i.e. $30 million per year) which matched the maximum amount that would be payable on the sukuk certificates each year.

Through the medium of the sukuk and the mudaraba agreement the investors have a prior claim to the profits being generated from the business, with that prior claim being limited to a maximum return of 6%. If the business generates no profits then nothing will be paid to the investors since there is no debt claim.

At the expiry of the sukuk period, XYZ Trading Company will repurchase the assets for $500m, allowing XYZ Sukuk Ltd to repay the sukuk certificates.

The above examples show how it is possible to replicate most of the economics of a debt instrument without infringing Shariah. In the ijara sukuk, the owner must pay the rent on the building in each period. Failure to pay the rent would result in eviction from the building, with the SPV then selling the building to a third party, and probably also suing the owner for non-payment of rent which could drive the owner into insolvency.

In the mudaraba sukuk, the investors are taking a greater commercial risk. If the business activities conducted with the mudaraba assets are unprofitable, there will be insufficient profit available to pay the investors their profit entitlement. Other things being equal, one would expect the maximum profit rate payable under the mudaraba sukuk to exceed the rate of rent payable on the ijara sukuk, since the investors in the mudaraba sukuk are in principle taking a greater degree of risk.

The mudaraba sukuk structure outlined above raises several issues from a tax perspective.

(i) Potential treatment as partnership

Firstly, the mudaraba agreement looks very much like a partnership when analysed from a western tax and legal perspective. It is a basic principle of partnership taxation that distributions paid to a partner in respect of his profit entitlement are not tax deductible expenses. Accordingly, the 99% profit distribution to the Trust under the mudaraba agreement looks as if it should be non tax deductible to the mudaraba (partnership).

From XYZ Trading Company's perspective, this may be less significant. If it had borrowed conventional debt, it would have been taxable on all of the profit from the business use of its assets, while obtaining a tax deduction for interest paid. Instead, with sukuk, part of the profit arising from using the assets would be taxable to the Trust (in its capacity of a participant in the mudaraba partnership) and to that extent it would not be taxable to XYZ Trading Company.

However, when one considers the tax position of the Trust, one sees potential difficulties. The Trust would be taxable on its share of the income of the mudaraba (partnership) as many countries will charge tax on partnership trading activities carried on within their territory, especially if the managing partner (here XYZ Trading Company) is resident within that country. This tax reduces the cash available to pay to the sukuk holders. After those sukuk holders receive their sukuk income payments, they may or may not be able to obtain a refund of the tax paid by the Trust or possible credit for that tax against taxes payable in their home jurisdiction.

The position is significantly unfavourable compared with the issue of a eurobond by XYZ Trading Company, where there would be straightforward tax relief to the borrowing company for the interest paid and no withholding tax on payments of interest to the eurobond investors.

(ii) Transaction taxes

As with the ijara sukuk, there is scope for transaction taxes when XYZ Trading Company (the sponsor) first sells the assets to XYZ Sukuk Ltd (acting as a trustee) and again when the sukuk expires as there will be a sale back of the assets to the sponsoring company.

4 A review of the UK tax legislation governing Islamic finance

As mentioned above, the UK is a pioneer among major western economies in adapting its tax law to facilitate Islamic finance. The government has had two strategic goals for making these changes.

- Financial inclusion – to enable Muslims who object to the payment or receipt of interest to access Islamic personal financial services such as mortgages and savings accounts.
- UK competitiveness – the City of London is very important to the UK economy. As Islamic finance grows internationally, the goal is to have the UK benefit from cross border transactions being channelled through London, in the same way as the UK dominates the eurobond market.

4.1 The overall UK approach to legislating for Islamic finance

The approach taken by the UK to set up a tax regime for Islamic finance is to enact specific legislation which sets out a definite tax treatment for certain specific types of Islamic finance, with economic returns equivalent to interest being treated in the same way as interest for all tax purposes. The new legislation is applicable to all financing arrangements which fall into its definitions, regardless of whether they are compliant with Shariah or not.

The legislation which began with Finance Act 2005 does not mention the Shariah or use any Islamic finance terms. Instead the legislation creates a freestanding set of definitions for use in UK tax law which are entirely neutral regarding religion. For transactions which fall within these definitions, the legislation specifies how to determine the finance cost and how that finance cost is treated by both the payer and the recipient. Broadly speaking, the finance cost is brought within the same tax rules as those that apply to interest.

The legislation does not change the nature of the financial arrangements, nor does it in any way impute interest, or deem interest to arise where there is none. It simply sets out a code for the tax treatment of transactions that fall within its definitions.

4.2 Tax law rewrite project

Following the rewrite of tax law, the rewritten legislation for Islamic finance is in CTA 2009 for corporation tax purposes, and in ITA 2007 for income tax purposes.

To make it easier to follow the development of the law, these notes primarily cite the original statutes, with footnotes for the rewritten corporation tax rules. The income tax rules are only mentioned when they are specifically relevant, as in most cases the wording of the law is the same for both corporation tax and income tax.

4.2.1 Alternative finance return

This refers to the returns earned / suffered by a provider / recipient of finance under alternative finance arrangements.

The law does not refer to Islamic finance or to Shariah at any point, instead defining the transactions in language which has no religious connotations:

Tax law	Islamic finance
Purchase and resale	Murabaha
Deposit	Mudaraba
Profit share agency	Wakala
Diminishing shared ownership	Diminishing musharaka
Investment bond (née alternative finance investment bond)	Sukuk

4.3 Definition of a financial institution

The legislation begins in CTA 2009 s 502 with some introductory definitions, including that of a “financial institution” for the purposes of the legislation.

Subsection (1) states that “Financial institution” means—

(a) a bank, as defined by section 840A of ICTA[1],

(b) a building society within the meaning of the Building Societies Act 1986,

(c) a wholly-owned subsidiary of a bank within paragraph (a) or a building society within paragraph (b),

(d) a person authorised by a licence under Part 3 of the Consumer Credit Act 1974 to carry on a consumer credit business or consumer hire business within the meaning of that Act,

(e) a bond-issuer, within the meaning of section 507, but only in relation to any bond assets which are rights under purchase and resale arrangements or diminishing shared ownership arrangements, or

(f) a person authorised in a jurisdiction outside the United Kingdom—

(i) to receive deposits or other repayable funds from the public, and

(ii) to grant credits for its own account.

(2) For the purposes of subsection (1)(c) a company is a wholly-owned subsidiary of a bank or building society (“the parent”) if it has no members except—

(a) the parent or persons acting on behalf of the parent, and

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[1] Now CTA 2010 s 1120

(b) the parent's wholly-owned subsidiaries or persons acting on behalf of the parent's wholly-owned subsidiaries.

The ICTA 1988 s 840A definition of a bank is limited to UK and European Economic Area (EEA) regulated institutions. Accordingly (f) is needed to extend the definition of financial institution to non-UK authorised deposit takers. However, an equity capitalised company set up to provide Islamic finance but not licensed to take deposits would fail to meet the definition of a financial institution, and this may be a challenge for some non-UK Islamic financiers.

The requirement for bank or building society subsidiaries to be wholly-owned makes it relatively straightforward for bank groups to avoid these rules when desired, by having at least one share of the subsidiary owned by a person outside the group. The above reference to persons "acting on behalf of the parent" risks imprecision. For example, the question arises as to whether it would apply to the trustees of an employee benefit trust set up for the bank's employees.

4.4 Contracts giving rise to alternative finance return

The legislation applies to several types of contract that give rise to alternative finance return.

4.4.1 Purchase and re-sale

A finance arrangement can, as an alternative to payment of interest, be structured as a purchase of an asset and its onward sale at a higher deferred price. (This is discussed above under murabaha.) The provisions define the circumstances in which such a structure is to be taxed in the same way as if the return were a payment of interest. The difference between purchase price and sale price is treated as a "finance return".

The following four conditions must be present for an arrangement involving a purchase and sale of an asset to fall within the provisions described here:

(*a*) a person (X) purchases an asset and sells it, either immediately or in circumstances in which the conditions described below are met, to the other person (Y);

(*b*) the amount payable by Y in respect of the sale is more than the amount paid by X in respect of the purchase;

(*c*) all or part of the sale price is deferred beyond the date of the sale; and

(*d*) the difference between the sale and purchase prices equates, in substance, to the return on an investment of money at interest.

The conditions referred to in (*a*) extend its scope where a financial institution holds a stock of assets for the purposes of a sale under an alternative finance arrangement.

Arrangements are excluded where neither party is a financial institution.

For the purposes of these rules, "the effective return" is the excess of the sale price over the purchase price of the asset. References to "alternative finance return" are to be read in accordance with the following rules:

(*a*) Where the sale price is paid on one day in full, the sale price is to be taken to include alternative finance return equal to the effective return.

(*b*) Where the sale price is paid by instalments, each instalment is to be taken to include alternative finance return equal to the "appropriate amount".

The "appropriate amount", in relation to any instalment, is an amount equal to the interest that would have been included in the instalment if:

(*a*) the effective return was the total interest payable on a loan by X to Y of an amount equal to the purchase price;

(*b*) the instalment were part repayment of the principal with interest; and (*c*) the loan were made on arm's length terms and accounted for under generally accepted accounting practice.

To clarify the main requirements, if Y is a financial institution, then X can be any person provided X sells the asset to Y as soon as X has purchased it; in the case of a non-immediate sale, irrespective of the status of Y, X must be a financial institution and must have bought the asset "for the purpose of entering into arrangements falling within" these provisions. The latter requirement could be problematic. For example, a car dealer wholly-owned by a bank has a stock of cars which it normally sells on hire purchase. If it purports to make a sale within these rules, it will fail to qualify as the stock was bought for other purposes. Instead, the car dealer could sell to another group company which then makes the alternative finance arrangements sale.

The requirement to apportion the effective return in accordance with generally accepted accounting practice (see above) should mean that a straight-line apportionment is unacceptable. However, this is not the case. HM Revenue & Customs (HMRC) in their published manual indicates that a straight-line apportionment would be accepted by HMRC, and there is no reason for a taxpayer to object to such acceptance. A strict actuarial apportionment is clearly acceptable and in most cases also an apportionment using the "rule of 78".

4.4.2 Diminishing shared ownership

As discussed above, this is often used as a Shariah compliant alternative to a mortgage. It requires arrangements under which both a financial institution and another person (called the eventual owner) acquire a beneficial interest in an asset. There are then a number of prescriptive requirements.

1. The eventual owner must have the exclusive right to occupy or use the asset, but the legislation permits the eventual owner to grant an interest in the asset to other persons, excluding, however, the financial institution or its related parties as defined.
2. The eventual owner must be required to make payments to the financial institution which will amount in aggregate to the price paid by the financial institution for its share of the asset, and must acquire the financial institution's beneficial interest as a result of those payments. Accordingly, the arrangements will not qualify if the eventual owner has an option whether or not to make the payments to acquire the financial institution's beneficial interest.
3. The eventual owner must be exclusively entitled to any income or growth in value from the asset. There is, however, some flexibility allowed regarding the contractual arrangements:

    (1) The acquisition by the financial institution can be from a third party or from the eventual owner. This mirrors the scope for conventional mortgages to be used to either acquire property or to refinance property already owned.

    (2) In addition, third parties are permitted to have a beneficial interest in the asset.

    (3) It does not matter who has the legal interest in the asset.

    (4) The financial institution is permitted (but not required) to share in any loss from the asset falling in value. As there is an express requirement for the eventual owner to make payments to the financial institution aggregating to the financial institution's purchase price, it would appear that if the financial institution is to share any loss, the contract will have to make separate provision for this - for example, by requiring the financial institution to make an appropriately calculated payment to the eventual owner.

If the contract meets the statutory requirements, then payments by the eventual owner to the financial institution comprise alternative finance return, unless they are the payments for the acquisition by the eventual owner of the financial institution's interest or payments for an arrangement fee, legal costs, or other expenses. For the avoidance of doubt, arrangements which qualify as diminishing shared ownership are expressly excluded from being a partnership for tax purposes.

4.4.3 Alternative finance investment bond (now called investment bond)

Finance Bill 2007 contained eagerly anticipated provisions[2] that enable UK companies to issue sukuk and clarify the tax treatment of UK resident investors buying and selling sukuk. The rules follow the consistent UK approach of precisely defining transactions in the tax statute and then applying the tax law, irrespective of whether the transactions are intended to be Shariah compliant or not.

4.4.3.1 Definition

There is a definition of arrangements which give rise to an alternative finance investment bond. They require:

a) One person (the bond holder) to pay a sum of money (the capital) to another (the bond issuer).

b) Identification of assets (the bond assets) which the bond issuer will acquire to generate income or gains.

c) A specified period when the arrangements will end (the bond term).

d) The bond issuer undertakes:

- To dispose of any remaining bond assets at the end of the bond term.
- To make repayments of capital during or at the end of the bond term.
- To make other payments to the bond holder (additional payments).

e) The additional payments must not exceed what would be a reasonable commercial return on a loan equivalent to the capital.

f) The bond issuer undertakes to manage the bond assets.

g) The bond holder is able to transfer his rights to other persons who thereby become bondholders.

h) The arrangements are listed on a recognised stock exchange as defined in the Income Tax Act 2007 s.1005. (This mirrors the requirement for eurobonds to be listed if interest is to be paid gross without withholding tax.)

i) The arrangement would be treated as a financial liability of the bond issuer if accounted for under International Accounting Standards.

Having set out a prescriptive set of definitional requirements, the Finance Bill then contains a number of relaxations:

- The issuer can acquire the bond assets before or after the arrangements take effect.
- Bond assets may be property of any kind, including rights in relation to property owned by another person.
- A declaration of trust may be used but is not mandatory.

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[2] Now in CTA 2009 s 507.

- Bond holders are allowed to have early termination rights.
- The additional payments can be fixed or variable. However, if they are not fixed, then the test at (e) is made by reference to the maximum amount of the additional payments. This may cause difficulty if the maximum amount cannot be determined.
- The redemption payment may be reducible if there is a decline in the value of the bond assets or their income.
- It is permitted to satisfy the redemption payment by the issue or transfer of shares or securities.

It is possible to designate a stock exchange for the purposes of the alternative finance investment bond rules, without having to designate it for other purposes. (This power may be used in future to designate certain foreign exchanges where existing sukuk are listed without the UK having to recognise those exchanges for all other tax purposes.)

4.4.4 Deposit

Under general tax rules (as discussed above), a payment of part of the profit to the investor would be treated as a distribution. The provisions define the circumstances in which such a structure will be taxed in the same way as if it involved payment of interest. Essentially, the arrangements will involve the sharing of profits between a customer and a financial institution in a form that represents a return on the customer's deposit.

Subject to the rules covered below concerning provisions that are not at arm's length, the following four conditions must be present for an arrangement involving a profit share payment to fall within the provisions described here:

(*a*) a person (the depositor) deposits money with a financial institution;

(*b*) the money, together with other money deposited with the institution by other persons, is used by the institution with a view to producing a profit;

(*c*) from time to time the institution makes or credits a payment to the depositor, in proportion to the amount deposited by him, out of any profit resulting from the use of the money; and

(*d*) the payments made or credited by the institution equate, in substance, to the return on an investment of money at interest.

The requirement in (*d*) could theoretically cause difficulty if the institution is very successful at producing profits and pays these to the depositors. For example, if the deposits taken were used to finance share dealing with profits of zero in some years and say 25 per cent in others, the question arises as to whether the bank's payments would satisfy the condition. Assuming they do not, question then arises as to how one identifies the boundary. The problem may not arise in practice, as bank regulators are unlikely to authorise deposit contracts which expose the depositors to a meaningful risk of sharing trading losses, although that would be normal in a mudaraba contract. The need to eliminate the risk of loss to depositors may significantly reduce the profits available for payment to them.

4.4.5 Profit share agency

In the case of a profit share agency, the financial institution acts as agent of the principal (the investor) and uses the money provided by the agent with a view to producing a profit. Whereas in most principal/agent relationships the principal is entitled to most of the rewards (and risks), in the case of a profit share agency the principal is entitled to the profits to a specified extent while the agent is entitled to any additional profits (and may also be entitled to a fee). The provisions require the payments to the principal under his profit entitlement to equate, in substance, to the return on an investment of the money at interest.

If the above conditions are met, the amounts paid to the principal are alternative finance return, while the principal is not taxable on the profits to which the agent is entitled.

4.4.5.1 Detailed drafting of profit share agency rules

The provisions regarding profit share agency originally inserted into FA 2005 by FA 2006 were, however, silent on the attribution for tax purposes of the profits of the underlying commercial venture undertaken by the agent with the money provided by the principal.

The profit share return paid to the principal by the agent financial institution was treated as if it were interest paid by the agent under a loan relationship. Accordingly, to reach the expected taxation answer, the agent needed to be taxable on the whole of the profit earned from the commercial venture. However, there seemed to be a lacuna, in that the legislation apparently omits specifying that the financial institution shall be taxable on the whole of the underlying commercial profit which it produces in its capacity of agent. Instead, the agent financial institution seemed to be left with a deduction for its payments to the principal, but with no amounts on which it was taxable. The draftsman may have assumed that the financial institution is taxable upon the whole of the underlying commercial profits from the venture on general principles, but such an assumption appeared to ignore the fact that the financial institution is acting only as agent for its principal.

HMRC had never accepted that the FA 2006 profit share agency legislation contained the above defect. However, to put the matter beyond any doubt, an amending provision was contained within Finance Act 2007 to ensure that the profits of the underlying commercial venture were taxable upon the agent before giving a deduction for the amount paid to the principal.

4.5 Overall treatment of alternative finance arrangements

The following general provisions apply.

4.5.1 Companies - use of loan relationships rules

Where a company is a party to an arrangement within the purchase and resale and diminishing shared ownership provisions described above, the loan relationships regime set out in FA 1996[3] has effect in relation to the arrangements as if:

(*a*) the arrangements were a loan relationship to which the company is a party;

(*b*) the amount of the purchase price of the asset were the amount of a loan made to the company by, or by the company to, the other party to the arrangements; and

(*c*) alternative finance return payable to or by the company under the arrangements was interest payable under that loan relationship.

Where a company is a party to a deposit arrangement within the provisions described above, the loan relationships regime has effect in relation to the arrangements as if:

(*a*) the arrangements were a loan relationship to which the company is a party;

(*b*) any amount deposited under the arrangements was the amount of a loan made by the depositor to the financial institution; and

(*c*) the profit share return payable to or by the company under the arrangements was interest payable under that loan relationship.

Similarly, in the case of a profit share agency the loan relationships regime regards the company as a party to a loan lent (if the company is the principal) or a loan borrowed (if the company is the agent).

[3] Now CTA 2009 Part 5.

The effect of applying the loan relationships provisions is to bring in all the detailed rules set out in FA 1996 which govern the treatment of debt and interest in UK tax law. This is accomplished by deeming loans and interest to exist for tax purposes; there is no implication in the tax law that the transactions give rise to debt for any other legal purposes.

4.5.2 Persons other than companies

Alternative finance return or profit share return is treated for income tax purposes in the same way as interest.

The rules for relief for interest against income tax in ICTA 1988 sections 353 - 368 are applied to alternative finance arrangements as if the arrangements were loans and the alternative finance return were interest. This includes the rules about certificates of interest paid.

The following rules apply where a person, other than, a company is a party to alternative finance arrangements for the purposes of a trade, profession or vocation carried on by him or a property business of his.

(1) Alternative finance return or profit share return paid by a person is to be treated as an expense of the trade, profession or vocation or of the property business.

(2) Incidental costs of an alternative finance arrangement qualify for tax relief on the same basis as incidental costs of finance by applying the rules in the Income Tax Trading and Other Income Act (ITTOIA) 2005 s 58 as if:

   (*a*) references to a loan included references to alternative finance arrangements; and

   (*b*) references to interest included references to alternative finance return or profit share return.

4.5.3 Provision not at arm’s length

The provisions described here ensure that, where the parties to what would be an alternative financial arrangement are connected and the recipient of the alternative finance return is not subject to tax on that return, the arrangement is not treated as an alternative finance arrangement. They also deny any tax relief to the payer of the alternative finance return.

The provisions apply where:

- an arrangement would fall within the rules governing alternative finance return or profit share return.
- the parties are connected for the purposes of the transfer pricing legislation set out in ICTA 1988 Sch 28AA[4].
- one of the parties receives “relevant return” (or an amount representing relevant return) and is not subject to income tax or corporation tax, or any corresponding tax under the law of a territory outside the UK, on that amount. Relevant return is defined as an amount that would be alternative finance return or profit share return if the arrangements were alternative finance arrangements.

Where the provisions apply, arrangements are not to be alternative finance arrangements. In such cases, the person paying relevant return is not entitled to any deduction in computing any profits or gains for the purposes of income tax or corporation tax, or against total income or total profits in respect of the relevant return. Where a deduction for relevant return is denied, group relief (which allows companies to surrender certain types of losses to other companies) is also denied.

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[4] Now TIOPA 2010 Part 4.

This far-reaching provision may be regarded as part of HMRC's new approach to international tax arbitrage.

4.6 Tax treatment of alternative finance investment bonds

If an arrangement falls within the definitions given above, then a number of significant tax consequences follow. It should be noted that these apply only for tax purposes, and not for other legal purposes.

The overall approach is that the rights of the bond holder (normally expressed in the form of sukuk certificates) are treated for tax purposes as if they were debt securities giving rise to interest income. This overall result is achieved by a number of detailed tax provisions including the following:

- The additional payments are treated as alternative finance return.
- The bond holder is not treated as having any legal or a beneficial interest in the bond assets, and is not entitled to any relief for capital expenditure in connection with the bond assets. The aim is to tax the bond holder purely by reference to the redemption and additional payments made to him, ignoring the legal form of the arrangements.
- The bond issuer is not treated as a trustee of the bond assets, and any income or gains derived from the bond assets are treated as those of the bond issuer in a beneficial capacity. This ensures that the bond issuer is taxable on the income or gains.
- The arrangements (the sukuk certificates) are treated as securities for tax purposes, with the alternative finance return treated as interest and the redemption payment treated as giving rise to redemption of the securities. This means that for corporate issuers or corporate investors, the loan relationships provisions apply. Non-corporate investors are taxed in the same way as they would be if they owned securities.
- The bond issuer is treated as being party to a capital market arrangement for the purposes of FA 2005 s.84. This enables the bond issuer to qualify for the new permanent UK tax regime for securitisation companies if the other requirements of s.84 are met.
- The arrangements are treated as a qualifying corporate bond if they are in sterling and meet requirements similar to those that must be met by actual qualifying corporate bonds. The consequence is that they are not chargeable assets for capital gains tax purposes.
- The arrangements are not treated as a collective investment scheme.

The definition of financial institution given previously is extended to include the issuer of an alternative finance investment bond, but only in relation to bond assets which are rights under arrangements falling within purchase and resale and diminishing shared ownership discussed above.

The alternative finance investment bond rules as originally implemented would assist Islamic banks seeking to securitise their portfolios of murabaha and diminishing musharaka assets by issuing sukuk, provided these assets fall within the definitions above for purchase and resale and diminishing shared ownership. However, they were insufficiently broadly drawn for the purpose of facilitating many other types of sukuk transactions. For example, they needed additional reliefs to be introduced in FA 2009 Sch 61 to eliminate capital gains tax disposals and SDLT charges before they could be used, for example, by a company seeking to implement an ijara sukuk using a UK building as discussed above.

4.7 Treatment specific to alternative finance return transactions

4.7.1 Sale and purchase of asset

To ensure that the effective return on arrangements (within the rules described above) is not taxed or relieved twice, the effective return is excluded in determining the consideration for the sale and purchase for all other tax purposes where an asset is sold by one party to the other under an arrangement within those rules. This does not override cases where any provision of the Tax Acts or the Taxation of Chargeable Gains Act 1992 provides for the consideration for a sale or purchase to be other than the actual consideration received.

4.7.2 Deduction of tax at source

The rules for deduction of tax at source in part 15 Income Tax Act 2007 (previously within ICTA 1988 s 349) are applied as if the alternative finance return or profit share return were interest. This creates an obligation to withhold income tax. Contractually, the customer's payment under the arrangements for purchase and resale described above will be for the purchase of the asset. However, the effect of the provisions defining alternative finance return is to split that payment for tax purposes into two components, the capital element of the price and the part representing alternative finance return. The withholding of income tax can then be imposed by this rule.

The rules in chapter 2, part 15, Income Tax Act 2007 (previously within ICTA 1988 sections 477A and 480A – 482) which require a building society or a deposit taker to deduct tax from interest paid under a relevant deposit, are applied to relevant arrangements as if the relevant arrangement was a deposit and alternative finance return or profit share return was interest.

4.7.3 International aspects

4.7.3.1 Foreign currency

The legislation sets out how alternative finance return is calculated if the return is paid in a currency other than sterling. Where alternative finance return is paid in a foreign currency to or by a person other than a company - and in circumstances where it is not paid for the purposes of a trade, profession or vocation or property business - then the effective return and the appropriate amount (see above) in relation to that person are to be calculated in that currency and each payment of alternative finance return is to be translated into sterling at a spot rate of exchange for the day on which the payment is made.

Strictly speaking, this provision may be unnecessary for companies as the general requirement to use generally accepted accounting practice for loan relationships and trading profits should mean that the legislation does not need to prescribe how the calculations to convert from other currencies into sterling are to be performed.

4.7.3.2 Permanent establishments/UK representatives

The provisions defining "permanent establishment" in FA 2003 s148 are amended to ensure that where a non-resident company is party to an arrangement within the above provisions, the company is not treated as having a UK permanent establishment by virtue of anything done in relation to the arrangement. This amendment is necessary because otherwise the actions performed in the UK by the customer or by the financier's agents could look like the creation of a UK permanent establishment of the financier. This is because they will involve the purchase and sale of assets which may be tangible goods located in the UK.

The provisions in FA 1995 s127 dealing with persons who are not treated as UK representatives are amended to ensure that where a person not resident in the UK is a party to an arrangement within the above provisions, neither the other party to the arrangement nor any other person acting for the non-resident in relation to the arrangement is regarded as the UK representative of the non-resident in relation to alternative finance return.

4.7.3.3 Position under double tax treaties and Interest and Royalties Directive

The HMRC manual points out that although alternative finance return is treated as interest for UK tax purposes, it may not be interest for the purpose of double taxation agreements or for the Interest and Royalties Directive (2003/49/EC).

In the case of double taxation agreements, the matter needs to be considered treaty by treaty.

Article 11(2) in the new UK/US treaty, includes a definition of interest as: “all other income that is subjected to the same taxation treatment as income from money lent by the taxation law of the Contracting State in which the income arises”. Accordingly, for this treaty the HMRC caution does not apply and alternative finance return would be treated as interest for the purposes of the treaty.

However, the Organisation for Economic Cooperation and Development (OECD) Model Treaty does not contain similar language and the HMRC caution appears appropriate. Having said that, in most cases alternative finance return should fall within Article 21 of the OECD Model Treaty (other income) and be taxable only in the country of residence, protecting the recipient from all UK withholding tax- even if the interest article of the treaty has a withholding rate above zero. For the UK to deny the application of Article 21, it would have to contend that alternative finance return is not of an income nature, despite the fact that UK domestic law treats it as income and imposes an income tax withholding. Such a contention appears difficult to sustain if challenged through the mutual agreement procedure of treaties based on the OECD model.

In the case of the Interest and Royalties Directive it is clear that the definition of interest in Article 2(a) does not extend to alternative finance return.

4.8 Treatment specific to profit share transactions

4.8.1 Profit share return not to be treated as distribution

Where the return on arrangements within the profit share rules (described above) is taxed by this legislation, it is not regarded as a distribution under the rules that apply where an amount payable by a company in respect of a security depends on the results of that company’s business (see above). As explained above, without this provision the paying company would not be able to claim a deduction against corporation tax for payments made under these arrangements.

4.8.1.1 Profit share agency and non-residents

Where the principal is a non-resident company, the actions of the agent - or of any other party acting for the company in connection with the profit share agency - do not cause it to have a permanent establishment. Similarly, the agent is not treated as a UK representative of the principal.

4.9 Amendment by statutory instrument

The Treasury has been given extensive powers to amend the alternative finance arrangements provisions by statutory instrument (a legislative process which does not require an act of Parliament) to cater for other arrangements which in its opinion equate to loans, deposits or other transactions involving the payment of interest, but which achieve a similar effect without the payment of interest.

4.10 Arbun transactions and UK tax law

The UK has not considered it necessary so far to enact specific legislation to facilitate Islamic derivatives, such as the arbun transaction discussed above.

FA 2002 Sch 26[5] contains a complete and relatively complex code governing derivatives transactions entered into by companies. (Detailed discussion is beyond the scope of these notes.) The rules in Sch 26 should apply as satisfactorily to arbun transactions as they do to conventional derivatives transactions.

There is also tax legislation, albeit simpler and less comprehensive than Sch 26, that applies to derivatives such as forward purchase contracts entered into by persons who are not companies. Again, this should apply equally well to arbun transactions.

4.11 UK stamp duty land tax relief

Stamp duty land tax (SDLT) was legislated in FA 2003, and is the name given to the UK's form of real estate transfer tax. When FA 2003 was enacted, it contained the UK's first tax provision to facilitate Islamic finance by eliminating the double charge to SDLT on Islamic mortgages (once when a bank purchases the property and again when the property is resold to the customer) provided specified qualifying conditions were met.

Originally, the relief only applied to acquisitions by individuals but FA 2006 extended the relief to acquisitions by all persons, so it also applies to acquisitions by companies and partnerships. The SDLT legislation originally used a definition of "financial institution" which is narrower than used in the alternative finance arrangement rules. However, Finance Act 2007 harmonised the two sets of legislation so in future the SDLT rules will always use the definition of financial institution originally set out in FA 2005 and since rewritten in CTA 2009 s 502 for the alternative finance arrangement rules.

[5] The tax law is now in CTA 2009 Part 7.

5 Summary

As discussed above, the taxation of Islamic finance is simpler to accommodate if a country's tax system is based upon taxing the economic reality of transactions. Such countries will decompose an Islamic finance transaction into its constituent parts to identify the component that represents a finance cost, and tax/relieve it accordingly. However, even in the case of such countries, transaction costs need careful consideration and there would be merit in pressing for specific legislation to facilitate Islamic finance for those countries where Islamic financiers wish to operate.

Where countries base their tax system primarily on the legal form of transactions, it is essential to bring in specific legislation to facilitate Islamic finance.

The UK is a pioneer in this area. While the legislation enacted over the last few years has enabled Islamic banks to operate in the UK, and will now enable the issue of some forms of sukuk by UK companies, further legislation will be needed to cater for the full range of transactions that Islamic financiers wish to implement.

Most fundamentally, the UK rules require one of the parties to an Islamic finance transaction to be a financial institution. There is no such requirement in the case of conventional finance, demonstrating how far the UK tax system will need to adapt before there is a completely level playing field between conventional finance and Islamic finance.

6 Value Added Tax

6.1 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 is regularly listed in searches on the EU's Europa Lex website http://eur-lex.europa.eu/content/welcome/about.html which contains EU law but the pages where it should appear fail to display it!

6.1.1 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.

6.2 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. Some non-EU countries do not treat financial services as being exempt from VAT. As this paper concentrates on the UK, that policy question is not explored further.

6.2.1 The implementation of VAT in the 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 ensure 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. 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.

6.3 Some transactions used in Islamic finance and their generic VAT implications

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.

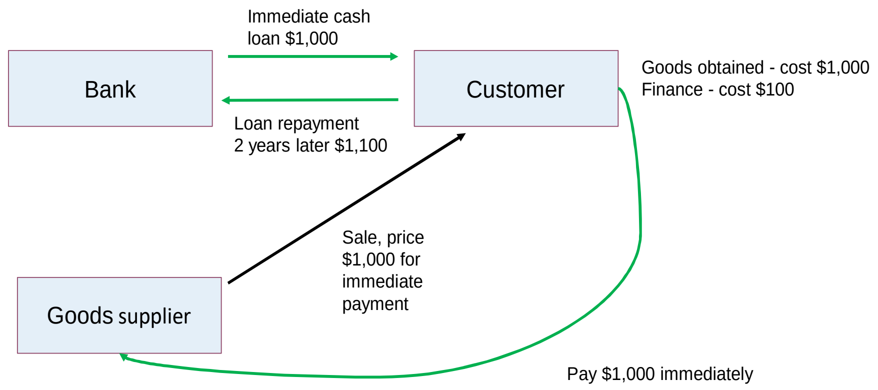
As the needs of Muslim customers and non-Muslim customers are essentially the same, for most services provided by conventional financial services firms there is an analogous service provided by Islamic financial services firms. However, this is not always the case, as for some conventional financial 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.

6.3.1 Murabaha (purchase and resale)

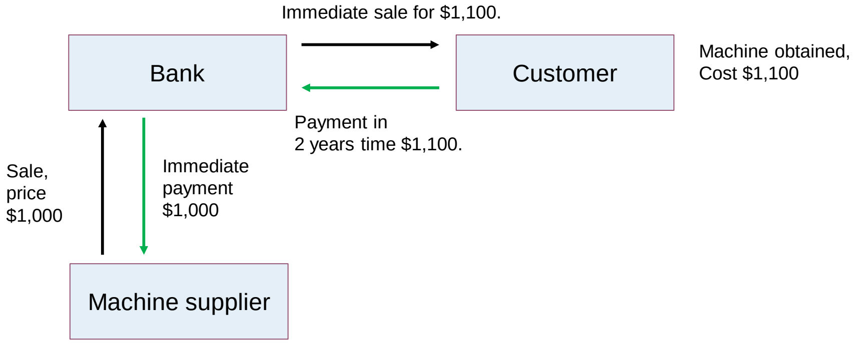
If the customer of a conventional bank requires finance to purchase an asset, the conventional bank will make a loan to the customer who then purchases the asset. In due course the customer will repay the loan plus interest.

Conventional bank loan



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.

Murabaha transaction



6.3.1.1 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.

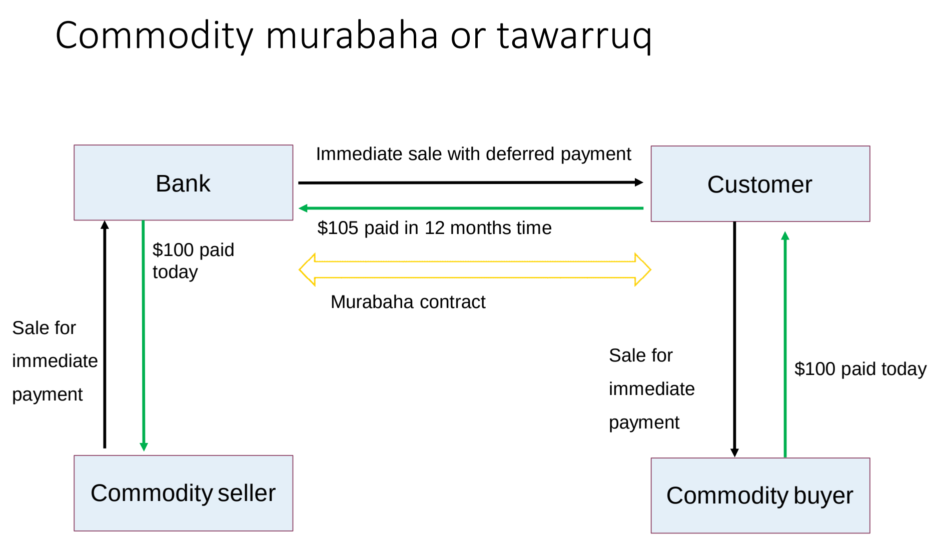
The above VAT analysis is from first principles. Later on, this paper discusses how the UK deals with the VAT treatment of some Islamic finance transactions.

6.3.2 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.

6.3.2.1 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.

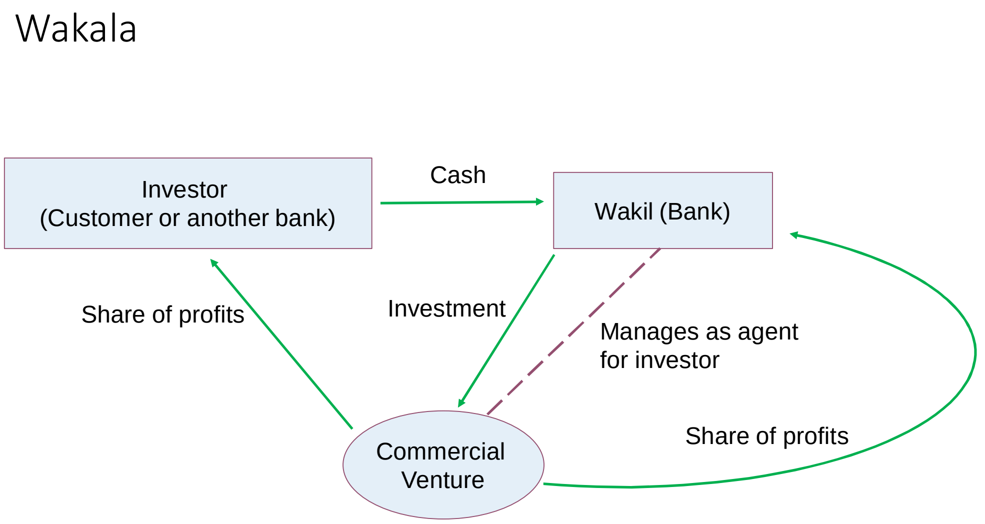
2. The bank uses the copper it has purchased for \$100 + VAT of \$20 to make a taxable supply to the customer of \$105 + VAT of \$21. Under the commodity murabaha agreement, the bank has agreed to allow the customer to defer payment of the \$105 price for 12 months. The bank and the customer need to 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 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 on this report considers what amelioration for the above outcome may be possible either under general VAT principles or under specific legislation for Islamic finance.

6.3.3 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.



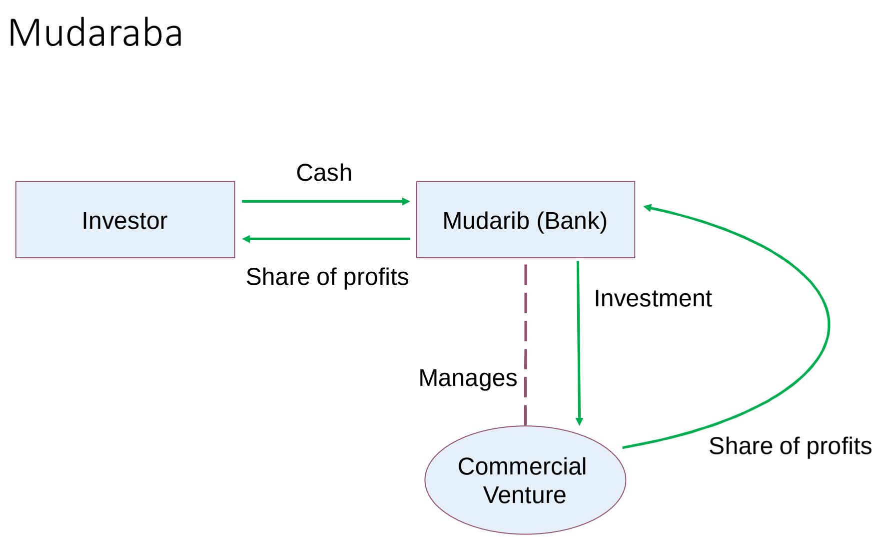
The economics of the arrangement are usually that the wakil (the agent, here a bank) keeps all of the profits beyond a specified share that is paid to the principal (here either a customer or another bank). The arrangement is often used for inter-bank lodgements of cash, instead of using a commodity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

6.3.4 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.



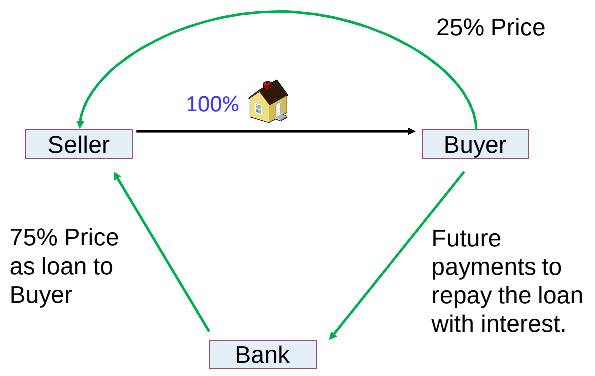
In the United Kingdom, banks are not permitted to offer bank accounts which fully comply with the above requirements, as UK law governing banking requires that unless a bank is insolvent bank accounts must always be repayable at face value. Accordingly, a solvent bank is not permitted to have losses 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.

6.3.5 Diminishing musharaka

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

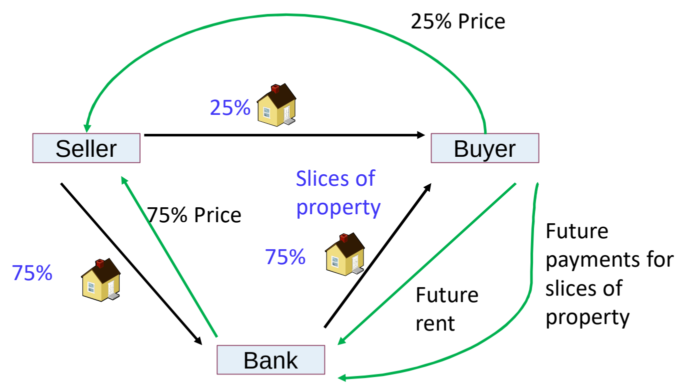
In the case of the conventional mortgage illustrated below, the bank finances 75% of the purchase price by making a loan to the buyer. Typically, the loan will be at floating rate of interest, which may be reset periodically, for example annually.

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.

6.3.5.1 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.

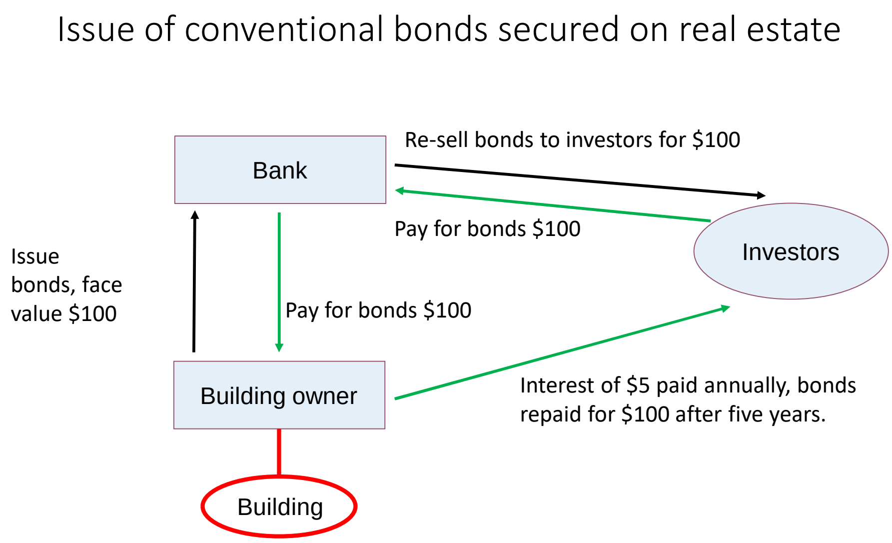
With diminishing musharaka, 75% of the real estate is sold twice, once by the seller to the bank and then again, in stage, by the bank to the buyer. There is also a supply of the right to occupy 75% of the real estate, as the bank begins by renting 75% of the property to the buyer. These additional supplies 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.

6.3.6 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.

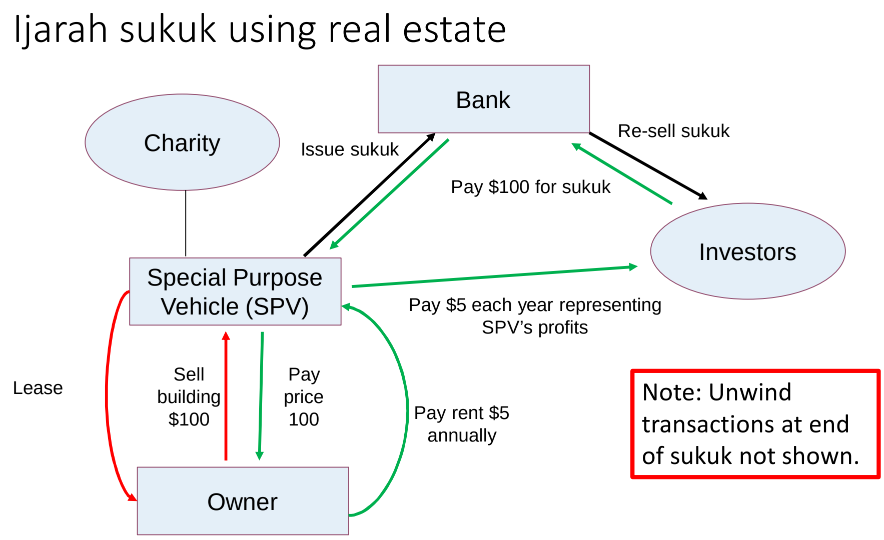


In this example, the bank facilitates the issue of the bonds by purchasing the entire issue of $100 from the borrower (the building owner) and then re-selling the bonds to third party investors. For simplicity the bank is shown as buying the bonds at the same price at which it re-sells them, in which 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.

6.3.6.1 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.

6.3.7 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.

6.3.7.1 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.

6.4 The United Kingdom approach to VAT on Islamic finance

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.

6.4.1 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."

6.4.1.1 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.

6.4.1.2 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 37 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.