Institute of Islamic Banking and Insurance

Tax Treatment of Islamic Finance Transactions in the MENA Region

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Presentation outline

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- Purpose, scope and methodology of the study
- Current status
- Key findings and recommendations
- Next steps

Disclaimer

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

Speaker's details

Mohammed Amin

Mohammed Amin is an Islamic finance consultant. Previously he was a partner in PricewaterhouseCoopers LLP and led their Islamic finance practice in the UK.

He is:

- a chartered accountant, a chartered tax adviser and a qualified corporate treasurer
- a Council member of the Chartered Institute of Taxation
- a member of Editorial Advisory Board of New Horizon, the magazine of the Institute of Islamic Banking and Insurance

Amin has spoken on Islamic finance in over 20 cities covering every continent except Antarctica. Many of his articles and presentations on Islamic finance can be found on his website:

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Purpose, scope and methodology of the study

Purpose

- Ascertain the tax treatment of common Islamic finance structures in MENA countries.
- Focus on cross border transactions.
- Identify tax obstacles to Islamic finance.
- Provide policy recommendations.

Study team

- Qatar Financial Centre Authority - sponsor
- International Tax and Investment Center
- Ernst & Young – Questionnaire management
- PwC Malaysia – Malaysian questionnaire
- Researchers:
  - Mohammed Amin – lead writer
  - Salah Gueydi – Qatar Tax Authority
  - Hafiz Choudhury - ITIC

Sponsor: Qatar Financial Centre Authority

- Strategically located as an important platform for conducting business in the rapidly growing Middle East and North Africa region, the Qatar Financial Centre (QFC) has firmly established itself as a thriving location for global and regional financial services firm looking to capitalise on the opportunities offered by the region.

- The QFC Authority is the commercial and strategic arm of the QFC. The QFC Authority also serves as a ‘think-tank’ for the State of Qatar on financial services, in addition to acting as an interface between participants who would like to use the QFC as a platform to expand within the region and the State of Qatar. The QFC has a specific set of regulations covering the taxation of Islamic Finance transactions, and a QFC entity has already been used in the structuring of a Sukuk funding a property development in Qatar.

- The QFC is delighted to be able to support further research into the developing subject of the taxation of Islamic Finance transactions by the thought leaders in this area.

Scope - MENA Region

Study information received	No information for this phase
Egypt	Algeria
Jordan	Bahrain
Kuwait	Iran
Libya	Iraq
Oman	Lebanon
Qatar – main territory	Morocco
Qatar – special rules in QFC	Palestinian Territories
Saudi Arabia	Syria
Turkey	Tunisia
	United Arab Emirates
	Yemen

Taxes covered

- Taxes on income payable by companies, individuals and trusts (where applicable.)
- Taxes on capital gains
- Taxes on the transfer of assets, such as real estate transfer tax, where such taxes are not recoverable by the purchaser

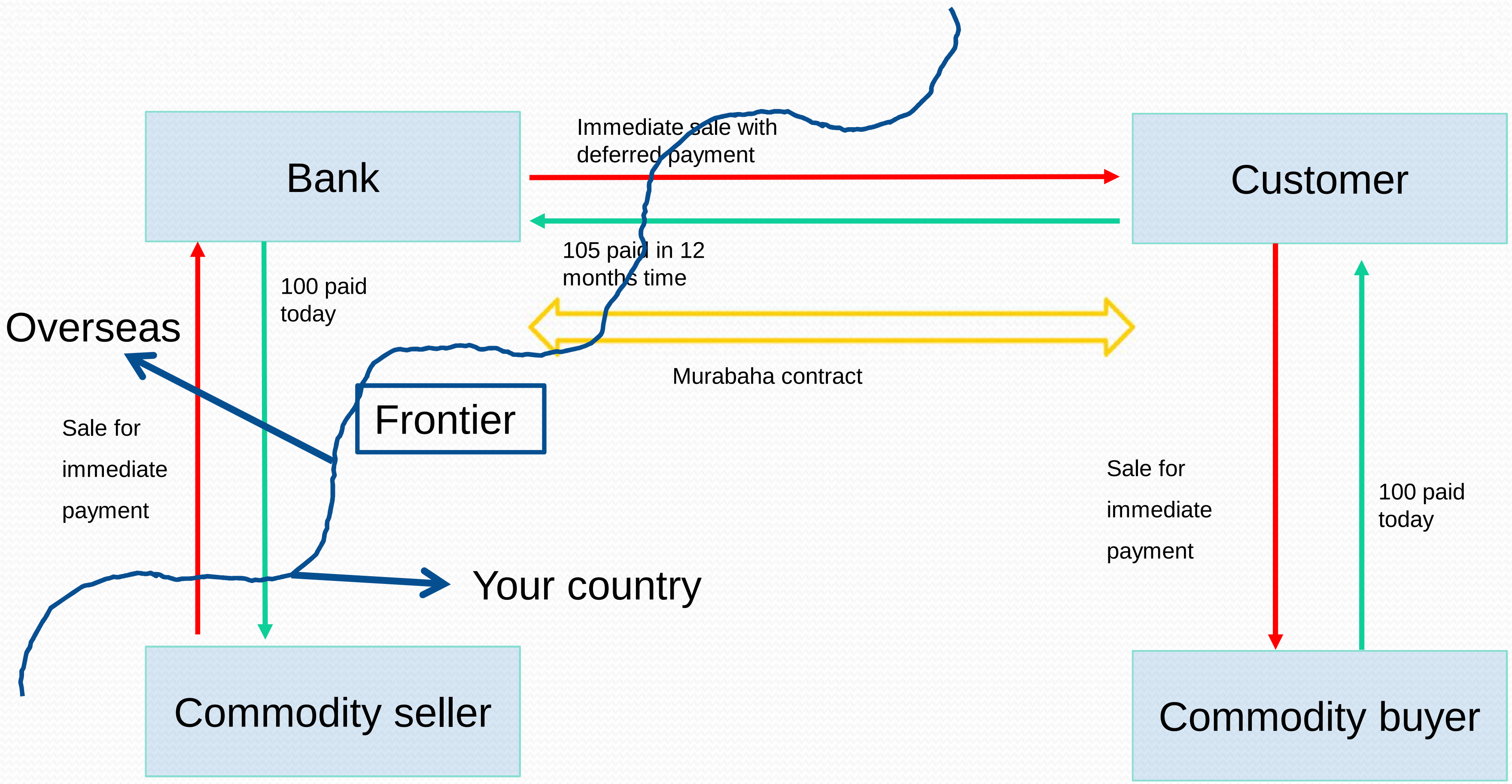
VAT excluded from this initial study

Methodology

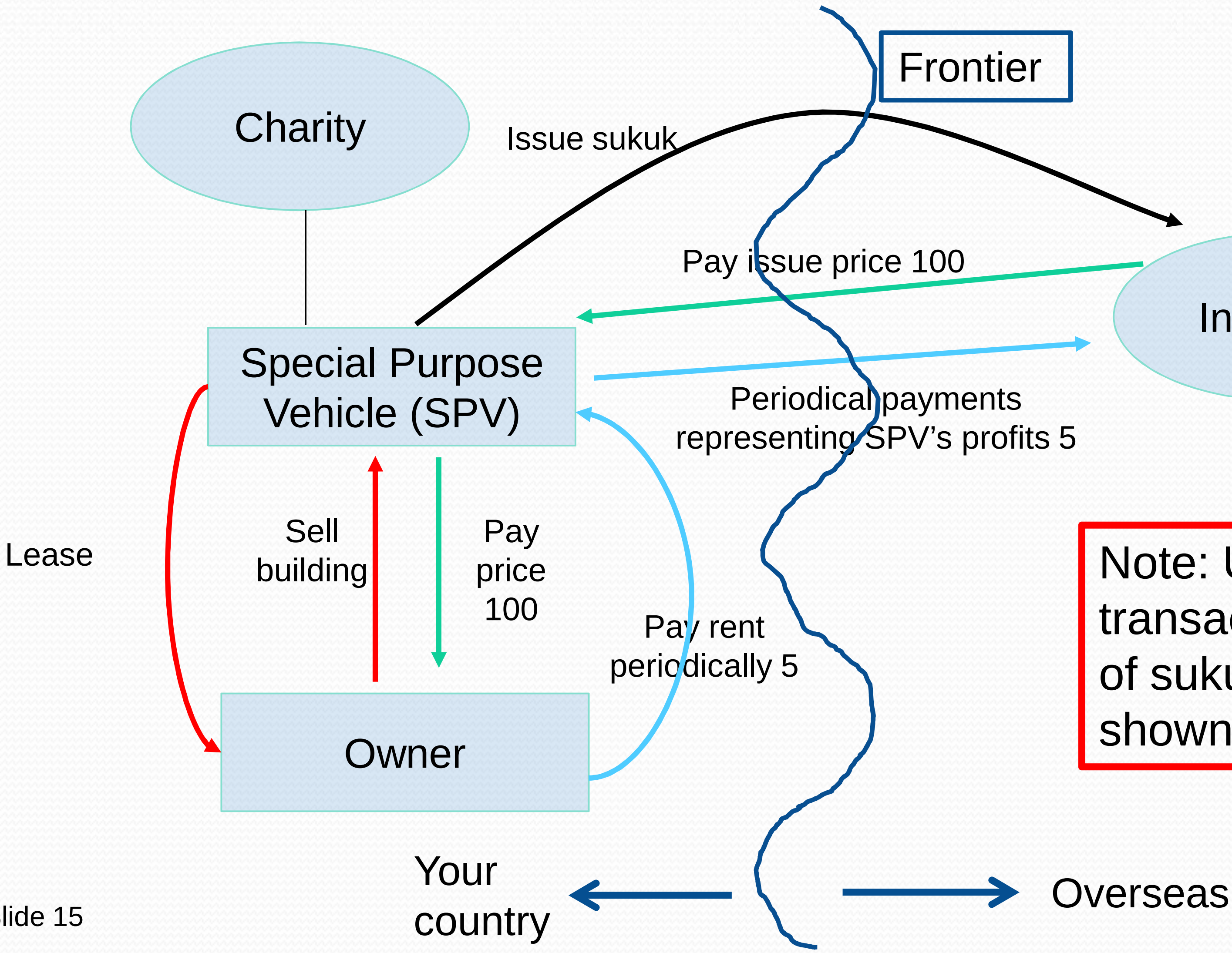
Structures analysed

- Four structures chosen for study.
  1. Commodity murabaha / tawarruq – economically equivalent to a conventional loan.
  2. Ijarah sukuk (onshore and offshore SPV) – economically equivalent to issuing a tradable bond.
  3. Salaam – economically equivalent to financing by committed forward purchase of goods.
  4. Istisna – economically equivalent to construction finance.
- Detailed transaction descriptions

Commodity murabaha or tawarruq



Ijarah sukuk with onshore SPV

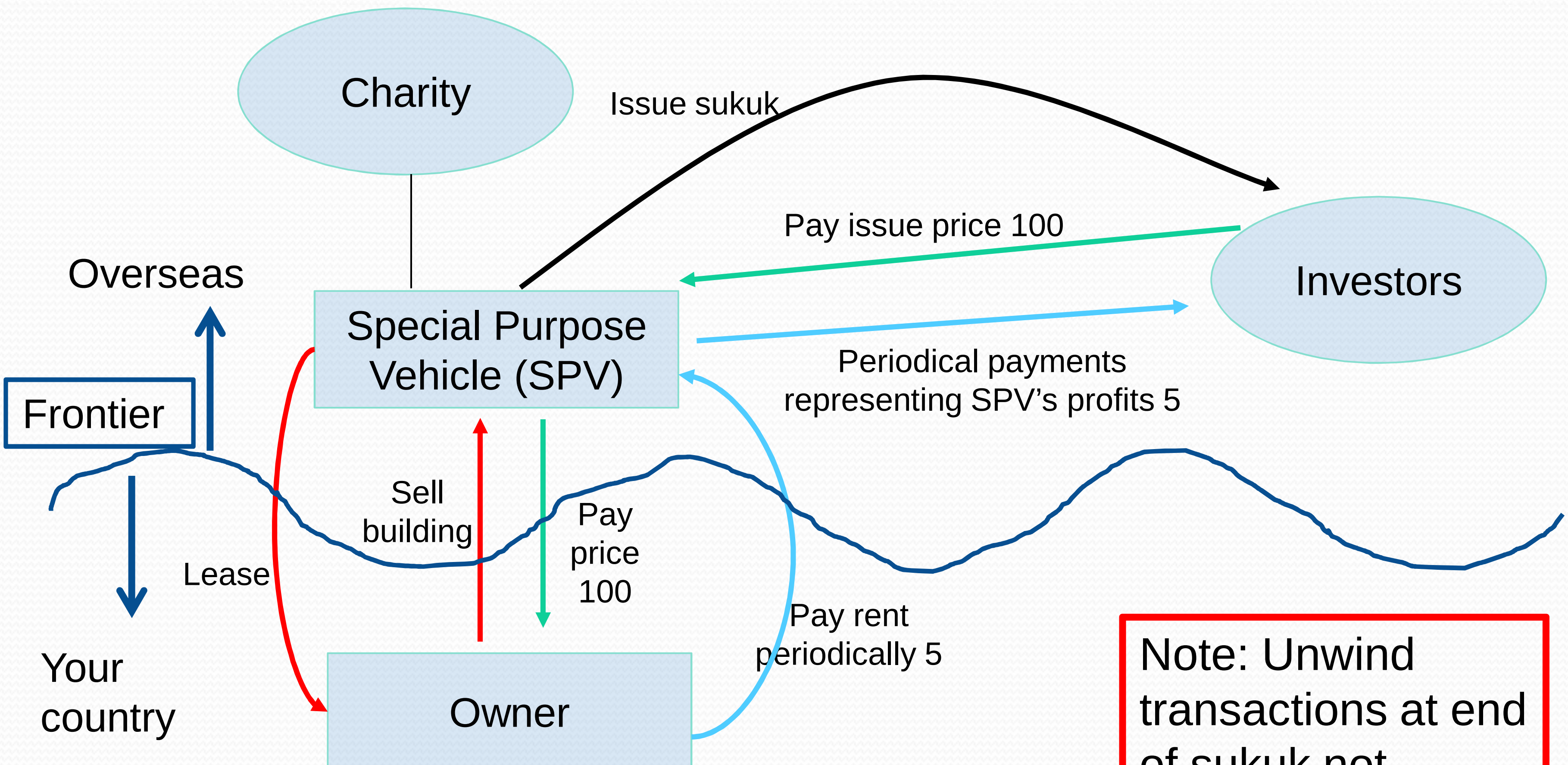


Note: Unwind transactions at end of sukuk not shown.

Transaction description for sukuk with onshore SPV

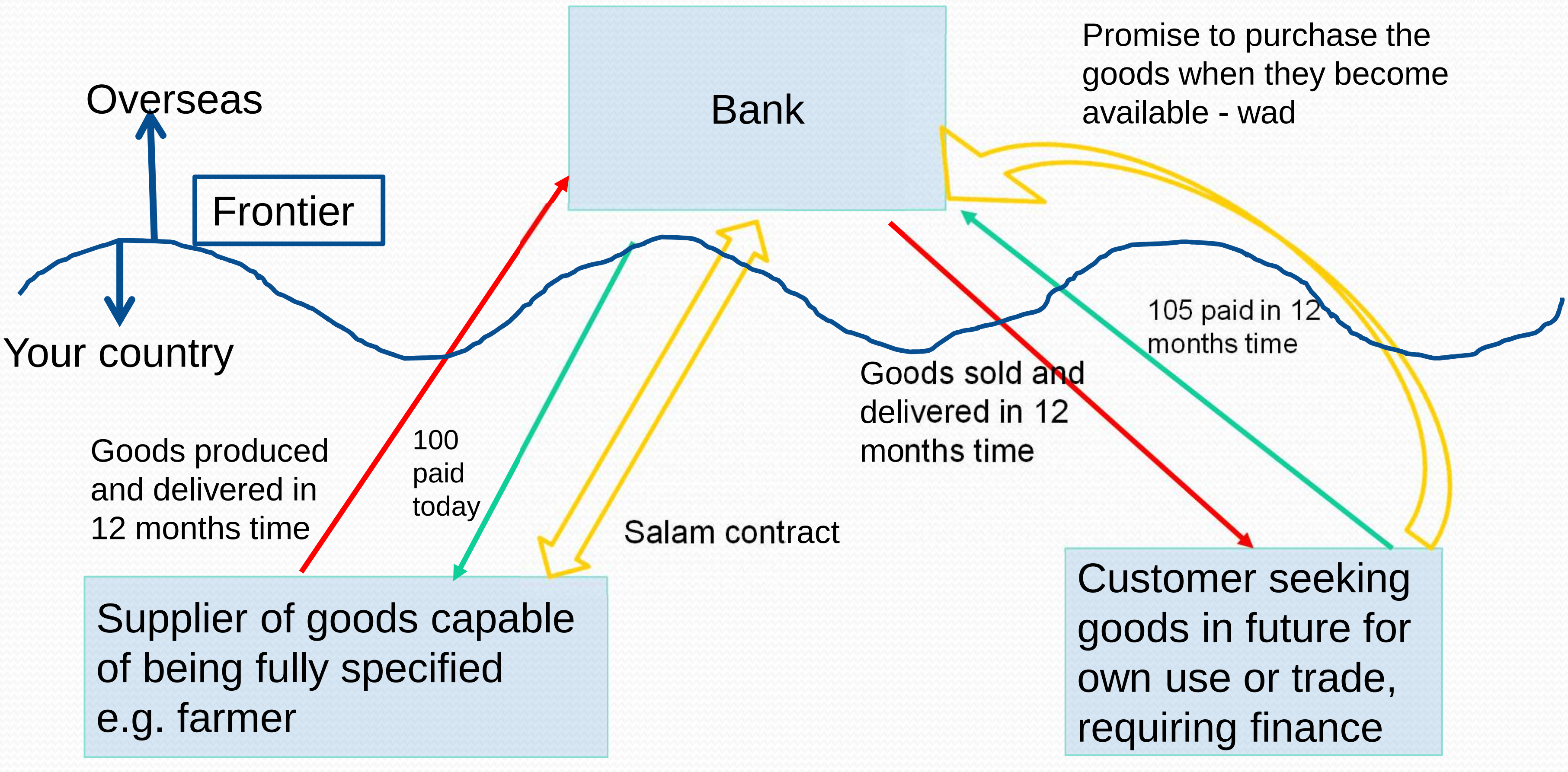
1. Owner is a company located in your country.
2. Today Charity which is not connected with Owner creates a company called Special Purpose Vehicle (SPV) located in your country.
3. Owner owns a building which it purchased many years ago for $20 million. Today, after SPV has been formed, Owner sells that building to SPV for a price of $100 million 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 $110 million, 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 $110 million, SPV will sell.
6. Today SPV rents the building to Owner with a lease which is five years long. The rent is $5 million 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 to investors for a total price of $100 million. All of the investors are located overseas.
9. On day 30, SPV pays the $100 million to Owner which is owed for the purchase of the building.
10. In 12 months' time, Owner pays rent of $5 million 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.
11. Also at the end of year 5, Owner offers to buy the building from SPV for a price of $110 million. SPV agrees to sell, as it has promised to do under the terms of its sale undertaking. Owner pays $110 million to SPV and SPV transfers ownership of the building to Owner.
12. SPV passes the $110 million sale price of the building on to the investors in proportion to their ownership of the sukuk certificates.
13. The sukuk certificates are cancelled as they have no further value as SPV has no remaining assets.
14. After completion of the above transactions, as SPV should have no assets and no liabilities, SPV will be liquidated.

Ijarah sukuk with offshore SPV

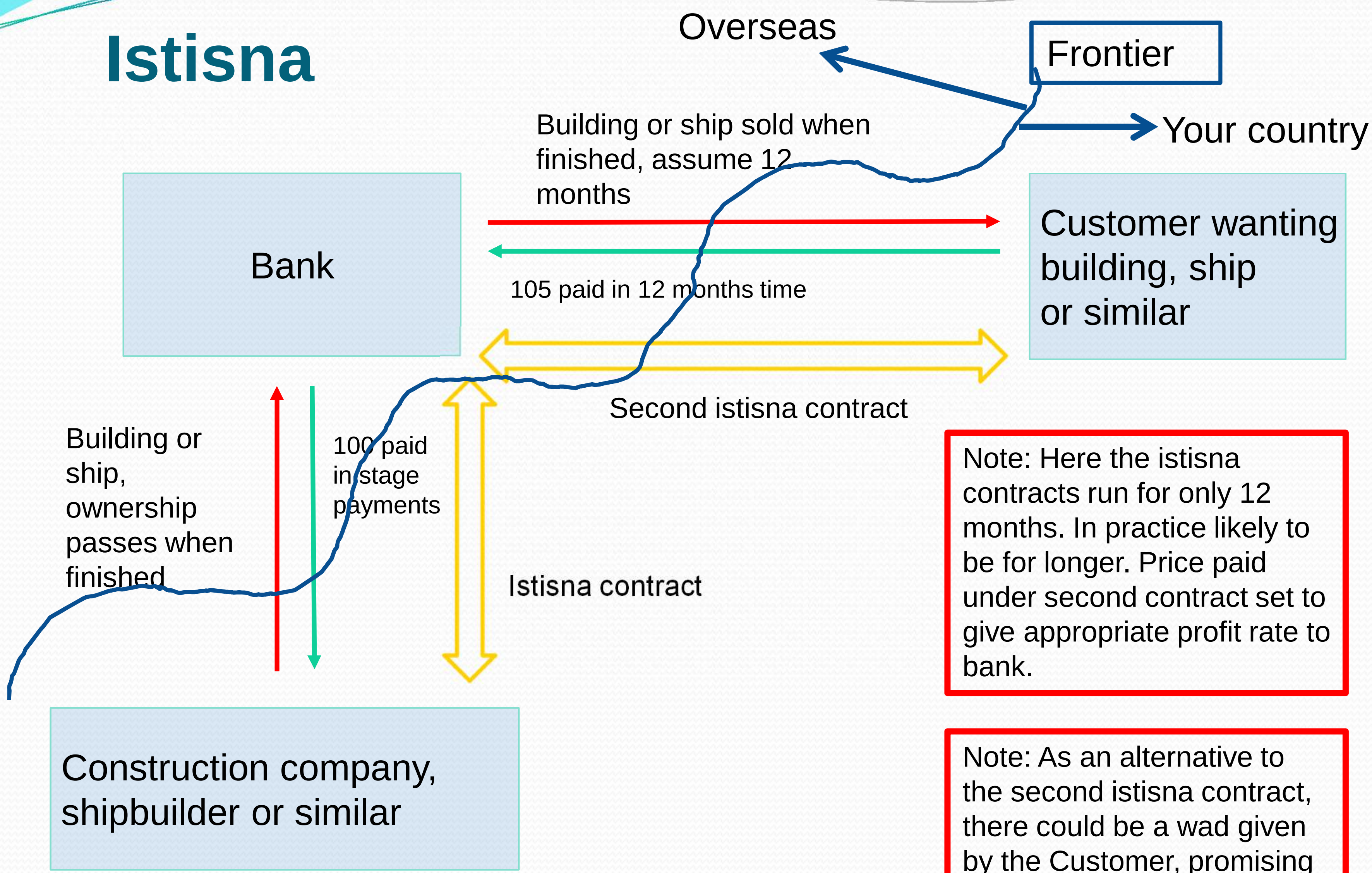


Note: Unwind transactions at end of sukuk not shown.

Salaam


Bank
Promise to purchase the goods when they become available - wad
Overseas
Frontier
Your country
Goods produced and delivered in 12 months time
100 paid today
Salam contract
Goods sold and delivered in 12 months time
105 paid in 12 months time
Supplier of goods capable of being fully specified e.g. farmer
Customer seeking goods in future for own use or trade, requiring finance

Istisna



Note: Here the istisna contracts run for only 12 months. In practice likely to be for longer. Price paid under second contract set to give appropriate profit rate to bank.

Note: As an alternative to the second istisna contract, there could be a wad given by the Customer, promising to purchase the building when finished.

Specific questions

- 68 questions about law and tax treatment in the host country, including tax treaty implications.

Key tax issues being explored

Commodity murabaha

- Tax deductibility of Customer’s expense
- Does transaction create a taxable presence for Bank?
- Withholding tax
- Impact of tax treaties
- Transfer taxes

Ijarah sukuk

- Taxation of transfer of building to SPV
- Deductibility of rental expense
- Income tax position of SPV
- Withholding tax on payments to investors
- Taxation of sale of sukuk certificates
- Taxation of SPV on closing sale of building
- Impact of tax treaties
- Transfer taxes

Salaam

- Does transaction create a taxable presence for Bank?
- Withholding tax
- Impact of tax treaties
- Transfer taxes

Istisna

- Does transaction create a taxable presence for Bank?
- Withholding tax
- Impact of tax treaties
- Transfer taxes

Current status of study

Current status of study

- Questionnaires distributed to jurisdictions;
- Responses for eight countries received and analysed;
- Response also obtained from Malaysia, and implicitly from UK (as author is a UK tax specialist) to provide non-MENA comparisons.
- Report finished and being printed.

Key findings and recommendations

Legislation for Islamic finance

- Turkey has rules for onshore sukuk.
- So does the Qatar Financial Centre.
- Otherwise no MENA country responding has any special tax law for Islamic finance.

Murabaha, salaam and istisna

- Some commercial restrictions on involvement by foreign banks. For example Libya prohibits foreign persons buying and selling commodities within Libya.
- Overall, all jurisdictions appear to give a tax deduction to the party receiving finance.
- Lack of certainty on whether these are treated as financing transactions and on timing of deductions.

Sukuk

- Only Turkey and QFC have specific rules for sukuk.
- Kuwait does not tax gains by companies where all the shareholders are GCC individuals.
- Otherwise, significant tax charges on our hypothetical transactions, making the use of sukuk prohibitively expensive.
- Sukuk transactions have been done (eg in Saudi Arabia) so facts may have differed or special exemptions been given.

Malaysian and UK legislative approaches

- Both have legislated for Islamic finance.
- Both have equalised taxation of Islamic finance and conventional finance.
- Malaysia
  - Muslim majority country.
  - Explicit recognition of Islam.
  - Central pre-approval of Islamic finance transactions.
- UK
  - No recognition of Islam.
  - Legislation religiously neutral.

Overall Malaysian approach

- Financing structures based on Shariah principles are accorded tax neutrality, subject to first obtaining approvals from regulatory bodies, such as the Bank Negara Malaysia, Securities Commission or Labuan Offshore Financial Services Authority.
- Regulatory approval first → neutral tax treatment.

Malaysia - key tax statutes

Income Tax Act, 1967 – Paragraph 2(7) & 2(8)

“2(7) Any reference in this Act to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah.

2(8) Subject to subsection (7), any reference in this Act to the disposal of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank, the Securities Commission, the Labuan Financial Services Authority or the Malaysia Co-operative Societies Commission as a scheme which is in accordance with the principles of Syariah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing.”

Stamp Act, 1949 – Schedule II, Para (6)

“An instrument executed pursuant to a scheme of financing approved by the Central Bank, the Labuan Financial Services Authority, the Malaysia Co-operative Societies Commission or the Securities Commission as a scheme which is in accordance with the principles of Syariah, where such instrument is an additional instrument strictly required for the purpose of compliance with those principles but which will not be required for any other schemes of financing”

Overall UK approach

- UK examined transactions Islamic finance uses.
- Mirrored those transactions in UK tax law
  - No reference to Shariah
  - No reference to Arabic terminology

Tax law	Islamic finance
Purchase and resale	Murabaha
Deposit	Mudarabah
Profit share agency	Wakala
Diminishing shared ownership	Diminishing musharaka
Investment bond	Sukuk

UK legislation example (1)

Corporation Tax Act 2009 section 503 Purchase and resale arrangements

(1) This section applies to arrangements if—

(a) they are entered into between two persons ("the first purchaser" and "the second purchaser"), one or both of whom are financial institutions, and

(b) under the arrangements—

(i) the first purchaser purchases an asset and sells it to the second purchaser,

(ii) the sale occurs immediately after the purchase or in the circumstances mentioned in subsection (2),

(iii) all or part of the second purchase price is not required to be paid until a date later than that of the sale,

(iv) the second purchase price exceeds the first purchase price, and

(v) the excess equates, in substance, to the return on an investment of money at interest.

UK legislation example (2)

(2) The circumstances are that—

(a) the first purchaser is a financial institution, and

(b) the asset referred to in subsection (1)(b)(i) was purchased by the first purchaser for the purpose of entering into arrangements within this section.

(3) In this section—

"the first purchase price" means the amount paid by the first purchaser in respect of the purchase, and

"the second purchase price" means the amount payable by the second purchaser in respect of the sale.

(4) This section is subject to section 508 (provision not at arm's length: exclusion of arrangements from this section and sections 504 to 507).

Commodity murabaha

- Malaysia and UK both:
  - Treat it as a financing transaction = loan
  - Markup taxed in the same way as interest
  - Markup subject to standard withholding tax rules when paid cross border
  - No taxable presence for foreign bank created
- Different approaches to legal drafting.
- Same tax treatment, equivalent to conventional finance, achieved.

Sukuk with onshore SPV

- Malaysia and UK both:
  - Disregard transfer of assets to/from SPV for tax purposes.
  - Tax sukuk investors as if they were receiving interest.

Recommendations

- Malaysian model more suitable for MENA countries
  - No problems with explicit recognition of Islam.
  - Central certification of Islamic finance transactions allows simplified tax law drafting.
  - Much quicker and simpler than UK approach.

Next steps

Next steps

- Complete geographical coverage
- Cover additional structures
- Cover additional taxes and levies
  - Consumption taxes
  - Zakat
- Double taxation treaties
- Consider regulatory and governance issues
  - Prudential regulation
  - Shariah governance