Institute of Islamic Banking and Insurance

How should indirect taxes deal with Islamic finance?

Mohammed Amin

13 January 2014

Presentation outline

- Disclaimer
- Speaker’s details
- Theoretical overview
- How indirect taxes impact upon Islamic finance
- Possible ways forward

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
- a qualified corporate treasurer
- a Council member of the Chartered Institute of Taxation

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:

www.mohammedamin.com

Theoretical overview

Theoretical overview

- What are good taxes?
- Categories of taxes
- Overview of consumption taxes
- VAT policy issues
  - Financial services generally
  - Islamic finance
  - Implementation issues
    - UK bound by EU Sixth Directive

What is a good tax?

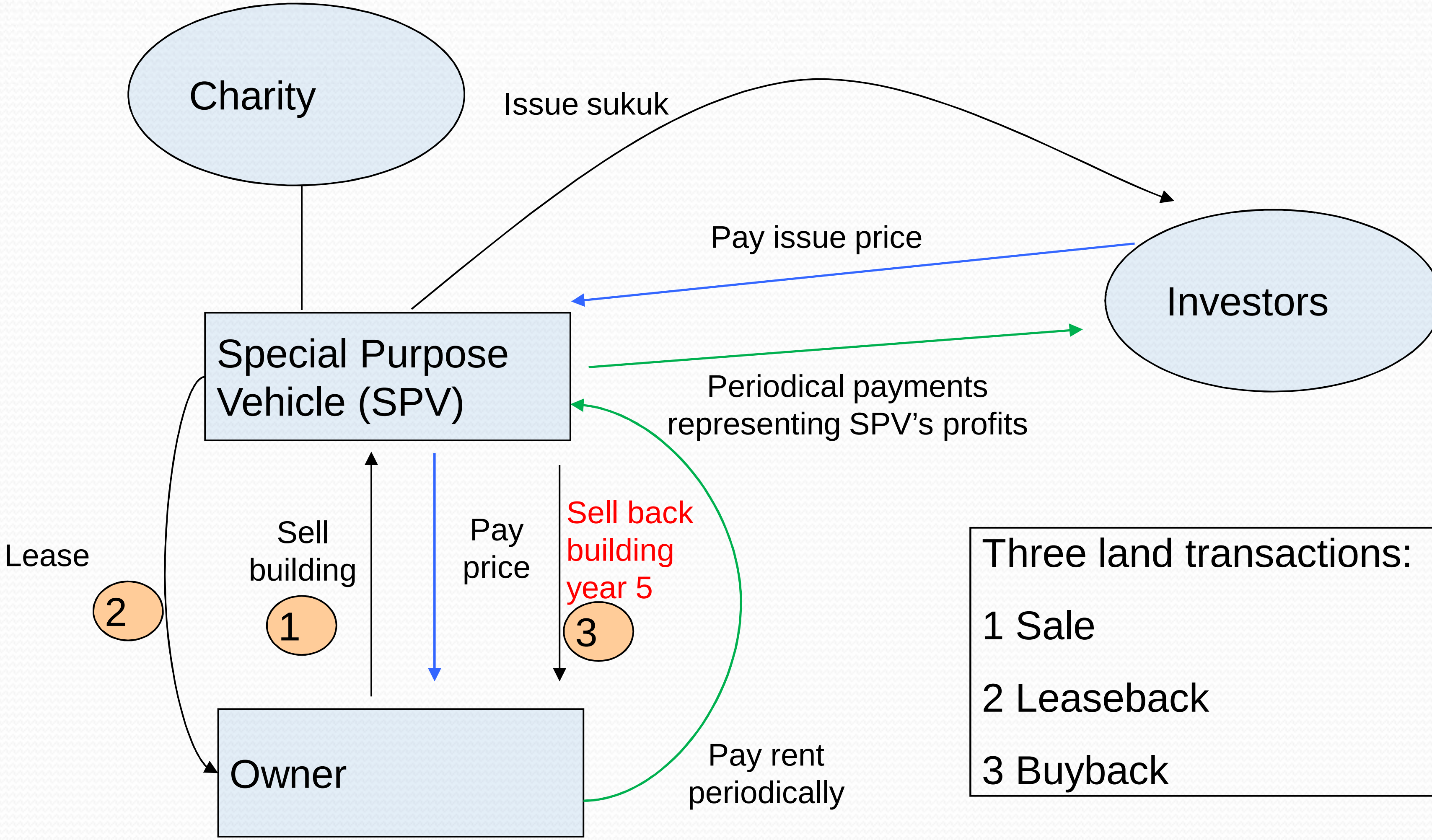
- Adam Smith “The Wealth of Nations”
- Four criteria
  1. Equity
  2. Neutrality
  3. Certainty
  4. Administrative efficiency

What to tax?

- Income and gains
- Consumption
  - When spend, not when consume!
- Wealth
  - Imputed income from owner occupied housing
- Transactions
  - Real estate transfer tax
  - Other transfer taxes

Transfer taxes

Real estate transfer tax costs



Three land transactions:

1 Sale

2 Leaseback

3 Buyback

Real estate transfer taxes and IF

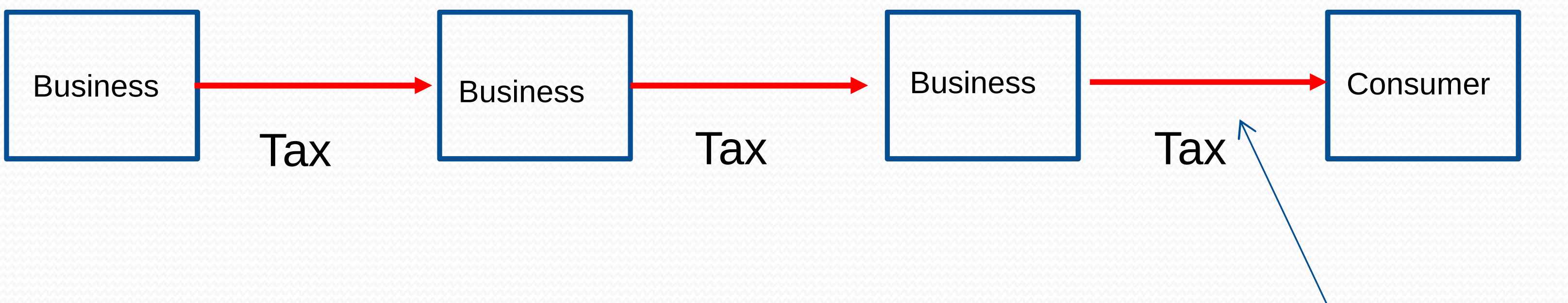
- Need for relief from transfer tax
- Several countries give relief
- Different approaches
  - Malaysia
  - UK

Consumption taxes

Consumption taxes

- Sales taxes
- Value added tax

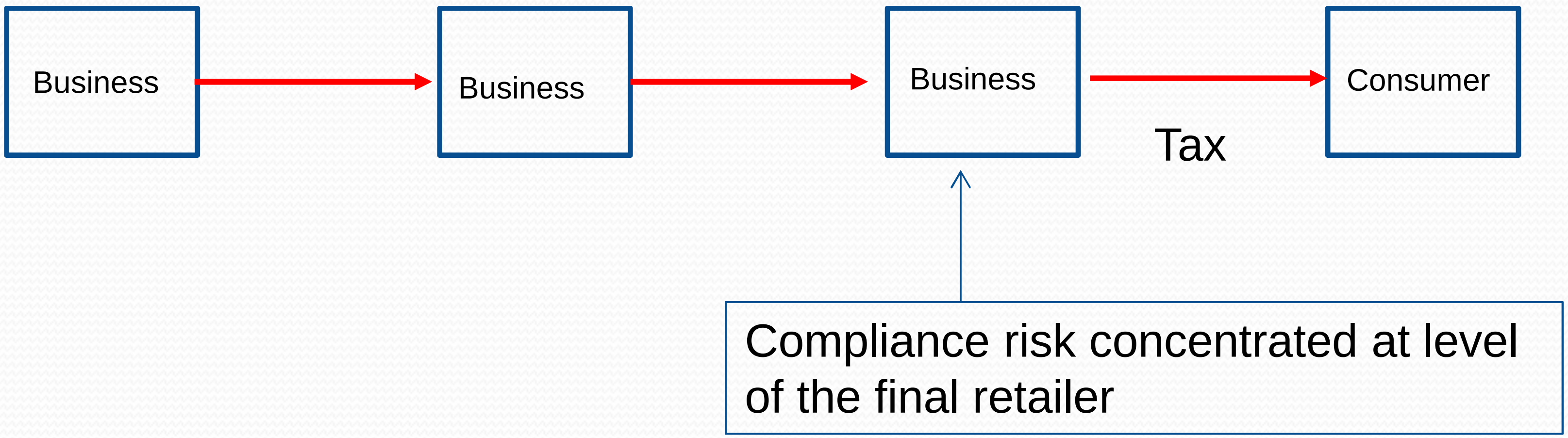
Sales taxes at each stage



All tax in chain part of final price

Sales taxes often charged at each stage in chain.
May compound with no offset for earlier taxes.
Should sales tax apply to sales which are part of Islamic finance transactions?

Sales tax on consumer sale only

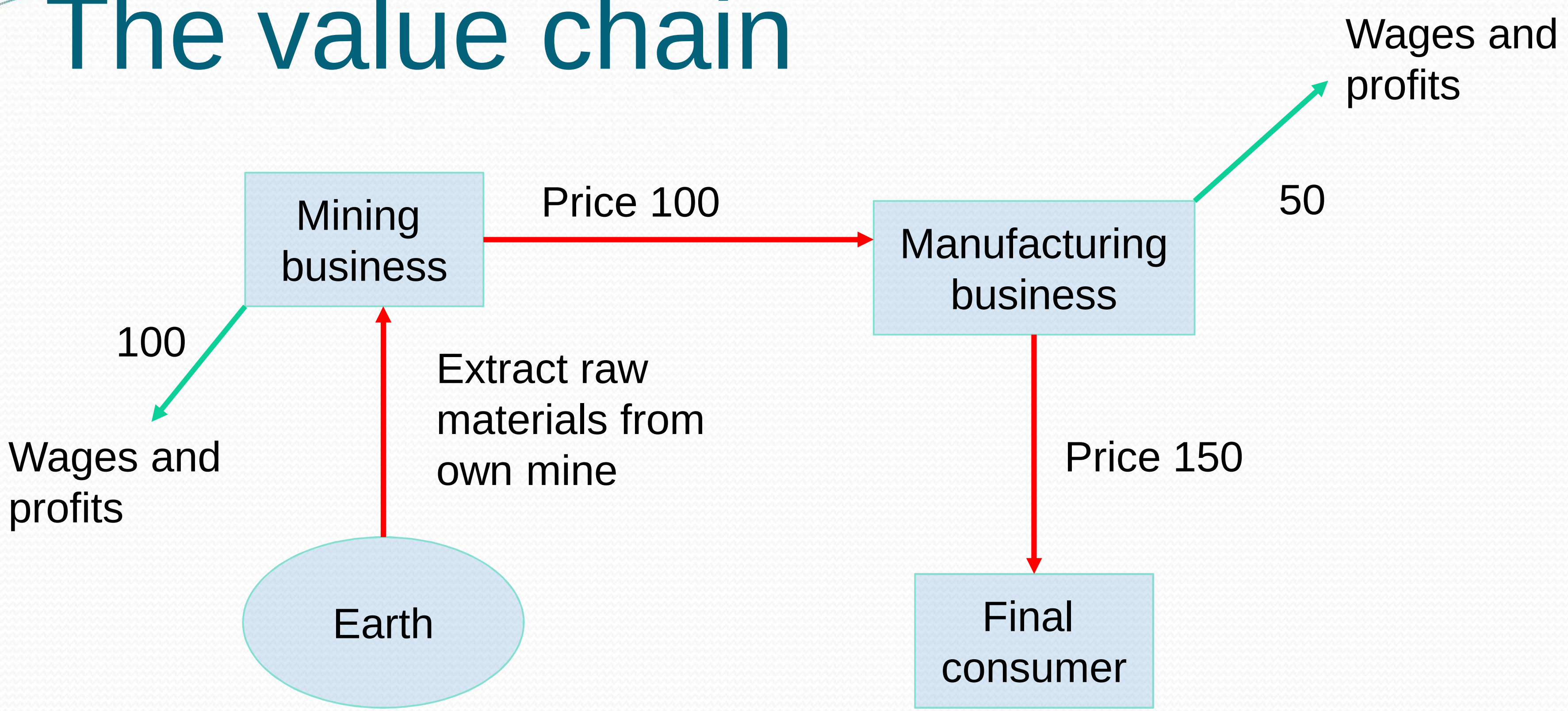


Should sales tax apply to sales which are part of Islamic finance transactions?

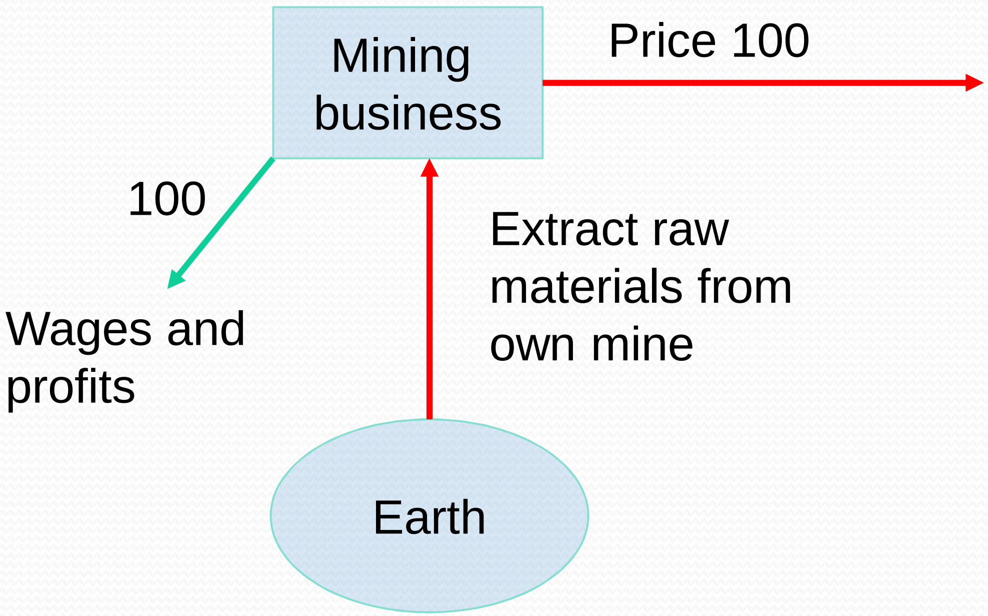
Value added tax

- A consumption tax born only by final consumer
- Foreign consumers normally not taxed
- Charged on sales at each stage
  - Minimises compliance risk
  - Credit mechanism to avoid compounding tax

The value chain



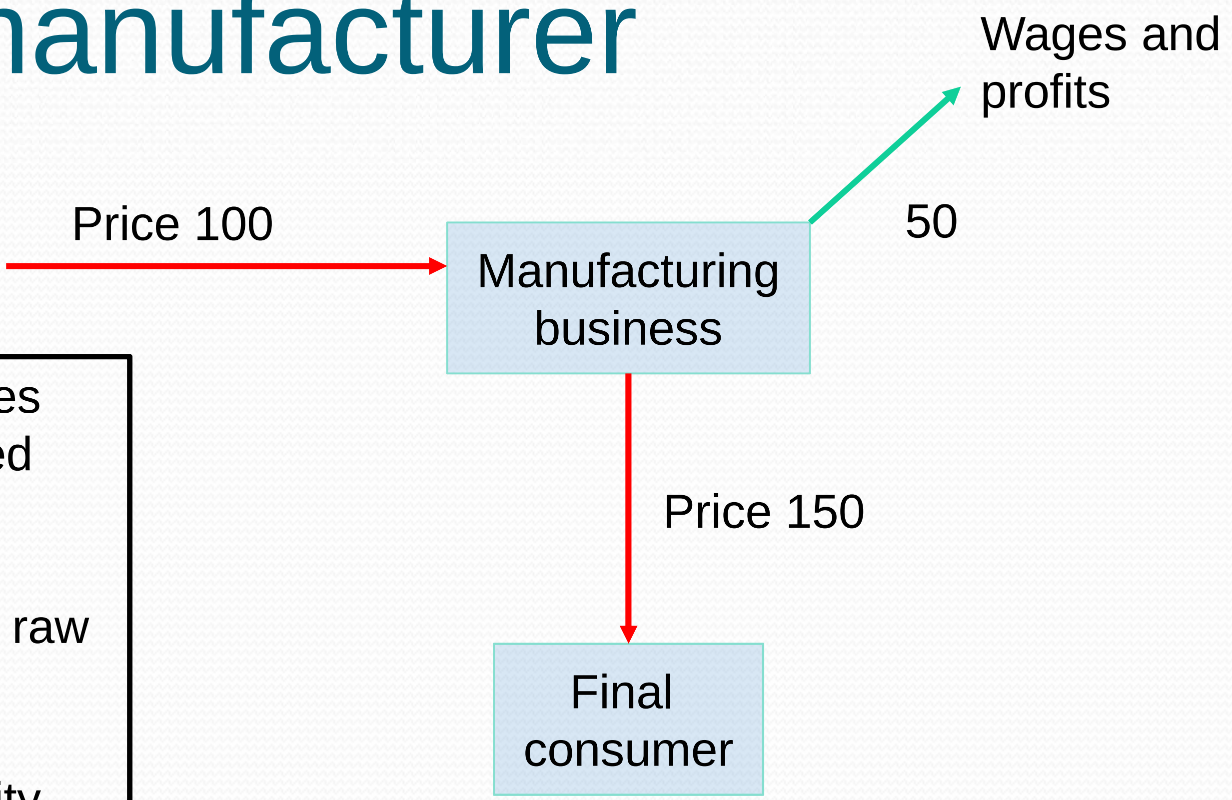
VAT for miner



VAT payable on sales value of 100 at say 20%, tax 20.

Tax base 100 = value added in the business

VAT for manufacturer



Charge 20% VAT on sales price of 150. VAT charged 30.

Deduct VAT paid on 100 raw materials, 20.

Pay net 10 to tax authority

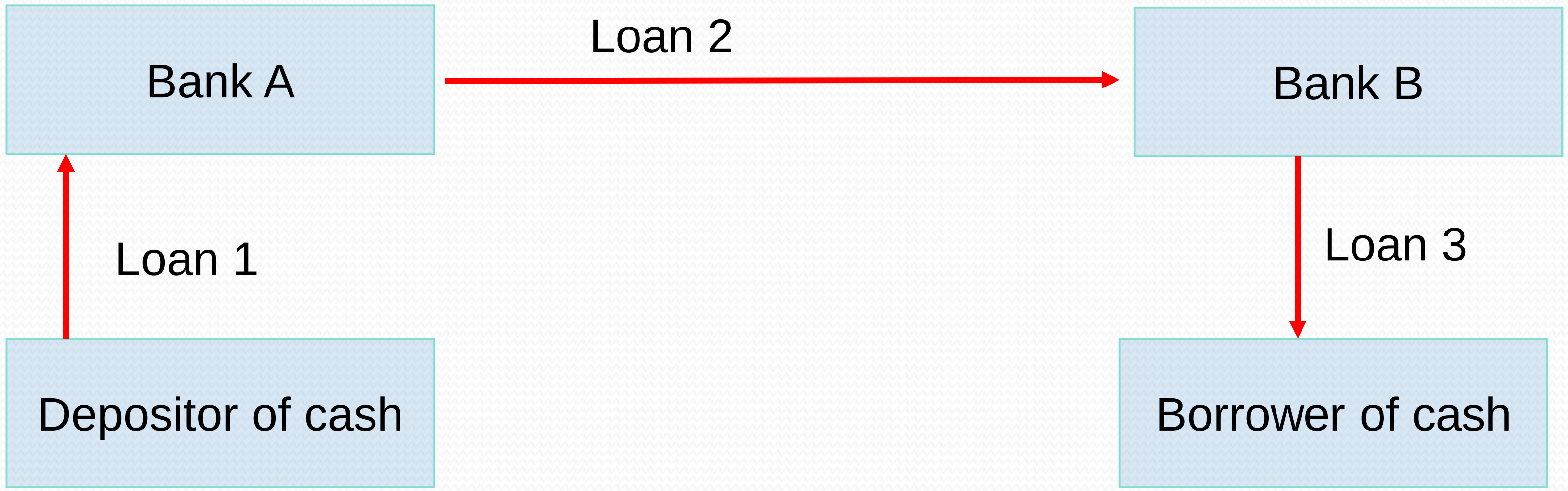
Compliance risk spread over all stages of business

Suffers VAT of 30 on 150 price

Financial services and VAT

- Conceptual approaches
  - A service is a service
    - Charge VAT on all financial services
  - Financial services are special
    - More complex treatments

A service is a service: VAT on all FS



Three loans.
Each a supply of credit, price = interest paid
VAT charged on loan 2 and loan 3
No VAT on Loan 1 if depositor is not in business

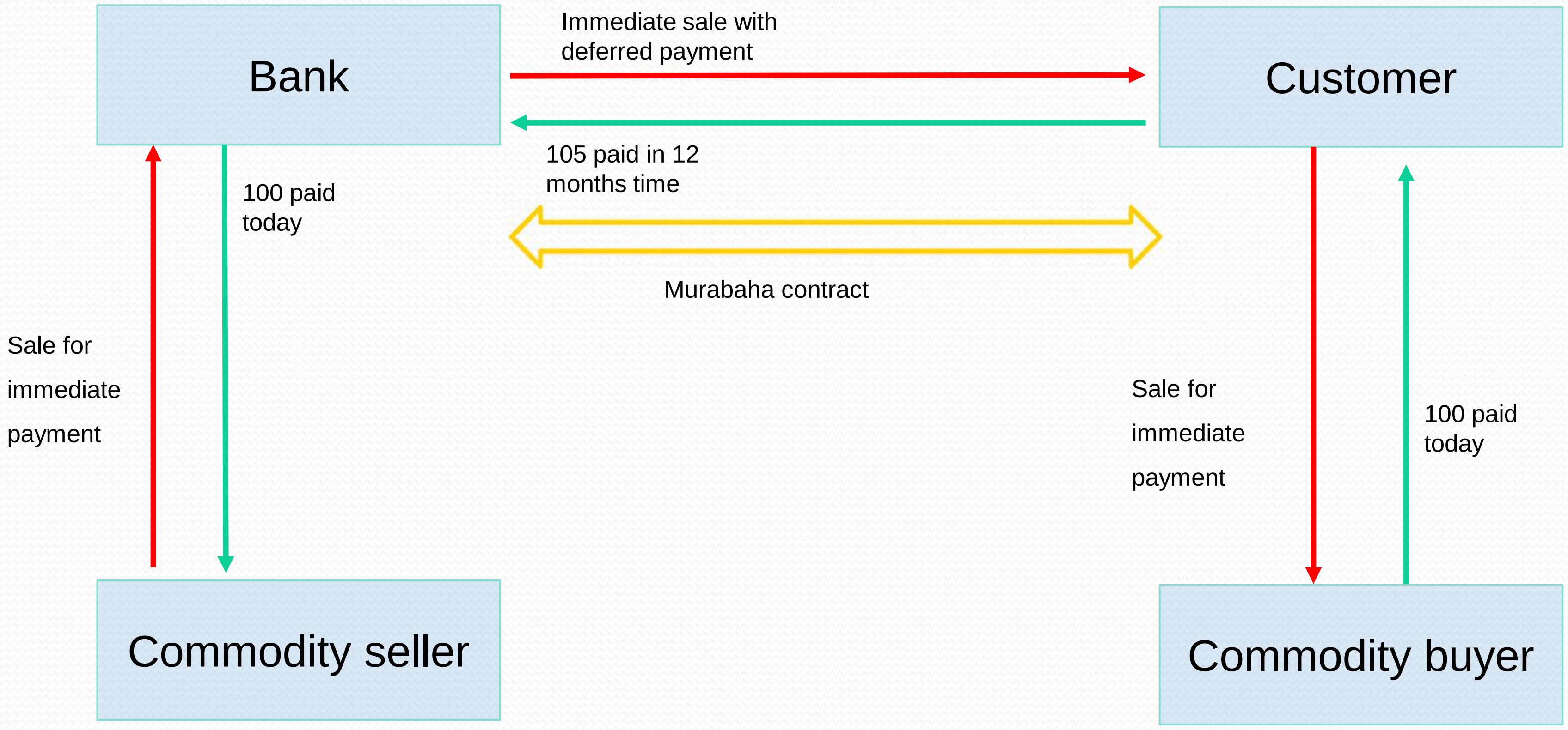
FS treated as a special service

- May be “exempt” with no VAT charged and no VAT recovery by bank on its costs.
- May be “zero rated” – no VAT charged but bank can recover VAT on its costs
- Other choices are possible – perhaps loans to business and loans to final consumers treated differently

VAT and Islamic finance

- Special challenges
- Legal form of transactions can differ from economic substance

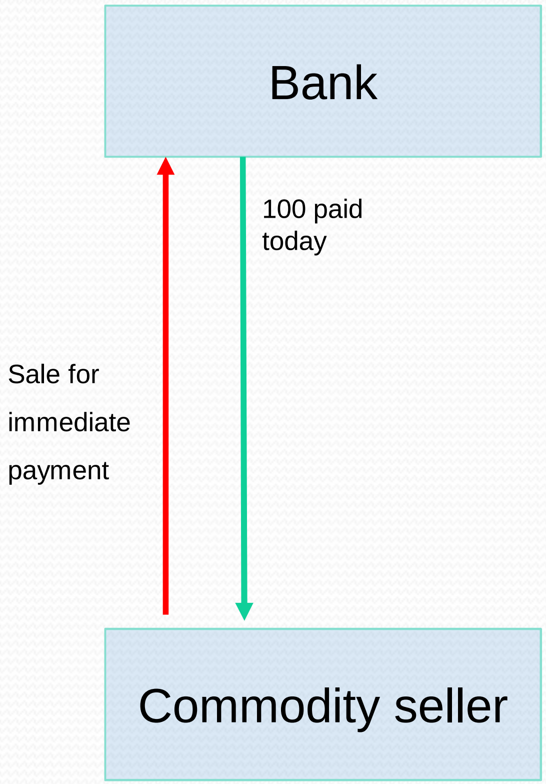
Commodity murabaha or tawarruq



Form v substance

- Legal form
  - Three separate sales of commodity
- Economic substance
  - Equivalent to 12 month loan from bank to customer at 5% interest rate
- How treat for VAT purposes?

Sale to bank

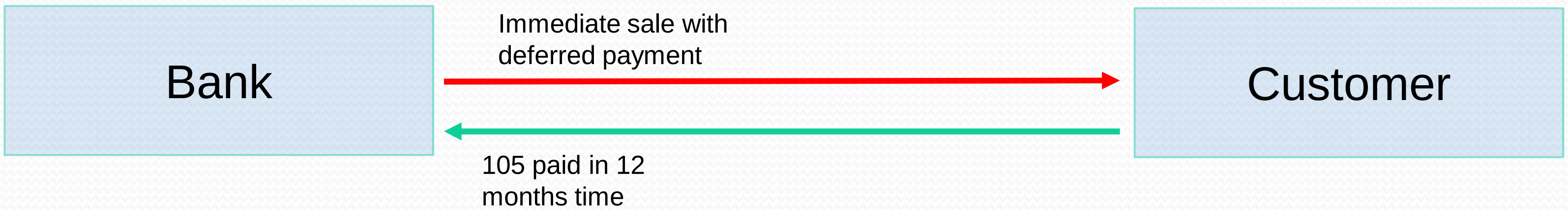


How treat for VAT?
Tax authority does not know if Islamic finance

Safe approach: Charge 20% VAT on sale of 100

Risky approach: Treat as exempt sale.
Creates compliance risk

Sale to Customer



Should bank charge VAT on 105?
Should bank charge VAT on 100?
Compliance risk if sale exempted from VAT

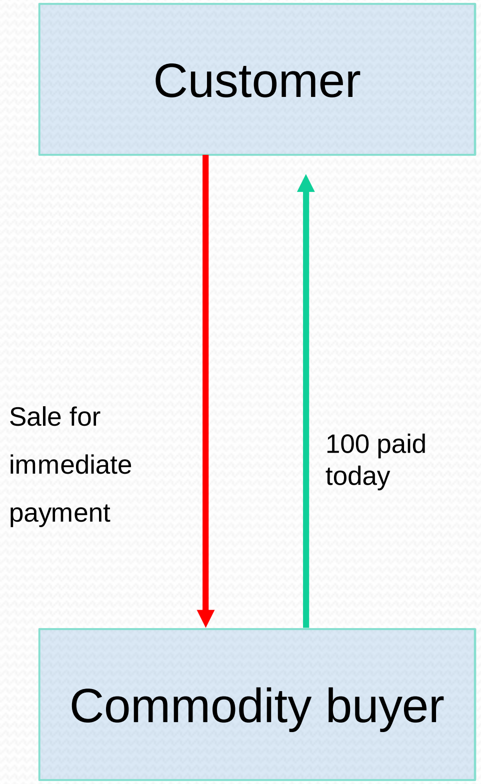
Is the customer a final consumer?

Sale to commodity buyer

Is customer in business?

YES Charge VAT on 100, recover VAT paid on purchase from bank.

NO Customer cannot charge VAT
No way to recover VAT paid on purchase from bank.



Summary with non-business customer

- Customer suffers VAT cost making Islamic finance too expensive

Possible ways forward

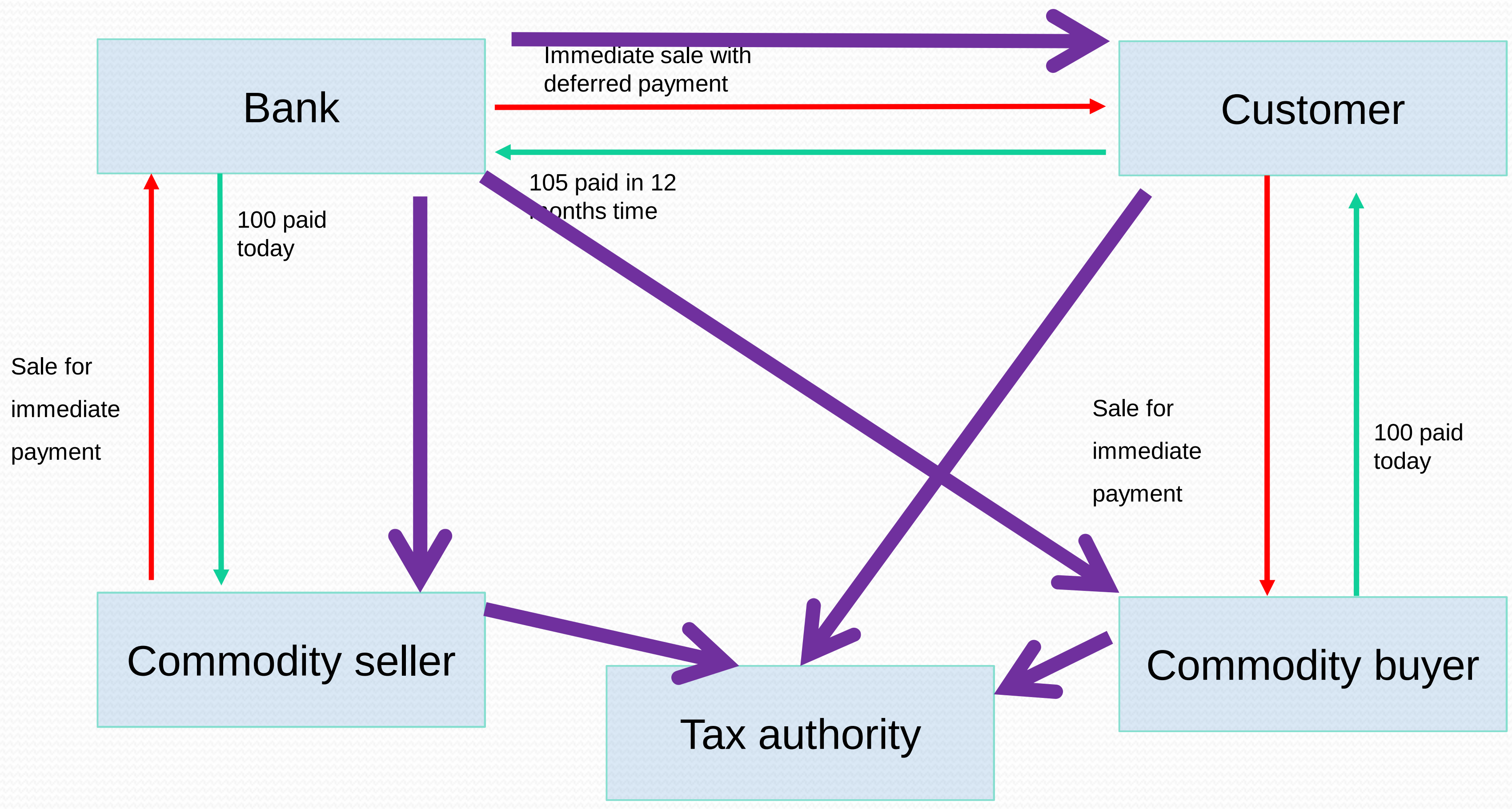
Three ideas

1. Commodities with a special VAT regime
2. Certification mechanism
3. Allow non-business persons to charge VAT

Commodities with special VAT regime

- Use commodity held in special VAT regime (e.g. tax exempt warehouse)
- Ensure the regime applies to non-business persons
- All transactions in the commodity are ignored for VAT

Certification mechanism for IF transactions



Certification mechanism

- Bank creates electronic certificates
  - Issued to other parties in transaction
  - Authorise commodity sales without VAT
  - All recipients of electronic certificates must forward to tax authority
  - Tax authority electronically matches certificates to ensure no VAT compliance failures

Allow non-business persons to charge VAT

- Enable Customer to charge VAT on sale to Commodity buyer, and recover VAT paid to Bank
- Process?
  - Need to register the customer
  - Need for compliance checks to counter false claims
    - Customer is due a VAT refund (105 inputs, only 100 outputs)

Q&A